

# Thomson Reuters Regulatory Intelligence: Demand for D&O insurance explodes with SPAC-related activity and future litigation concerns

By Antonita Madonna

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Demand for directors' and officers' (D&O) liability insurance has exploded along with the proliferation in SPAC-related activity in the United States, giving insurers more business but bringing with it some concerns of an elevated, unsized level of litigation risk down the road.

Federal financial regulators have broadly warned on risks associated with these blank checks or shell companies that raise funds to acquire a private company with the purpose of taking it public. This alternate route allows the target company to sidestep the higher costs and regulatory scrutiny associated with a traditional initial public offering (IPO).

The popularity of special purpose acquisition companies, or SPACs, spiked in the second half of 2020 and this interest is projected to continue into early 2022. The sheer volume of SPAC formations has led to soaring demand for D&O insurance from the SPACs, their sponsors, and their target companies, driving up prices of premiums and retention (deductible-like costs) and reducing availability. More

insurance companies are also expected to enter the market this year to take advantage of the increased opportunity.

SPACs typically operate with a two-year timeline to identify and acquire a target company, leading to an increased risk of lawsuits against the board for breach of fiduciary duty on allegations relating to the merger, such as missed timelines, nature of the target company, or a broad range of other scenarios that have not yet played out.

"The biggest concern [from clients] is that people are going to be personally named in a lawsuit... People are investing in these SPACs with a lot riding on the individuals," said Jonathan Selby, General Manager at Founder Shield, a commercial insurance broker that has seen premiums double over the last 18 months.

Selby said the company has seen inquiries for D&O coverage double over the last six months and estimates retentions have increased about 150 to 200 percent over the same period.

#### Regulatory attention

The U.S. Securities and Exchange Commission is reported to be seeking information on how underwriters are managing the risks, while insurance regulators will also likely be closely watching.

Any insurance company that has too much exposure to D&O insurance for SPACs should be a source of potential concern because the risks associated with legal precedents or changes in regulation are going to create correlated outcomes, said Jay Ritter, IPO expert, and professor at the University of Florida. Correlated outcomes could lead to multiple claims at a given point in time for an insurer.

"State insurance regulators and the NAIC are aware of the proliferation of SPACs and continue to evaluate any potential implications they may have to the insurance industry, as well as actions of any other regulatory bodies including the (Securities and Exchange Commission)," the National Association of Insurance Commissioners (NAIC), a body of state insurance heads, told Regulatory Intelligence.

The group added it has not yet identified any specific regulatory concerns requiring any industry-wide regulatory action and expects states to evaluate relevant risks to individual insurers, either related to investment or underwriting.

Insurance regulators are, however, expected to play a smaller role in the regulation of SPACs that could continue to pique the attention of other financial regulators such as the SEC.

"The risks associated with SPACs, from an insurance perspective, fall within the four corners of D&O liability risk and that is a mature area of risk well understood by insurance carriers," said Priya Huskins, senior vice president of management liability at Woodruff Sawyer, an insurance brokerage and consulting firm.

#### Risk-mitigation by insurers

Given the lack of historical data on how this risk could play out, and the scope for more regulatory scrutiny, insurers are becoming cautious about the risk they're taking on by reducing coverage limits, increasing the retention on policies, and most importantly, using broad policy language to contain their liability.

"In light of the increasing public and private scrutiny of SPAC-related activity, insurers are taking a conservative approach with respect to policy-wording. This may increase as regulators and class-action plaintiffs increasingly focus their attention on SPACs," said Adam Ziffer, partner at Cohen Ziffer Frenchman & McKenna.

Foundersshield's Selby also said his company was working with insurance companies to offer broad verbiage as the industry is yet to see the full scope of the types of allegations that might be forthcoming in lawsuits. He expects the industry to evolve over time to address the full extent of the risks associated with the explosion in SPAC activity as it did with other issues, such as cyber risk a few years ago.

However, underinsurance continues to remain a problem in the face of increasing prices and demand. Ziffer said ensuring that the D&O insurance covers each of the entities and their likely overlapping directors and officers from regulatory inquiries, as well as lawsuits, will continue to be a challenge for insurers and their clients.

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