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SPACs and the Associated Insurance Coverage Risks at Play

The top three coverage issues potentially arising out of SPAC transactions.

By **Robin Cohen and Andrew Bourne** | August 12, 2021

(L-R)Andrew Bourne and Robin Cohen. Courtesy photos

Insurance issues surrounding the Special Purpose Acquisition Company (SPAC) frenzy over the past 18 months are only beginning to percolate. As SPACs continue to raise capital and consummate transactions, SPAC-related litigations are on the rise. In addition to increased risk of SPAC-related litigations, SPACs, SPAC sponsors, the target company, the going-forward company and each of these entity's directors and officers face complex insurance coverage issues. This article will present the top three coverage issues potentially arising out of SPAC transactions.

SPACs and Their Litigation Risks

SPACs are essentially companies set up by investors with the sole purpose of raising money through an initial public offering to acquire another company. In thinking about insurance issues for SPACs, commentators have described there being three phases of a SPAC:

- **SPAC IPO**. The SPAC goes through the IPO process. Directors are elected. The SPAC files a Form S-1 with the Securities & Exchange Commission and the SEC approves the Form S-1 statement. A management team is put in place and the SPAC becomes publicly traded.

- **SPAC Business Combination**. Following the IPO, management will identify a target to be acquired. As the process plays out, shareholder approval will be obtained, and the target eventually acquired.
- **New Public Company**. Combined company is up and running, with all the risks of operating a public company.

All the entities and their directors and officers involved in a SPAC transaction are vulnerable to litigations arising from the SPAC transaction. These risks include claims asserting securities law violations like material misrepresentations and omissions in proxy statements and other materials, securities fraud claims, and common law claims like breach of fiduciary duties. A recent analysis found that 12% of 276 SPACs with announced or closed deals through the first quarter of 2021 were hit with a lawsuit or demand letter alleging a common law claim, while 10% of the 157 completed mergers were hit with securities class actions lawsuits. In fact, in the first quarter of 2021, 11 securities class actions involving a SPAC transaction were filed.

D&O Insurance Implications

Which Program Responds to a Claim

Multiple D&O insurance programs could potentially respond to a SPAC-related litigation. Depending on the allegations, a SPAC-related litigation could trigger the D&O program of: (a) the sponsoring entity; (b) the SPAC; (c) the target company; and (d) the newly formed public company. Thus, it is critical to analyze the details of the terms and conditions of each D&O program to avoid potential gaps in coverage.

A recent Delaware decision highlights the need for a thorough review of all potentially applicable D&O insurance programs. Although *Northrop Grumman Innovation Systems, Inc. v. Zurich American Insurance Company*, 2021 WL 347015 (Del. Super. Feb. 2, 2012), involved a reverse triangular merger and not a SPAC transaction, the decision demonstrates the need for a thorough review of all the potentially applicable insurance programs. In *Northrup Grumman*, Alliant and Orbital Sciences proposed a reverse triangular stock-for-stock merger out of which OATK would be born. The transaction closed in February 2015. After spinning off the sporting goods arm, Alliant formed a SPV and merged it with Orbital Science. Orbital Science survived and its stock was converted into a right to receive Alliant stock. Alliant issued shares to consummate the exchange, linked to the pre-existing control of Alliant and was split 53.8% for Alliant stockholders and 46.2% for Orbital Sciences stockholders. Alliant was renamed OATK, which absorbed Alliant's portfolio, but not Orbital Science's portfolio.

A class of OATK stockholders brought an action under 10(b) of the Securities Exchange Act. The claim was that OATK and its managers intentionally disseminated false, post-merger data about OATK's financial health to mislead securities holders about the value of their investments. At the same time, a class of former Orbital Science stockholders added a violation of Section 14(a), targeting certain directors, alleging that the control groups pronounced false or misleading statements in the proxy solicitation materials and other filings distributed and certified in advance of the transaction. The claim accused a coerced vote, stating that OATK and the managers: (a) misrepresented Alliant's net value; (b) omitted detrimental liabilities; (c) omitted flaws in the operations; and (d) oversold the near-half OATK split. According to these Orbital Sciences stockholders, the false and misleading statements caused Alliant to be overvalued and impacted the OATK ownership split, which deprived them of their right to a fully informed vote and induced them to vote their shares and accept inadequate consideration. The class sought compensatory damages, which were settled for $62.4 million for the 10(b) claims and $45.6 million for the 14(a) claim.

The policyholders then sought coverage under three separate D&O insurance programs: OATK, which was the current policy, as well as the runoff policies of Alliant and Orbital Sciences. The Delaware Superior Court found that the Section 14(a) claim was covered under the Alliant policies, rejecting the Alliant insurers

argument that the “Bump Up Exclusion” barred coverage because the Section 14(a) claim concerned loss that occurred prior to the merger. The Delaware Superior Court also rejected the OATK insurers argument that a prior acts exclusion barred coverage for the Section 10(b) occurring prior to the transaction finding that because OATK was in existence before the merger the prior acts exclusion did not apply. Thus, the court effectively held that the Section 14(a) claims were covered by one program and the Section 10(b) claims were covered by another.

SPAC Sponsor as a Covered Entity

In addition to the close review of the various entities of D&O programs, SPAC sponsors need to pay particular attention to their own program. Recently filed cases indicate that SPAC sponsors face potential controlling entity claims based upon their sponsorship of the SPAC. Once the SPAC is formed, it will likely secure its own D&O program, which, absent an endorsement, will likely not cover the SPAC sponsors. As a result, close attention must be paid to the program under which the SPAC sponsor is covered to ensure that the SPAC sponsor can find coverage for “securities claims.”

For example, a SPAC sponsor may be formed as a subsidiary of a company for a variety of purposes. The SPAC sponsor would likely qualify as an insured under its parent company’s D&O insurance program. Nonetheless, a standard form definition of a “securities claim” may be limited to a claim brought by securities holders of the Company (the parent and SPAC sponsor) or arising from the purchase or sale of securities issued by the Company (the parent and SPAC sponsor). The SPAC itself, which is the entity that issued the securities, is not a subsidiary. Thus a securities claim arising out the SPAC’s stock may not be covered under the Company’s D&O program, which could cause a gap in coverage for the SPAC sponsor. An example of this situation can be found in *IDT Corp. v. U.S. Specialty Insurance Co.*, 2019 WL 13692 (Del. Super. Jan 31, 2019). *IDT* involved a transaction by which IDT spun off a company named Straight Path. In 2017, Straight Path entered a consent decree with the FCC concerning Straight Path’s renewal of certain licenses, which occurred prior to the spin-off, in which Straight Path paid a substantial fine and forfeited 20% of its licenses. In July 2017, a securities class action was filed by Straight Path shareholders alleging breaches of fiduciary duties against certain individuals, one of whom was the controlling stockholder of Straight Path, and that IDT aided and abetted the breaches of fiduciary duties. The Delaware Superior Court held that the claim against IDT did not qualify as a securities claim because it was not brought by the securities holders of IDT, but rather Straight Path. *IDT* shows the difficulty the SPAC sponsors and affiliates may have in securing coverage if brought into a lawsuit arising from the SPAC’s securities.

Scope of Coverage

In coverage disputes arising from SPAC transactions, insurance companies are also expected to raise a host of traditional D&O coverage defenses. These include whether policies that do not expressly exclude disgorgement and restitution from covered “Loss” are uninsurable. Recent case law suggests not, *see, e.g., Sycamore Partners Management, L.P. v. Endurance American Insurance Company*, 2021 WL 761639 (Del. Super. Feb. 26, 2021), but policyholders should be vigilant in the placement of their policies to ensure that there is coverage and to make sure that, at the very least, the definition of Loss includes language that the insurance company agrees not to assert that claims under the 1933 Securities and Exchange Act are not uninsurable.

Similarly, close attention must be paid to the definition of Loss to see if it includes so-called “bump-up exclusion” language. Although the language can vary, most D&O insurance policies contain a version that insurers content excludes from coverage any Loss that could be characterized as an increase (“bump up”) in the price of a company. Policyholders should examine such language closely before M&A activities take place to fully understand its potential scope.

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Robin Cohen (https://www.cohenziffer.com/team/robin-cohen/), chair of law firm Cohen Ziffer Frenchman & McKenna LLP in New York, is recognized as one of the top insurance coverage lawyers in the world. Robin co-founded Cohen Ziffer in January and has recovered more than $5 billion in assets for her policyholder clients during her more than 30-year career.

Andrew Bourne (https://www.cohenziffer.com/team/andrew-n-bourne/), partner at Cohen Ziffer, is a highly experienced commercial litigator focused on working diligently to obtain the insurance proceeds and other recoveries to which his clients are entitled. Andrew draws on nearly two decades of insurance industry-related legal experience.

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