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Buying SPACtacular Coverage: Special Considerations for SPACs in Purchasing D&O Insurance

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Special purpose acquisition companies ("SPACs") have become the predominant form of initial public offerings ("IPOs") in the last couple of years, and their popularity continues to grow. In 2020, SPAC IPOs outpaced traditional IPOs in both total number of offerings and capital raised, according to a report in Nasdaq.[1] And the outlook for SPACs in 2021 is even more promising. SPAC IPOs in the first quarter of 2021 alone outpaced all of 2020 in number of offerings (298 versus 248) and collective capital raised ($88 billion versus $83 billion), according to a report in Kiplinger.[2]

SPACs differ from traditional IPOs in that they have no commercial operations—they are formed solely for the purpose of raising funds, through an IPO, to acquire an existing target company that is later identified after the SPAC goes public. For that reason, they are often referred to as "blank check companies." Because the directors and officers liability ("D&O") insurance marketplace traditionally has focused on operating companies, placing D&O coverage for SPACs raises a host of unique issues. While a handful of insurers have now developed specialized D&O policy forms to address certain of these SPAC-specific issues, much of the D&O coverage issued to SPACs continues to be written on traditional D&O policy forms.

D&O policies are not written on a standard insurance industry form, so there tends to be material variation in language among policy forms issued by different insurers—and even among different policy forms issued by the same insurer. Moreover, the specific language of D&O policies tends to be more negotiable than with other types of policies. The recent proliferation of SPACs has stretched the underwriting capacity of the D&O marketplace, and their unique risk profiles and underwriting needs have tested the insurance industry's resolve to cover them. This has resulted in some SPACs having limited availability of policy form options and negotiating leverage. That said, where a SPAC does have some choice of available policy language, it should pay particular attention to the following provisions—all of which have potentially significant D&O coverage implications for SPACs.

Scope of covered "Insureds": Traditional D&O policies typically designate officers, directors, managers (and employees in certain capacities) within the scope of covered "insureds." Individual members of a SPAC's organizational team, however, may not fit neatly into any of these categories, and therefore may not be covered. SPACs should carefully review the definition of "Insured" and "Inured Person" in their specimen policy forms to ensure that all members of the SPAC's organizational team are unambiguously included within these definitions. If there is any doubt in that regard, the SPAC should seek a policy endorsement that more clearly identifies all individuals on the organizational team—either by description of their functions or specifically by name (or both).

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[1] Sanghamitra Saha (Dec. 28, 2020). 2020 Has Been the Year of SPAC IPOs: Here Are the Prominent 4. Nasqaq. https://www.nasdaq.com/articles/2020-has-been-the-year-of-spac-ipos%3A-here-are-the-prominent-4-2020-12-28

[2] Jeff Reeves (Apr. 13, 2021). The SPAC List: 10 Dealmakers to Watch. Kiplinger. https://www.kiplinger.com/investing/stocks/ipos/602601/spacs-list-dealmakers-to-watch

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Scope of "Securities Claim" coverage: Because the SPAC will be structured as a publicly-traded entity, its Side C (*i.e.*, company-specific) D&O coverage likely will be limited to "Securities Claims." That said, the SPAC should seek to ensure that it has the broadest "Securities Claim" coverage available. In particular, the nature and function of the SPAC may invite heightened regulatory attention, particularly from the Securities Exchange Commission ("SEC"). In most cases, regulatory action by the SEC will begin with an investigation, and may or may not be followed later by a formal proceeding. In many cases, the bulk of the insured's defense costs will be incurred in the investigation stage. While most D&O policies expressly cover defense of regulatory proceedings, some do not cover investigations—or cover them so incompletely that the investigation coverage has marginal value (at best). SPACs should be particularly mindful about ensuring that that their D&O policy expressly covers defense of government investigations and, if possible, that an investigative subpoena from a governmental entity is adequate to trigger that coverage.

Tail coverage: By design, SPACs have a limited lifetime—typically two years—to locate and merge with a target company. Under the terms of most D&O policies, this anticipated merger (often referred to as the "de-SPAC" transaction) will constitute a change of control that will terminate the active coverage provided by the policy on the date of the merger. The SPAC will then need to purchase so-called "tail coverage" (often referred to as an "extended reporting period" or "ERP") to protect against post-merger claims arising from pre-merger events and conduct.[3] Many traditional D&O policies include a provision stating that when a change in control occurs, the insured, at its option, may purchase an ERP (typically for a term between one and six years), and specifies the pricing for each term option in advance. Many D&O policies, however, do not ensure the availability or pricing of tail coverage—they merely state the insurer will make an offer to sell the insured an ERP at the insured's request. Given the near certainty that the SPAC entity will need to purchase tail coverage within two years, there is no compelling reason why a D&O insurer should not be prepared to negotiate the terms of the tail coverage when the policy is being purchased. Accordingly, SPACs should seek to secure predetermined tail periods and pricing as part of the policy underwriting process.

Retroactive dates: Generally speaking, "retroactive dates" (sometime referred to as "continuity dates") are less common in D&O policies than other types of claims-made policies (such as errors and omissions policies). But where they are included in D&O policies, they typically purport to preclude coverage for claims arising from events or conduct that occurred prior to the applicable retroactive date. When an insurer issues D&O coverage to a policyholder for the first time, the insurer may designate the policy's date of inception as the applicable retroactive date. This can be problematic for a SPAC because its D&O policy typically is not secured until the date of its IPO. By that time, the SPAC's organizers will already have undertaken substantial operations on behalf of the SPAC, which may involve liability-generating events or conduct. Ideally, the SPAC will have the option to purchase D&O coverage that is not subject to any retroactive date. However, if such coverage is not available, the SPAC should seek to have the retroactive date backdated to when the SPAC's organizers first undertook any SPAC-related activities, as opposed to the policy inception date.

Conduct exclusions: One of the most significant liability exposures for SPACs is that they misled investors in the SPAC's IPO offering materials or in their subsequent statements regarding the value of the proposed target

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[3] Typically, the SPAC's D&O policy will remain in effect from the date of the merger through the end of the policy period, but will only provide coverage for pre-merger events and conduct. The ERP will further extend the reporting period for such claims. In addition, the newly merged de-SPAC entity will need to acquire a new D&O policy at the time of the merger for going-forward claims against the de-SPAC entity. This coverage typically would be negotiated and placed as part of the merger transaction. The pre-merger target entity also may need to acquire an ERP for pre-merger events and conduct.

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company (once it is identified). Such allegations may be expressed as fraud claims. Most D&O policies contain exclusions precluding coverage for losses arising from certain specified conduct, including fraud. The specific language of these exclusions varies, often meaningfully. For instance:

- Notwithstanding that intentionality is at least implied in allegations of fraud, an insurer may assert that misrepresentation claims—even where they do not include specific allegations of intentionality—are excluded. Most, but not all, D&O conduct exclusions apply only to "intentionally" or "deliberately" fraudulent conduct. SPACs should confirm that the conduct exclusions in their specimen D&O policies contain this important qualifying language.

- Most, but not all, D&O policies limit application of the conduct exclusion to situations where there has been a final, non-appealable adjudication that excluded conduct occurred and resulted in the loss at issue. SPACs also should confirm that this critical qualifying language appears in their policies.

- Relatedly, some D&O policies further limit application of the conduct exclusion to a final adjudication occurring in the underlying matter for which coverage is being sought. Other policies, however, either impose no such limitation or expressly state that the adjudication may occur in a "separate action or proceeding." This is a critical distinction because the latter construction may encourage the insurer to sue the SPAC in a separate declaratory judgment action seeking to establish that such conduct occurred and resulted in the loss at issue, even though there was no such finding in the underlying case. In order to avoid buying into a second (coverage) lawsuit, the SPAC should seek exclusion language limiting the final adjudication at issue to the underlying action.

- Some D&O conduct exclusions also purport to preclude coverage for violations of statutes, rules, or other laws, although many do not. Claims that a SPAC misled investors are likely to include allegations that the SPAC violated securities laws. Accordingly, the SPAC should seek conduct exclusion language that does not include violations of law. But even if such language is not available, the SPAC should ensure that application of this language is limited to "intentional," "willful," or "deliberate" violations.

Bump-up exclusions: In corporate acquisitions, the target company's shareholders often assert that the acquiring company paid too little for the target, and may assert claims against both the acquiring and target companies. Some, but not all, D&O policies contain so-called "bump-up" exclusions, which typically purport to preclude coverage for the portion of loss attributable to the acquiring company's alleged underpayment. Because a SPAC's sole business is obtaining a target company, it is particularly exposed to such claims.[4] Where available, SPACs should seek D&O policies that do not contain bump-up exclusions.

These policy language distinctions (and others) can make a critical difference as to whether D&O claims against a SPAC will be covered. Working with a commercial broker experienced in placing D&O coverage for SPACs is crucial to obtaining the most favorable terms of coverage available. A SPAC may also be well-advised to have an experienced policyholder-side coverage attorney review its specimen policy forms to make specific policy language recommendations prior to purchasing its D&O coverage. Even with the most favorably negotiated policy terms, however, D&O insurers inevitably will deny some claims—particularly the closer ones—in the

[4] The target company also will be exposed to such claims, possibly to an even greater degree than the SPAC entity. Accordingly, the SPAC should consider reviewing the target entity's D&O policy as part of the due diligence process to determine the extent to which the newly merged entity will have D&O coverage for such claims.

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hopes that such claims will simply go away. In many cases, such claims have substantial merit, and the SPAC would be well advised to seek advice from experienced D&O coverage counsel before accepting no for answer.

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