D&O insurance for SPACs: differentiating the risk

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As most readers are aware, securities litigation in the special purpose acquisition company (SPAC) space continues to outpace almost all other securities-related litigation. While overall securities class action filings dropped by 25% from the second half of 2020 to the first half of 2021, SPAC-related filings increased by 367% during this same time period.

As of the time of this writing, 2021 has already seen a total of 25 SPAC class actions, eclipsing the totals for 2019 and 2020 combined. (*Cornerstone Research / Stanford Law School Securities Class Action Clearinghouse*. https://stanford.io/3BiE7BR)

Because of the many parties involved in a SPAC business combination, SPAC suits can cast a wide net when it comes to alleging culpability. In a typical example earlier this year, a suit against electric vehicle manufacturer Lucid Motors named various defendants associated with the SPAC: the SPAC entity itself (Churchill Capital Corporation IV), the target company that merged with the SPAC (Atieva, Inc. d/b/a Lucid Motors), as well as the SPAC's CEO, the SPAC's CFO, and the target company's CEO.

The suit alleges that the defendants, both companies and individuals, are liable for materially false and misleading statements made to investors regarding Lucid Motors' business operations and production schedule (*Phillips v. Churchill Capital Corporation IV*).

Because SPAC litigation is rampant, it follows that the insurance that is designed to pay for the defense and settlement of such suits, Directors and Officers (D&O) Liability Insurance, is very expensive.

D&O insurance is typically needed for three entities involved in a SPAC's lifecycle:

(1) the original SPAC shell company;

(2) the private target company that will merge with the SPAC; and

(3) the surviving, post-merger company.

For the original SPAC shell company, D&O insurance typically covers wrongful acts actually or allegedly occurring up until the closing of the merger. Upon consummation of the merger, the SPAC D&O policy will convert into a "run-off" or "tail" policy which is designed to cover any claim that is made during the six-year period following the transaction for wrongful acts that occurred prior to the date of the transaction.

D&O insurance for the private target company — which ultimately becomes the surviving, post-merger company — is trickier. Although an SEC Form S-4 (i.e., the filing required when a reporting company engages in a merger, acquisition, or stock exchange offer) may suggest or even require that both (a) run-off insurance for the private operating company and (b) go-forward coverage (with a prior acts exclusion) be purchased at the time of transaction, this contractual construction leaves coverage gaps which, while anticipated, are becoming glaringly obvious as SPAC/de-SPAC claims have rolled in. It is imperative to consider alternative structures that include full prior acts coverage for the private target company.

SPAC advisors and brokers can help drive the D&O underwriting process and differentiate their clients in the marketplace. The best ways to drive and differentiate are to (a) transparently participate in the D&O underwriting process and (b) be amenable to creative insurance solutions.

So just how expensive is D&O insurance for SPACs and their directors and officers? Very, very expensive. As of the publication of this article, pricing for traditional D&O insurance (insurance that covers not only individuals, but the SPAC entity itself for securities claims) is roughly $125K per million for the initial two-year policy. This pricing does not contemplate the run-off premium upon the de-SPAC merger at a cost of 2.5x to 3x the annual premium.

Not only is the cost of the insurance through the roof, self-insured retentions (i.e., deductibles) are in the millions of dollars. For those insureds purchasing traditional D&O insurance coverage upon a de-SPAC transaction, retentions range from $5M to $20M, depending on the risk.

Although there are exceptions, insurance carriers often have the upper hand in terms of policy language negotiation as fewer and fewer markets are willing to underwrite tough SPAC risks. Those insurance carriers that do offer coverage in the SPAC space are (justifiably) cautious and typically limit the number of coverage

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enhancements for these policies as compared to "plain vanilla" public company D&O risks.

With all of this negative news, one might think that there is a blanket belief in the D&O marketplace that SPAC risks are, by their very nature, bad risks. That, however, is not the case. SPAC advisors and brokers can help drive the D&O underwriting process and differentiate their clients in the marketplace. The best ways to drive and differentiate are to (a) transparently participate in the D&O underwriting process and (b) be amenable to creative insurance solutions.

SPAC management must be prepared to deviate from traditional D&O purchasing if the economics of the proposed insurance do not "work."

Although insurers will have access to the SPAC's S-1 from which they can gather valuable underwriting information, face-to-face meetings between SPAC management and interested D&O insurers are very valuable in differentiating one SPAC risk from another. Underwriters are broadly interested in both the SPAC and the prospective target company.

Factors such as the following can benefit a SPAC when being underwritten:

- The SPAC's management team is highly experienced, with upstanding track records.
- The SPAC team is running a robust due diligence process into the financials, operations, and directors and officers of the target company.
- The target industry is mature and highly regulated.

Underwriters will typically also inquire into the following:

- Does the SPAC management team intend to stay on post-transaction?
- What type of financial arrangement is contemplated? Is it transparent?
- What is the ultimate promote (i.e., founder shares)?
- What will the private investment in public equity (PIPE) look like?

While transparent disclosure to underwriting questions is critical to achieving D&O coverage, SPAC management must also be prepared to deviate from traditional D&O purchasing if the economics of the proposed insurance do not "work."

Traditional D&O insurance has three insuring agreements. Side A is designed to cover claims brought against individuals for which the company cannot legally or financially indemnify. No retention applies to Side A claims. Side B is designed to reimburse the company for its indemnification of individuals against whom claims are brought. Side C is designed to cover the company for securities claims only. A retention applies to both Side B and Side C claims.

As noted above, retentions are very high. As SPACs do not generally maintain a large operating budget, alternative D&O structures, including Side A-only coverage, may be more economically sound and efficient.

Despite recent litigative and regulatory pushback to SPACs, this market is still seeing explosive growth, which will likely mean even more SPACs vying for coverage from a limited number of carriers in the future. While obtaining D&O insurance can seem daunting and even elusive to SPAC sponsors, active and transparent participation in the underwriting process, along with the willingness to embrace potential creative insurance solutions, can greatly aid in procuring an appropriate policy at more desirable rates.

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