Vinson&Elkins

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Are You Covered?

D&O Insurance Considerations for Going Public via SPAC

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Introduction

With more than 600 special purpose acquisition companies ("SPACs") currently looking for merger partners, private companies are likely being courted by a number of SPAC suitors. Although there are many considerations when choosing a SPAC partner, two items that are often overlooked when sizing up SPAC suitors are the SPAC's directors and officers ("D&O") insurance program and the private company's own D&O insurance program. Understanding the importance and logic of establishing a D&O program suitable for the life of the SPAC and the infancy of the newly public operating company greatly enhances the resulting combined company's ability to manage the risk inherent in public company operations.

Following closing of the de-SPAC transaction, the combined public company will have indemnification obligations to three groups of directors and officers: (1) the pre-closing directors and officers of the SPAC, (2) the pre-closing directors and officers of the private company, and (3) the post-closing directors and officers of the combined public company. Although the combined company will be obligated to indemnify all of these individuals, there will likely be separate D&O insurance programs that cover each of these three groups, with each program subject to its own retention and limit.

As discussed further below, key items to consider include:

- **The Extent of Prior Acts Coverage**. Securities lawsuits filed after closing of the de-SPAC transaction frequently allege wrongdoing both before and after the transaction. The D&O insurance program should be set up to cover pre- and post-closing allegations against all directors and officers whom the post-closing company is required to indemnify. The extent of this coverage can vary from jurisdiction to jurisdiction.
- **SPAC D&O Insurance Limits and Scope**. Due to the increased costs of D&O insurance, many SPACs are foregoing "Side B" and "Side C" D&O insurance at the time of the initial public offering ("IPO") or purchasing significantly reduced limits, each of which can have ramifications for the combined public company. A thorough evaluation of the SPAC's policy limits for balance sheet protection, with an understanding of the current litigation landscape, should be conducted to identify the proper level of "Side B" and "Side C" coverage.
- **Private Company D&O Insurance Limits and Scope**. Private companies generally carry significantly smaller D&O insurance limits than public companies, and private company D&O insurance often excludes public securities trading activities from the scope of coverage. Private companies should make sure that the D&O insurance program adequately covers the company's officers and directors for pre-closing activity in addition to post-closing activity.
- **Impact of SEC's New Proposed Rule**. One of the Security and Exchange Commission's ("SEC") new proposed rules for SPACs would treat the private company as a co-registrant on Form S-4 and Form F-4 and require the private company's directors and officers to sign the SPAC's registration statement, potentially subjecting them to additional liability under the federal securities laws. The private company should confirm whether its D&O insurance program would cover this liability.

- **Business Combination Agreement**. Confirm that the business combination agreement between the SPAC and the private company appropriately addresses D&O indemnification and insurance for directors and officers of both the SPAC and the private company. The increased costs of D&O insurance and tail policy coverage for the SPAC compared to the private company costs can be a sticking point during business combination negotiations.

Overview of De-SPAC Transaction Litigation Trends

The tremendous deal activity and market exuberance for SPACs in the past two years is, unsurprisingly, now leading to increased litigation. This is especially so for companies that fall short of expectations following a de-SPAC transaction, and such litigation is likely to increase given the broader market downturn in recent months. These SPAC lawsuits are taking several forms, but most frequently center on allegations that the SPAC and/or the target misrepresented the target's business prospects to stockholders.

One recent example is *In re MultiPlan Corp. Stockholders Litigation*, 268 A.3d. 784 (Del. Ch. 2022), in which the Delaware Court of Chancery denied a motion to dismiss breach of fiduciary duty claims against a SPAC's sponsor and directors that alleged a failure to disclose the target's potential loss of its largest customer impaired the SPAC stockholders' decision of whether to redeem their shares in advance of the de-SPAC transaction. In an issue of first impression, the Court of Chancery applied "entire fairness" review to the claims on the basis that (i) defendants' founder shares and certain other alleged conflicts provided a "unique benefit" to entering into the business combination agreement not shared by other stockholders, and (ii) the stockholders' redemption rights did not provide sufficient protection to avoid entire fairness review in light of the disclosure claims. Several other plaintiffs have sought to capitalize on *MultiPlan* by bringing similarly styled challenges to de-SPAC transactions. No motion to dismiss has been ruled upon in these other cases, leaving the degree of traction for such claims an open question.

While the *MultiPlan*-style of cases is the most unique to SPACs, it is by no means the only litigation these companies are facing. Many combined public companies that have experienced stock drops following a de-SPAC transaction have been sued — often along with the SPAC's and target's directors and officers — under the federal securities laws for allegedly misrepresenting the company's prospects, both before and after the closing of the de-SPAC transaction. Federal securities litigation against SPACs has proliferated recently, with an authoritative tracker finding that 6 such suits were filed in 2019, 7 in 2020, 33 in 2021, and 15 through the first four months of 2022.[1] Notably, a separate tracker finds that 64 de-SPAC transactions closed in 2020 and 199 de-SPAC transactions closed in 2021,[2] suggesting that the risk of a federal securities lawsuit following a de-SPAC transaction is fairly high, although the majority of de-SPAC transactions have not resulted in a federal securities lawsuit to date. Typically, these federal securities suits are followed by derivative lawsuits filed on behalf of the company against directors and officers of the SPAC and/or target claiming that the alleged misrepresentations also breached their fiduciary duties and harmed the company. Such derivative suits commonly are filed in several federal and/or state jurisdictions, largely repeat the factual allegations made in the underlying federal securities lawsuit, and are often stayed pending a ruling on a motion to dismiss the federal securities litigation.

SPACs have also been subject to the same pre-closing lawsuits as all public M&A activity, in which a stockholder plaintiff seeks additional proxy disclosures in exchange for a fee.

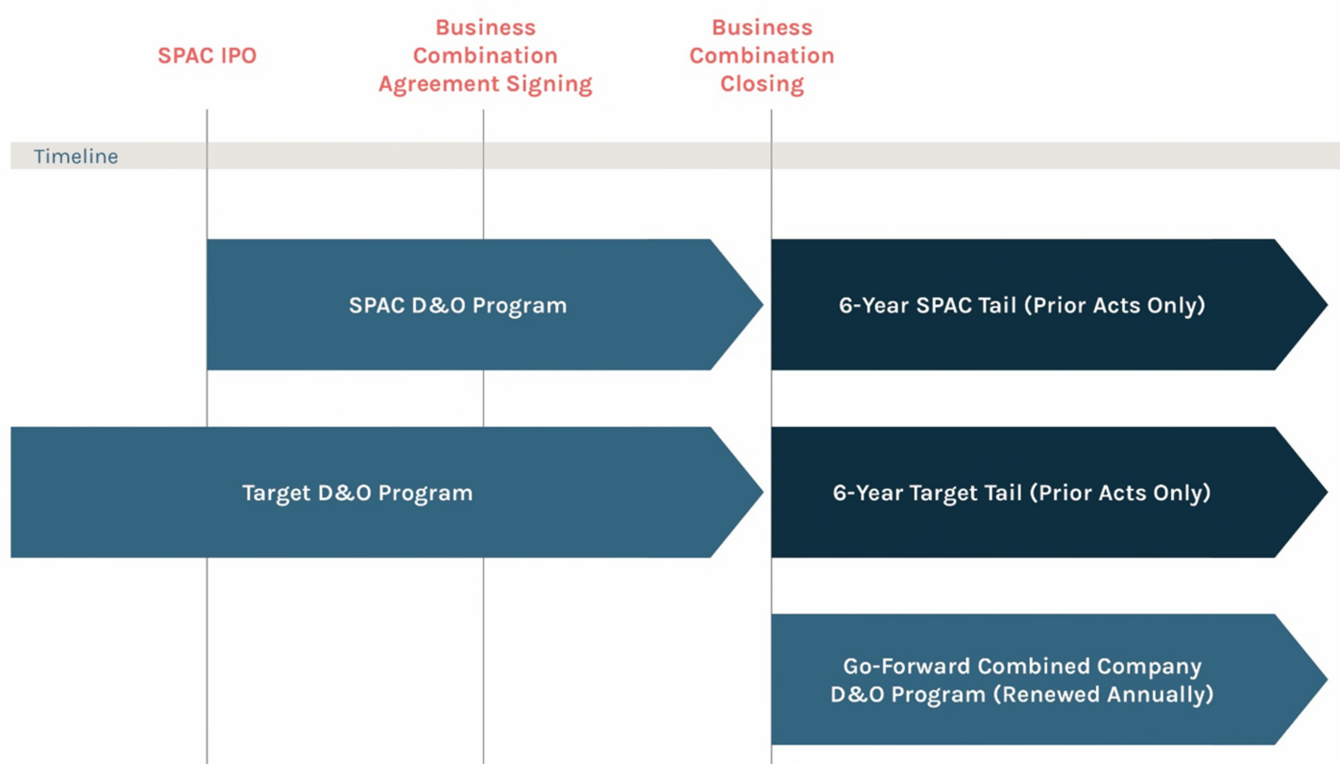
In addition to this private stockholder litigation, a number of SPACs have also faced investigations from the SEC — again, most frequently focused on descriptions of the target's business prospects. Over the past year and a half, the SEC has indicated in multiple ways that it is reexamining the rules governing SPACs and intending to make SPACs a greater enforcement priority. Most recently, on March 30, 2022, the SEC proposed new rules relating to SPACs, introducing further uncertainty about the federal securities law landscape moving forward.[3]

Notably, all of the above types of litigation could arise from the same set of facts — for example, a short seller report that casts doubt on projections for the target that were disclosed before the closing of the de-SPAC transaction, and then reiterated post-closing. Much of this litigation is still in its early phases, but taken together, it is clear that SPACs are facing much greater scrutiny and litigation risk than in the early days of the SPAC boom. As a result, it is more important than ever to confirm that the right D&O insurance program is in place.

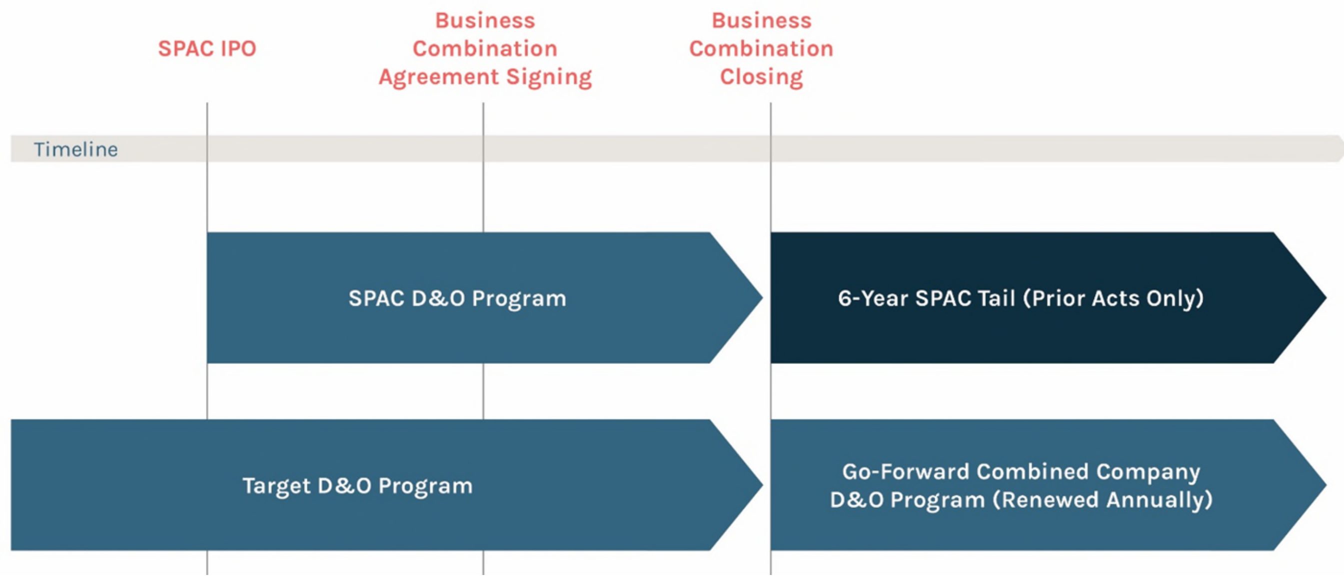
The Extent of Prior Acts Coverage

Most de-SPAC transactions result in either (1) three separate post-closing D&O insurance programs that may respond to claims or (2) two separate post-closing D&O insurance programs that may respond to claims.

Option 1, with three separate post-closing programs, generally looks like this:



Option 2, with two separate post-closing programs, generally looks like this:



Whichever option applies, it is important to confirm that "prior acts" (*i.e.*, alleged acts and omissions that took place prior to closing of the de-SPAC transaction) by both SPAC and private company directors and officers are covered.

For the SPAC directors and officers, prior acts are almost always covered by a "tail" policy based on the D&O insurance policy that the SPAC purchased at the time of its IPO. For the private company directors and officers, prior acts may be covered under a "tail" policy based on the private company's own D&O insurance policy (as in Option 1), or they may be covered under the new public company D&O insurance policy incepting at the time the de-SPAC transaction closes (as in Option 2). If not tailored appropriately, there could be unintentional coverage gaps for any prior acts allegations.

Whether under a private company "tail" policy or under the "prior acts" coverage of the new public company policy, the company should confirm with its broker and outside counsel that its D&O insurance program will provide adequate coverage for alleged wrongdoing in the period between signing and closing a business combination agreement with a SPAC.

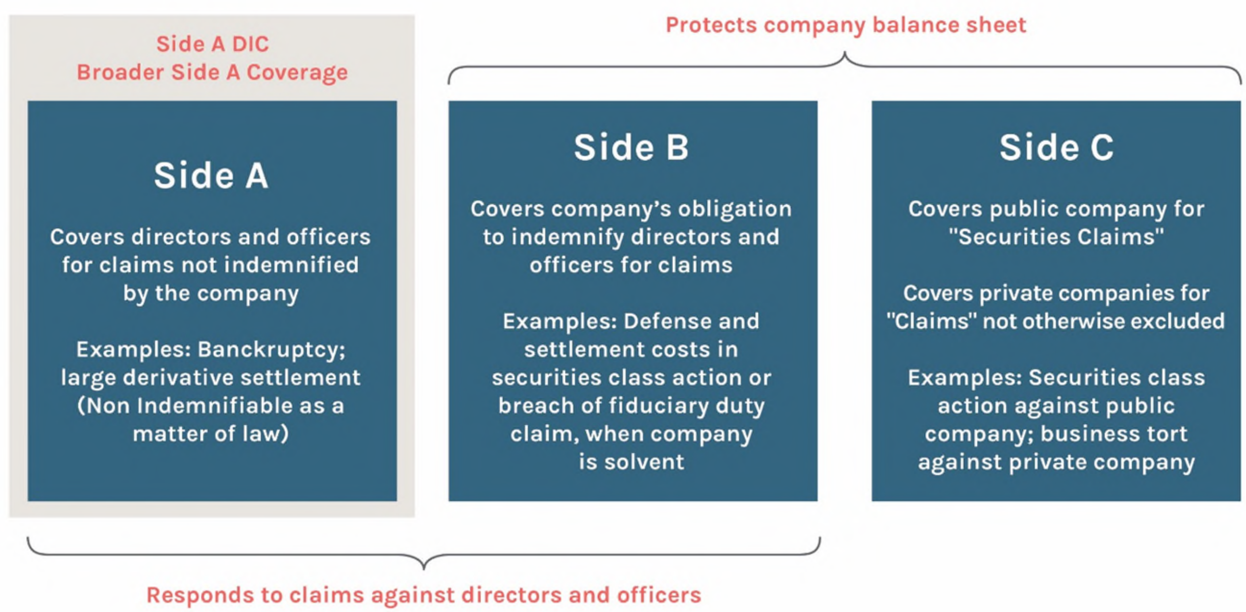
Commercial Considerations

Targets are often surprised by the costs of the SPAC's tail policy, which are often pre-negotiated at the time of the SPAC IPO. Some SPACs have agreed to higher premiums for the tail in exchange for a reduced premium at the time of the SPAC IPO. If there is a need to add "Side B" or "Side C" limits or additional limits at the time of the de-SPAC closing, that can increase costs on the SPAC tail piece of the D&O program.

The cost of the combined public company's D&O insurance is usually even more expensive, with rates historically in the double digits and retentions in the range of $5-15 million for "Side B" and "Side C" coverage, although premiums and retentions have softened slightly in 2022. Private companies preparing to enter into business combinations with SPACs should be prepared to budget accordingly following the de-SPAC closing.

SPAC D&O Insurance Limits and Scope

Public company D&O insurance policies, including those issued to SPACs at IPO, typically provide three types or “sides” of coverage:



There has been a growing trend for SPACs to purchase D&O policies that provide only “Side A” limits instead of traditional D&O policies that provide all three “sides” of coverage, or for SPACs to shift a large portion of their D&O insurance program to “Side A” only limits. There are several reasons for this trend, including the high cost of D&O insurance for SPACs and the reality that SPACs — as blank check companies that cannot access funds held in their trust accounts — do not have a balance sheet in the traditional sense to be protected by “Side B” and “Side C” D&O insurance. Some SPACs have concluded that their best option is to purchase “Side A” only protection for the period of time between the SPAC’s IPO and the SPAC’s business combination.

If the SPAC has only “Side A” limits that are converted into a tail policy at the de-SPAC closing, the surviving public company will have no insurance for its indemnification obligation to the SPAC’s pre-closing directors and officers for pre-closing events. The “Side A” limits are designed to respond only in the event the company is unable to indemnify the insureds.

As a result, private companies considering going public through a de-SPAC transaction should consider carefully whether their SPAC partner’s D&O insurance will provide adequate protection in the event of a post-closing claim. If a SPAC has “Side A” only limits or reduced “Side B” and “Side C” limits, the private company should consider requiring “Side B” and “Side C” limits be added to the SPAC’s D&O insurance program at the time it is converted to a tail policy.

Commercial Considerations

Purchasing "Side A" only coverage not only limits the SPAC's coverage, but poses significant reputational risks for the go-forward company. The SPAC's and the combined public company's ability to attract talented executives to each respective board will be limited if the company's D&O coverage is deemed insufficient by the market and the individual executive. Thus, limiting executive risk coverage may provide immediate premium relief but at a cost to the infrastructure and leadership of the organization.

Private Company D&O Insurance Limits and Scope

Most private companies purchase significantly smaller D&O insurance limits than public companies, because the risk of a large claim is smaller for private companies. Particularly if the private company D&O insurance program will be converted to a tail policy at closing of the de-SPAC transaction, the private company should carefully consider with its broker whether the amount of its D&O insurance limits is sufficient to protect the company and pre-closing directors and officers from lawsuits that may be filed post-closing.

In addition, private company D&O policies typically contain a publicly traded securities exclusion. While the language of this exclusion may vary, this exclusion could bar coverage for certain pre-closing claims against directors and officers of the company, in addition to certain claims related to pre-closing conduct that are brought post-closing. For example, some SPAC stockholders have filed lawsuits against SPACs, their private company merger partners, and the private company's officers and directors for public statements made between signing of the business combination agreement and the de-SPAC's closing. Depending on the wording of the policy's securities exclusion, such claims may or may not be covered under the private company D&O policy or a "tail" for that policy.

Ideally, private companies should review their D&O policies and address any concerns with the securities exclusion before entering into any business combination agreement with a SPAC. If this is not possible, private companies should work with their brokers and outside counsel to consider amendments to the D&O insurance program before it is converted to a tail policy and/or confirm that prior acts will be covered under the new public company D&O insurance program.

Commercial Considerations

As with a company going public by way of a traditional IPO, it is important for a private company going public via SPAC to develop a risk management structure capable of operating in a public company environment. Post business combination, the once private company must adhere to new regulatory requirements and face litigation exposures and legal demands that vary from jurisdiction to jurisdiction. How both the SPAC and the private company approach their D&O program is a litmus test for the combined public company's ability to operate in this new public environment. Those companies that understand the importance of evaluating their pre- and post-business combination risk profile and do so collaboratively among the SPAC, the private company target, and their brokers undoubtedly emerge from the business combination with a risk mitigation platform built for success.

Impact of SEC's New Proposed Rule

Among the SEC's new proposed rules for SPACs is a rule requiring the private company to be a co-registrant on Form S-4 and Form F-4 and requiring its directors and officers to sign the SPAC's registration statement. If such a rule is adopted, it is likely that allegations of wrongful pre-closing conduct by the private company's directors and officers will sharply increase. Prior to entering into a business combination agreement with a SPAC, a private company should consider whether its D&O insurance policy has a securities exclusion that would bar coverage for these activities. Prior to the closing of the de-SPAC transaction, companies should consider whether and to what extent post-closing allegations arising out of these pre-closing activities will be covered under a private company tail policy or under the combined company's public company policy.

Commercial Considerations

While it is too soon to say whether adoption of the SEC's proposed SPAC rules will impact D&O insurance premiums and retentions for SPACs and combined public companies following a de-SPAC transaction, there has been no significant impact on the D&O insurance market yet. If anything, premiums and retentions have softened slightly in 2022, which is likely a result of many factors.

Business Combination Agreement

Like most M&A agreements, business combination agreements between a SPAC and its private company partner include provisions regarding the parties' indemnification of directors and officers and outlining certain D&O insurance requirements. A private company considering going public through a business combination with a SPAC should confirm that any such provisions are appropriately tailored to both its D&O insurance program and the SPAC's D&O insurance program.

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[1] *Current Trends in Securities Class Action Filings*, STANFORD SEC. CLASS ACTION CLEARINGHOUSE, https://securities.stanford.edu/current-trends.html#collapse3 (last visited May 12, 2022).
[2] *De-SPAC Screener (completed mergers in 2020-)*, SPAC TRACK, https://spactrack.io/despacs/ (last visited May 12, 2022).
[3] Vinson & Elkins LLP, *SEC's Proposed SPAC Rules: A Closer Look at the Proposed Rules* (May 2022), https://www.velaw.com/insights/secs-proposed-spac-rules-a-closer-look-at-the-proposed-rules/

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