LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What SPAC Litigation Trends Could Mean For D&O Insurance

By **Huiyi Chen and David Kroeger** (July 20, 2021, 12:35 PM EDT)

Special purpose acquisition companies, sometimes referred to as blank-check companies, are shell entities that go through initial public offerings without any underlying business operations or assets, other than cash in a trust account, and are usually required to seek merger with a private company within two years of the IPO to avoid liquidation.[1]

Huiyi Chen

Special purpose acquisition companies, or SPACs, provide a fast track for private companies to go public and have become a popular vehicle for SPAC management teams and shareholders to obtain substantial return on investment relatively quickly.

David Kroeger

Accompanying the pressure to accomplish an initial business combination in a short period of time are possible higher risks of litigation, especially securities litigation arising from alleged fraudulent or misleading statements in respect to the target private company.

The exponential growth of SPAC IPOs and mergers in recent years have put them on the radar of the U.S. Securities and Exchange Commission, and regulation and enforcement actions are likely to increase in the foreseeable future, triggering even more private lawsuits against SPAC-related entities and their directors and officers.

This article takes a look at the SPAC-related securities litigation filed in the last two and a half years and identifies potential trends and effects in regard to directors and officers, or D&O, insurance coverage.

SPAC Securities Litigation Overview

According to Stanford Law School's Securities Class Action Clearinghouse,[2] from Jan. 1, 2019, to the first half of 2021, 26 class action complaints have been filed against de-SPACs — or the go-forward or post-merger public companies that are a combination of the publicly listed SPACs and the target private companies — and their directors and officers for alleged securities laws violations.

Of the 26 complaints, six complaints were filed in each of 2019 and 2020, and the remaining 14 complaints were filed in the first half of this year. To provide further context, there were 59 SPAC IPOs in 2019, 248 SPAC IPOs in 2020, and 377 SPAC IPOs this year so far.[3] The expansion in SPAC securities litigation corresponds to the exponential growth in SPAC IPOs in recent years.

We are not aware of any D&O insurance coverage litigation filed in federal or state courts over the defense costs or the judgment or settlement amounts involved in these cases so far,[4] and recent discussions focused on hypothetical coverage dispute scenarios that might arise out of the SPAC lawsuits.[5]

We have taken a closer look at the recently filed SPAC securities lawsuits in order to preview the D&O insurance coverage issues that might, or might not, actually arise out of them, and observed some interesting trends or phenomena.

First, the disputes show a concentration in the electric vehicle and recycling industries in general. For example, by our count, five of the 14 SPAC securities class actions filed in the first half of 2021 related to electric vehicles or electric vehicle batteries,[6] and another two are companies selling recyclable materials or recycling processing.[7] These cases constitute half of the SPAC securities class action dockets in the first half of 2021.

Second, while all six of the complaints filed in 2019 were based on allegedly false and misleading statements contained in the proxy statements in purported violation of Sections 14(a) and 20(a) of the Securities Exchange Act, the securities class actions filed in 2020 and the first half of 2021 have shown more diversity in their causes of action.

They mostly do not challenge the de-SPAC merger statements themselves, but instead base their alleged injuries upon misrepresentations in press releases and public filings the SPACs or the target private companies — and their directors and officers — made post the announcement of the mergers about the business and performance of the target companies or the go-forward companies, allegedly in violation of Section 10(b) of the Securities Exchange Act.[8]

Also worth noting is that the SEC's tightening regulatory and enforcement efforts regarding SPACs have already served as another guidepost for allegations made in private lawsuits.

In Lavin v. Virgin Galactic Holdings Inc.,[9] filed on May 28 in the U.S. District Court for the Eastern District of New York, the purported class alleged that the de-SPAC aerospace company and its officers failed to disclose that the company improperly treated warrants as equities as opposed to liabilities in the company's public statements and filings made prior to April 12, the date on which the SEC issued a statement that, for accounting purposes, warrants issued by SPACs should be treated as liabilities.[10] One can expect to see growth in this area as the SEC strengthens its oversight against the heated SPAC market.[11]

Third, for a great majority of the securities class actions that challenge representations outside of proxy statements, the class period start date falls into the window between the announcement of the de-SPAC transaction and the actual merger. Only a handful have a start date prior to the announcement of the merger,[12] or on or after the date of the actual merger.[13] As discussed below, this timing may become a source of tension among different towers of D&O insurance coverage.

The observations above are limited to securities class actions, but there have also been shareholder derivative actions filed against the officers and directors of de-SPAC entities based on similar fact patterns.[14]

As a routine practice, the shareholder derivative complaints all use D&O liability insurance to support their demand futility argument — i.e., if the company has purchased D&O insurance, the defendant directors and officers purportedly will not have an incentive to bring a lawsuit on behalf of the company against themselves because of the "insured versus insured" exclusion in D&O liability policies.

On the other hand, if the company does not have D&O insurance policies, the defendant directors and officers purportedly will not have an incentive to bring a lawsuit either because they will be facing individual liability out of their own pockets.[15]

Whether these arguments will succeed depends in part on whether there is a carveout in the insured entity versus insured exclusion for shareholder derivative lawsuits. Such a carveout is usually present in traditional D&O insurance policies for public companies.

Implications for D&O Insurance Coverage for SPAC Lawsuits

What implications could we draw from these trends observed in the SPAC securities litigation? Public and private companies in general are already encountering some difficulties in obtaining sufficient D&O liability insurance coverage at a reasonable price and facing a significant hike in premiums.[16]

SPACs and de-SPACs, due to their comparatively higher risk of securities litigation, have to pay even more to obtain D&O coverage; according to a recent report, de-SPAC entities may have to pay 10% to 20% more for D&O insurance than a company going through a regular IPO.[17]

It is less clear that a hike in D&O insurance premiums for all SPACs is justified in light of the recent litigation trends discussed above. Not all SPACs are created equal, and there appear to have been industry concentrations demonstrated by the securities class actions filed in the past two and a half years.

Individual SPACs and the go-forward entities should seek to negotiate individualized treatment, particularly if they focus on businesses outside the recycling or electric vehicle space. On the other hand, the anticipated increase in SEC regulation and enforcement actions may further harden the D&O market for SPACs across the board.

Even assuming SPACs and de-SPACs are able to purchase D&O insurance, it does not necessarily mean that directors and officers could smoothly use insurance to cover their defense costs or any judgment or settlement amounts.

As noted above, the great majority of the recent securities class actions were for a class period starting after the announcement of the de-SPAC transaction, before the actual merger and ending on a post-merger date — in other words, a period when there are technically three entities, the premerger SPAC, the private target and the post-merger public company, each of which could have separate D&O insurance policies.

Some private company D&O insurance policies may have a securities exclusion that excludes coverage for any claim arising from violation of federal or state securities laws.[18] So if a coverage dispute is going to arise, it may only implicate the tower for the SPAC and the tower for the de-SPAC entity.

It also is not uncommon for the D&O insurance policy purchased by the SPAC, which usually lasts for two years corresponding to the acquisition cycle of SPACs, to include the potential for tail coverage for a period of time after the de-SPAC transaction.

For example, in the proxy statement for the merger at issue in Rosenblatt v. Black Ridge Acquisition Corp.,[19] one of the SPAC securities class actions filed in 2019 in the U.S. District Court for the District of Delaware, it was disclosed that part of the merger agreement stipulated that "BRAC will maintain tail directors' and officers' liability insurance policies for a period of six years following the Mergers."[20]

Assuming the defendant directors or officers for the de-SPAC entity overlap at least in part with those of the premerger SPAC, it may be the case that the D&O insurance for both entities will be triggered, and if the policies were underwritten by different insurers, there is a risk of the different insurers seeking to redirect potential liability to one another.

Even if the coverage dispute could ultimately be resolved, it may still create a cash flow problem for the company to the extent it is forced to pay defense costs without prompt insurance reimbursement, and for the defendant directors and officers if they are forced to defend out-of-pocket for a prolonged period of time.

Under such circumstances, the related claims and other insurance clauses in the D&O insurance policies may come into play.

In some instances, more than one action was brought over the same alleged fraudulent or misleading statements or wrongful acts, such as two class actions or a securities class action plus a shareholder derivative action. They may be treated as related claims and insurers for a later-made claim may argue that the policy covering the first-made claim should also cover the later-made related claim.

Furthermore, insurers might argue that their policy only provides excess coverage due to the existence of other D&O coverage based on the other insurance clause.

If the defendant director and officer was a director or officer of the private target company, and if the private company's D&O policy contains a securities exclusion along the lines discussed above, then the only available D&O insurance might be that purchased by the de-SPAC entity, if at all.

The risk here then could be insufficient coverage under the policies for the de-SPAC entity. De-SPAC companies that have directors and officers from the private target company may therefore want to consider acquiring higher D&O coverage limits.

The takeaway for potential or actual policyholders involved in SPACs and de-SPAC transactions is to think early, and act early.

Policyholders should think early in terms of the overall structure and limit of D&O insurance coverage for all entities involved in the anticipated SPAC transactions, and try to avoid a coverage dispute among different insurance towers that might be triggered by securities litigation, as well as to avoid insufficient coverage if there will only be one tower that potentially will provide coverage.

Policyholders should also act early to obtain sufficient coverage for all relevant entities, particularly given the hardening D&O insurance market and rising premiums, the rise of SPAC-related securities litigation, and the anticipated increase in oversight and enforcement actions against SPAC-related entities.

Insurance professionals will be key in advising as to the appropriate structure and limit of D&O

insurance coverage, as well as the negotiation strategy in securing sufficient coverage with reasonable, to the extent possible, premiums.

Huiyi Chen is an associate at Jenner & Block LLP.

David M. Kroeger is a partner and co-chair of the insurance recovery and counseling practice and the reinsurance practice at the firm.

[1] See SEC's Office of Investor Education and Advocacy, What You Need to Know about SPACs — Updated Investor Bulletin, SEC Website (May 25, 2021), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.

[2] https://securities.stanford.edu/current-topics.html.

[3] https://www.spacanalytics.com/.

[4] Based on docket search as of June 23, 2021.

[5] See, e.g., Boris Feldman, Tower Versus Tower: Implications of SPAC Shareholder Litigation for the D&O Insurance World, Harvard Law School Forum on Corporate Governance (May 12, 2021), available at https://corpgov.law.harvard.edu/2021/05/12/tower-versus-tower-implications-of-spac-shareholder-litigation-for-the-do-insurance-world/.

[6] Phillips v. Churchill Cap. Corp. IV, Case 1:21-cv-00539-ACA (N.D. Ala.); Nichols v. Romeo Power Inc., Case 1:21-cv-03362-LGS (S.D.N.Y.); Blake v. Canoo Inc., Case 2:21-cv-02873-FMO-JPR (C.D. Cal.) (one of two class actions against Canoo Inc. before the same court); Rico v. Lordstown Motors Corp., Case: 4:21-cv-00616-PAG (N.D. Ohio); Suh v. XL Fleet Corp., Case 1:21-cv-02002-LGS (S.D.N.Y.); Malriat v. QuantumScape Corp., Case 3:21-cv-00058-WHO (N.D. Cal.).

[7] Rosencrants v. Danimer Scientific, Inc., Case 1:21-cv-02708-MKB-RLM (E.D.N.Y.) (one of two class actions against Danimer Scientific, Inc. before the same court); Theodore v. PureCycle Techs., Inc., Case 6:21-cv-00809-PGB-GJK (M.D. Fla.).

[8] Compare, for example, Wolf v. Boxwood Merger Corp., Case 1:19-cv-02184-RGA (D. Del.) (filed in 2019), and Theodore v. PureCycle Techs., Inc., Case 6:21-cv-00809-PGB-GJK (M.D. Fla.) (filed in 2021).

[9] Case 1:21-cv-03070-ARR-TAM (E.D.N.Y.).

[10] See id. (ECF No. 1).

[11] See, e.g., Robert Freedman, As SEC Ramps up SPAC Rules, Lawsuits Could Follow, CFODive (May 10, 2021), available at https://www.cfodive.com/news/as-sec-ramps-up-spac-rules-lawsuits-could-follow/599906/.

[12] See Phillips v. Churchill Cap. Corp. IV, Case 1:21-cv-00539-ACA (N.D. Ala.).

[13] See Lavin v. Virgin Galactic Holdings, Inc., Case 1:21-cv-03070-ARR-TAM (E.D.N.Y.); Jedrzejczyk v. Skillz Inc., Case 3:21-cv-03450-RS (N.D. Cal.); Moradpour v. Velodyne Lidar, Inc., Case 3:21-cv-01486-SI (N.D. Cal.); Malriat v. QuantumScape Corp., Case 3:21-cv-00058-WHO (N.D. Cal.).

[14] See, e.g., Luthra v. Garipalli, Case 3:21-cv-00320 (M.D. Tenn.) (on behalf of Clover Health Investments, Corp.); Bishop v. Ni, Case 2:20-cv-10657-ODW-AS (D. Del.) (on behalf of HF Foods Group Inc.); Gervat v. Singh, Case 5:21-cv-00989-NC (N.D. Cal.) (on behalf of QuantumScape Corp.); D'Arcy v. Gopalan, Case 1:21-cv-00369-UNA (D. Del.) (on behalf of Velodyne Lidar, Inc.).

[15] See id.

[16] Jenner attorneys previously have written about the hardening D&O insurance market. See Brian Scarbrough, Carline Meneau, and Huiyi Chen, How to Navigate a Hardening D&O Insurance Market, Law360 (October 6, 2020), available at https://www.law360.com/articles/1317119.

[17] Antonita Madonna, Regulatory Scrutiny, Lawsuits over SPAC Transactions Fuel D&O Insurance Sticker Shock, Reuters (June 22, 2021), available at https://www.reuters.com/legal/transactional/regulatory-scrutiny-lawsuits-over-spac-transactions-fuel-do-insurance-sticker-2021-06-22/.

[18] See Catherine Doyle and Jan Larson, Insureds Should Fear Exclusions With Broad Preambles, Law360 (March 5, 2019), available at https://www.law360.com/articles/1135138/insureds-should-fear-exclusions-with-broad-preambles.

[19] Rosenblatt v. Black Ridge Acquisition Corp., Case 1:19-cv-01117-MN (D. Del.).

[20] See https://www.sec.gov/Archives/edgar/data/1708341/000168316819001882/brac_defm14a.htm.