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Expert Analysis

SPAC Litigation And Insurance Implications

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As we move into the summer months of 2021, it is growing increasingly difficult to open a legal publication without reading about Special Purpose Acquisition Companies or SPACs. Many articles discuss the ever-growing number of SPACs, the increased regulatory scrutiny and anticipated regulations or the growing number of SPAC-related lawsuits. For this column, we teamed up with our insurance broker colleagues at Alliant Insurance Services to co-author a discussion of insurance issues associated with the SPAC-related lawsuits. These issues can be complex because SPAC-related lawsuits may implicate three separate directors' and officers' (D&O) insurance programs—(1) the insurance policies issued to the SPAC; (2) the insurance policies issued to the existing operating company; and (3) the go-forward policies issued to the post-transaction public entity.

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SPAC Background

A SPAC, often referred to as a "Blank Check Company," raises cash in an initial public offering (IPO) and places the proceeds from the IPO into a trust account. SPACs are formed by sophisticated financial practitioners, alternatively referred to as sponsors or founders. The sponsor manages the IPO process, including the selection of management, lead underwriters to conduct the IPO, auditors for the SPAC and counsel to prepare and file the Form S-1 registration statement with the SEC. The funds raised are then used solely to acquire an existing company in a business combination transaction ("de-SPAC transaction") with a public company emerging as the go-forward entity. The SPAC is typically required to complete this business combination within 18 to 24 months following the SPAC IPO date.

Increasing Numbers

According to SPAC Insider, as of June 16, 2021, there have already been 343 IPOs for SPACs in 2021, raising over $107 billion in offering proceeds. By comparison, in all of 2020, there were 248 SPAC IPOs which raised $83 billion. In 2019, the year with the most SPAC IPOs prior to 2020, there were only 59 SPAC IPOs raising a total of $13 billion. Prior to 2019, there had been, collectively, only 167 SPAC IPOs.

> The claims most frequently asserted in recently filed lawsuits have been based on the poor performance of the new public company or negative disclosures concerning the company (sometimes following a short seller report) and the related negative impact to share price.

This extraordinary increase in SPAC offerings has generated a great deal of attention from both the SEC and the plaintiffs' bar. According to Securities Class Action Clearinghouse, as of June

16, 2021, approximately 14% of the shareholder class action lawsuits filed in 2021 involved a de-SPAC company.

SPAC-Related Litigation

While there are numerous areas of potential liability involving the SPAC IPO process, the claims most frequently asserted in recently filed lawsuits have been based on the poor performance of the new public company or negative disclosures concerning the company (sometimes following a short seller report) and the related negative impact to share price. In addition, several lawsuits have been filed alleging claims based on alleged material misinformation distributed prior to and in support of the de-SPAC transaction.

Plaintiffs' allegations may include material misrepresentations and omissions in proxy statements in violation of §14(a) of the Securities Exchange Act, securities fraud claims under §10(b) or control person/entity liability claims under §20(a). Plaintiffs may also allege common law causes of action like breach of fiduciary duty to shareholders concerning the disclosures made prior to the transaction or aiding abetting breach of fiduciary duty by the target company and its board of directors.

D&O Insurance Implications

Depending on the allegations, litigation concerning a SPAC transaction could potentially implicate three separate insurance programs.

A SPAC D&O policy should be put in place at pricing of the IPO shares to provide coverage for the SPAC and its directors and officers as they go through the SPAC process, including the IPO and the initial business combination phase. The existing operating business will likely have its own private company D&O insurance, which provides coverage to the private company and its directors and officers in connection with the merger negotiations and the transaction. Finally, at closing of the merger, a go-forward D&O insurance program will need to be in place for the go-forward exposures of the newly formed public company.

Where lawsuits filed following the SPAC transaction allege wrongdoing both during the IPO process as well as post-merger, the specific provisions of the policies will dictate whether and where there is coverage available. Review of the details of the terms and conditions of the three sets of policies is critical if the insureds are to avoid gaps in coverage.

For example, an insurer may seek to include the following narrow exclusionary language in the run-off endorsement issued to the private company at the time of the business combination: "No coverage shall be available under this Policy for any Claim or Securityholder Derivative Demand Investigation based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving any: (1) Wrongful Act committed or allegedly committed; or (2) any fact, circumstance, situation, transaction, or event actually or allegedly occurring, on or after the Combination/Merger Date."

This exclusionary language is very broad because it not only excludes claims that arise out of wrongful acts that occur on or after the merger date but also any claim that in any way involves any facts or circumstances that occur after the merger date.

A preferred alternative to this language would limit the exclusion to only that part of the loss or claim related to post merger conduct. This would avoid the potential for an exclusion to bar coverage where only a trivial amount of allegations or facts pertain to post-merger conduct or activities.

This situation may be further complicated if the go-forward company's D&O insurance policy has a corresponding exclusion barring coverage for a claim that is "based upon, arising out of, directly or indirectly resulting from or in any way involving any act, error, omission, fact, circumstance, situation, transaction or event prior to the Combination/Merger Date." Once again, preferred alternative language would serve to limit the scope of the exclusion to only that part of the loss or claim that relates to pre-merger conduct or activities.

'Northrop Grumman v. Zurich'

While not a SPAC litigation, a recent Delaware trial court decision involving insurance claims related to underlying class action lawsuits concerning a reverse triangular merger illustrates some of the complexities that may arise in connection with SPAC-related insurance claims because claims were made concerning both pre-merger and post-merger acts and omissions and three separate insurance programs were implicated. *Northrop Grumman v. Zurich*, 2021 WL 347015 (Del. Superior Ct. Feb. 2, 2021).

The underlying lawsuits asserted claims arising out of the merger of Alliant Techsystems (Alliant) and Orbital Sciences Corporation (Orbital Sciences) to form Orbital ATK (OATK). A class of former Orbital Sciences stockholders brought a claim under §14(a) of the Securities Exchange Act against OATK and several former Orbital Sciences' executives alleging false or misleading statements in the proxy solicitation materials and other filings distributed in advance of the merger. These claims alleged that the pre-merger materials misrepresented Alliant's value and understated its liabilities to the detriment of the Orbital Sciences' shareholders. A separate class of OATK shareholders brought a claim under §10(b) of the Securities Exchange Act against OATK and the same executives in their OATK capacities alleging intentional dissemination of false and misleading post-merger data about OATK's financial health.

Both sets of claims were resolved by settlement with the §10(b) claims setting for approximately $62.4 million and the §14(a) claims settling for approximately $45.6 million. The insureds sought recovery from three separate towers of D&O insurance, each of which had been placed on notice of the claims—the current go-forward insurance policies issued to OATK as well as the policies issued to Alliant and Orbital Sciences, each of which had gone into runoff at the closing of the merger.

Alliant's insurers denied coverage for the §14(a) claims based on a Bump Up Provision within the definition of loss which provides that loss recoverable under the policies does not include any amount that effectively increased inadequate consideration paid for the acquisition of an entity or substantially all of the ownership interest of an entity. The trial court rejected this argument on a number of grounds including that the §14(a) claim was primarily about loss due to the alleged dissemination of materially false and misleading materials prior to the merger.

The OATK insurers denied coverage for the §10(b) claims on the basis of a Prior Acts Exclusion that barred coverage for claims arising out of acts and omissions occurring prior to the transaction on the grounds that the §10(b) allegations were interrelated with the facts that supported the §14(a) claims, which took place prior to the transaction. The court rejected this argument as well, holding that the Prior Acts Exclusion did not apply because the §10(b) allegations related only to dissemination of post-merger data by OATK. Since OATK was not in existence before the merger, the Prior Acts Exclusion could not apply and the alleged activities could not be interrelated with the facts that supported the §14(a) claims, which took place solely pre-merger.

As a result, the trial court held that the §14(a) claims were covered by the Alliant policies and the §10(b) claims were covered by the OATK policies. The insureds benefitted to some degree from the application of Delaware law, which narrowly construes interrelated claims arguments, finding claims to be interrelated only where the claims are fundamentally identical.

Looking Forward

The *Northrop Grumman* decision is instructive because it demonstrates the complexities involved with claims that potentially involve post-merger conduct as well as conduct during the IPO stage of the SPAC process. Since these claims may implicate two or three different insurance programs, it is important to review the policies and runoff endorsements to ensure that exclusionary language is not overly broad and that both pre and post-merger conduct is adequately insured.