CAC Specialty™ Freshfields

# MIND THE (SPAC) GAP

## INTRODUCTION:

As this article goes to print, there have been over 170 SPAC IPOs in 2020. To say that SPAC transactions are "the hot thing" would be an understatement. With their increasing popularity, however, we are also starting to see an increase in securities liability claims and other potential claim scenarios that can arise from missteps made during the lifecycle of the SPAC/deSPAC process. This article is not intended to provide an in-depth analysis of the SPAC/deSPAC business combination process. Instead, after a brief overview of the process itself, we will turn to a description of various SPAC/deSPAC-related Directors and Officers liability insurance structures we have seen in the marketplace, and the ways in which these structures should respond to securities claims arising during the lifecycle of the business combination process. Specifically, we will zero in on coverage concerns we have encountered in certain D&O programs placed in connection with the deSPAC portion of the process and how such concerns should be addressed.

## BRIEF OVERVIEW OF SPAC/DESPAC PROCESS:

**A SPAC (short for Special Purpose Acquisition Company) is a non-operating company that goes public solely to raise cash that will ultimately be used to purchase a private operating company (or companies) or assets (collectively referred herein as a "target company") at a future date (usually within 2 years of the IPO). With cash in hand, SPAC executives begin their search for a target company. Once such target company is identified, the parties enter into an agreement to consummate the transaction whereby the two entities will combine into one publicly traded company (referred herein as the "combined company"). In some instances, additional cash is required to finalize the transaction. The SPAC can raise that cash in a number of ways, the most popular being a PIPE transaction whereby sophisticated private investors buy in to the SPAC and help supplement the purchase price of the target company. The timeframe between the identification of a target company and the completion of the merger is commonly referred to as the deSPAC process.**

## SPAC RELATED DIRECTORS AND OFFICERS LIABILITY INSURANCE:

For purposes of this article, we make the following assumptions based on our experience in the D&O insurance marketplace as well as our understanding of various deSPAC filings detailing insurance requirements for the combined company:

*Assumption #1:* The target company and its directors and officers are insured, pre-consummation of the transaction, under a private company D&O policy which includes broad entity coverage.

*Assumption #2:* At the time of its IPO, the SPAC purchases a public company D&O policy which provides coverage for individuals as well as entity coverage limited to securities claims only.

*Assumption #3:* There are a number of options we have seen in the marketplace for the combined company's D&O coverage:

a. Public company D&O policy form with prior acts exclusion required and target company's private company form placed into run-off, i.e., it continues to operate as a claims-made policy for certain pre-merger acts, during a defined period of time.

b. Public company D&O form with full prior acts coverage. The contract wording is off-the-shelf.

c. Public company D&O form with full prior acts coverage. The contract wording is specifically tailored to appropriately address important nuances regarding insured capacity, the scope of covered securities and strict allocation concerns.

*Assumption #4:* The SPAC purchases run-off coverage designed to cover claims brought against SPAC insureds for wrongful acts that occurred prior to the completion of the deSPAC. To ensure that coverage is available for claims that allege both pre- and post- transaction wrongful acts, the run-off .coverage should include appropriate straddle and/or allocation ("that portion of") wording. This wording is designed to clarify that if a claim is made against the SPAC insureds as well as other entities/individuals for acts that "straddle" the deSPAC transaction, coverage will not be eliminated via absolute exclusionary wording but rather appropriately allocated between all insurance policies that may be triggered.

## FEDERAL SECURITIES CLASS ACTIONS AND/OR REGULATORY LIABILITY WHICH REQUIRE APPROPRIATE D&O COVERAGE

There are multiple shareholder actions which can arise as a result of, and following, the SPAC/deSPAC process.

**A.** **SPAC SEC Reporting: The SPAC Offering:** The SPAC offering itself is a public offering from which liability under the Securities Act of 1933 ('33 Act) arises. The SPAC and its directors and officers should have coverage available to them for any prospectus liability under Sections 11, 12 and 15 of the '33 Act, under the terms of the SPAC's public company D&O policy.

**B.** **SPAC SEC Reporting: Filings Pre-Identification of Target:** After the SPAC goes public, it is subject to the periodic reporting requirements of Securities Exchange Act of 1934 ('34 Act). Liability (including importantly Section 10(b) and Section 20 of the '34 Act) can arise from material misstatements or omissions in the SPAC's periodic filings (e.g. 10-Qs, 10-Ks, 8-Ks, etc.). As with the SPAC's prospectus liability coverage, the '34 Act exposure is likely covered under the SPAC's public company D&O policy.

**C.** **SPAC SEC Reporting:** Filings Post-Identification of Target Through the deSPAC Process: Here is where things get tricky! Once the SPAC identifies the target it intends to merge with, a wealth pending business combination, is filed by the SPAC with the SEC. Documents include, but are not limited to:

- SPAC 8-K(s) identifying the business combination (attaching the Business Combination Agreement, investor presentation(s), etc.);
- Reg FD communications (e.g. press releases, interviews, tweets);
- Private Placement information (if PIPE or other financing is needed to consummate the transaction);
- SPAC proxy material;
- An S-4 Registration Statement which, in many instances, includes proxy statement/prospectus;
- Schedule 14-A Proxy Statement; and
- A "Super 8-K" which, as the name implies, is a massive document designed to include all of the information that would normally be included in a Form 10 filing if one was made by the target company.

For the **SPAC entity and its directors and officers**, there should be coverage for claims brought by SPAC shareholders (and/or securities' regulators) for their '34 Act liability (and, if new shares are required to be registered during the process, coverage is also available for their '33 Act liability) arising from alleged material misstatements or omissions in the above referenced documents. Notably, any individuals named in the S-4 registration statement as about to join the board (e.g., key personnel from the target company) would also face potential liability and would require coverage.

For the **target company and its directors and officers**, the private company D&O form should cover defense costs related to any bump-up claim (arguing that the consideration for the transaction is inadequate) brought by the private company shareholders pre-transaction close. The D&O coverage is trickier for claims brought by the SPAC's shareholders (pre-transaction close: claims opposing the merger) as well as those brought by the newly combined entity's shareholders post-transaction (e.g., for alleged misrepresentations in the registration statement, proxy statement, or other filings associated with the transaction). Because the target company's financials and operating information (as well as its executives' comments related thereto) are included in many of the filings listed above, SPAC shareholders may bring securities claims against not only their own management, but also the management of the target company for alleged pre-transaction misstatements or omissions. The target's Ds & Os can be sued for '34 Act violations, specifically Section 10(b) and Section 14(a) violations, as well as for '33 Act violations if they are named in the registration statement as about to join the combined entity's board. Depending on the timing of these allegations and the construction of available D&O insurance, coverage may not be available under the existing framework.

For example, as noted above in Assumption #3, we have encountered three primary ways in which the target's D&O insurance has been structured to date. The first involves putting the target company's private company D&O form into run-off while placing a combined public company D&O form with a prior acts exclusion. When a securities claim is brought against target company directors and officers by shareholders of the SPAC for the individuals' alleged pre-transaction wrongful acts, this structure will likely fail. Unless amended, the private company run-off form to which the securities claim would attach may have an absolute public company securities exclusion, thereby knocking out coverage for the '34 and '33 Act claims. The typical exclusion touches on the company itself going public and any reporting requirements going forward. There are exclusions in the marketplace, however, that eliminate all securities litigation.

An off-the-shelf combined public company D&O form with full prior acts coverage may also fail to provide adequate protection for the target company's executives as it may not address the proper insured entities or the capacities in which such entities' directors and officers were/are acting. Additionally, the off-the-shelf definition of securities claim may be too narrow to contemplate all of claims that can arise from these transactions.

It is very important, therefore, to negotiate a manuscript combined public company D&O form. In doing so, consider the following:

1. Are all operating entities covered for liability exposure pre-combination?
2. Is there coverage for directors and officers in their appropriate capacity(ies)?
3. Is the definition of securities claims broad enough to cover all securities at issue?
4. If the SPAC executives are excluded from the combined company's D&O coverage (remember, they have run-off coverage), is the SPAC exclusion (or any other exclusion for that matter!) too broad?
5. Are there any other deal-specific issues that need to be thought through and covered?

Without ensuring that all nuances specific to the transaction are properly addressed within the policy wording, insurers may argue against coverage.

We would be remiss if we failed to mention that even outside of the securities claim context, the purchase of the target company's private D&O run-off coverage (in addition to the full prior acts coverage available in the combined public company D&O form) may still be advisable. Issues to keep in mind include the breadth of the private company D&O entity coverage, duty-to-defend benefits (100% allocation of defense costs if any part of a claim is covered) and the "other insurance clause" considerations (e.g., clarifying which policy erodes first in the event a claim triggers both the private company run-off and the combined public company form.)

**D. Combined Go-Forward Entity Offering, Periodic Reporting:** Finally, the combined go-forward entity and its directors and officers should have both '33 Act and '34 Act coverage available to them under the combined entity's public company D&O policy.

## CONCLUSION:

As you can see from the above, the SPAC/deSPAC process is riddled with complex D&O coverage issues. It is important for these issues to be appropriately addressed in the D&O coverage that is placed in connection with the process, while working closely with experienced securities litigators during the deSPAC stage. If you are entering into the SPAC/deSPAC process, or if you are advising entities that are, make sure that you actively engage with your D&O broker, insurers, and securities litigators to maximize coverage for your specific transaction deal terms and all potential securities-related exposures at issue.

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