Lowenstein Sandler's Insurance Recovery Podcast: Don't Take No For An Answer

Episode 11 - The Brave New Frontier of Securing D&O Insurance for SPACs and deSPACs

By Lynda A. Bennett and Valeska Pederson Hintz
Guests: Rob Crocitto

MARCH 2021

Kevin Iredell: Welcome to the Lowenstein Sandler podcast series. I'm Kevin Iredell, Chief Marketing Officer at Lowenstein Sandler. Before we begin, please take a moment to subscribe to our podcast series at lowenstein.com/podcasts. Or find us on iTunes, Spotify, Pandora, Google podcast, and SoundCloud. Now let's take a listen.

Lynda Bennett: Welcome to "Don't Take No for an Answer", an Insurance Recovery podcast. I'm your host Lynda Bennett, Chair of Lowenstein Sandler's Insurance Recovery practice. In today's episode, we're going to be tackling that brave new frontier of securing D&O insurance for SPACs and De-SPACs.

So special purpose acquisition companies or SPACs have taken the investment community by storm, and at least for the moment appear to be largely displacing the traditional IPO market. The SPAC wave seems to have started in the early days of the pandemic and has boomed to the point where in February, 2021 alone, it was reported that 132 issuers went public in February, including 98 SPACs, raising an astonishing 37 billion in proceeds. Those are some truly historic figures. So in today's episode, we're going to peel the onion back about as to why SPACs have grown so much in popularity and consider whether SPACs pose more or less risk than the traditional IPO model.

We're going to discuss the unique challenges that currently exist in the D&O space as insurers are scrambling to keep up with the dizzying pace of the deals and limit and risk appetite and capacity seem to be reaching a breaking point. I'm thrilled to have with me today, two leading authorities in this space. My partner Valeska Pederson Hintz, is a corporate lawyer who's been knee deep in the IPO and SPAC space for years. And I'm pleased to welcome back Rob Crocitto from ARC Excess & Surplus lines.

Rob has decades worth of experience placing D&O insurance for public and private companies. Both Rob and Valeska have spent much of the last year on the wild rollercoaster ride that is the SPAC and De-SPAC market. So to begin, I think it would be useful to level set the parameters of our discussion. So welcome Valeska. And why don't you give us an overview of IPO's SPACs and De-SPACs, what are the pros and cons of each model?

Valeska Pederson Hintz: Sure. So an IPO is, to state the obvious, the first time you sell a company securities to the public on a registration statement, but the important thing to keep in mind that we kind of forget because we do it all the time, is it's the company shares that we're selling. A SPAC is different, a SPAC is a financial product, basically. So in the IPO, the context in the SPAC world is the SPACs fundraising. It's a SPAC fundraising event, not the target. So the SPAC itself, in a nutshell what it does is it raises the money in a blank check IPO and then it puts that money in a pot, what we call a trust account and it locks it away. And then they go look for a private company to merge with. And that initial business combination is what everybody refers to is the De-SPAC.

So with the close of the business combination, the private company gets that pot of money that they raised and the SPAC public shareholders get stock in the combined entity. And then the target has raised money and went public. So it's slightly different in terms of pros and cons for the model, if you were looking at that, it's a little hard because there's different constituencies, but I'll try to bucket them that way. But for pros, you're looking at a target that's getting access to the public markets for the SPAC. And then depending on the SPAC and its investor base, it can also give you access to really good institutional investors and a broad investor base. That's going to take a little bit of diligence on your end as a target to see who the SPAC is.

Then it can also be a faster timeline than an IPO. Usually you could get approval on something like three to five months and be public effectively. You could also market without concern for quiet periods and gun jumping like you would have in an IPO. And you can use financial projections, which is helpful for pre-revenue companies. It's also easier to take it public as a SPAC than an IPO, in a lot of ways. They've already raised money through the IPO. A lot of them already have PIPEs lined up for investors that are ready to do the PIPEs. There's for existing target shareholders outside of the D&O and the big shareholders. A lot of times there's no or limited lockups for the target shareholders. And that's kind of nice.

Another thing, in the past, this wasn't true, but like what Linda was saying about all the energy and excitement in this market, now there is a lot of marketing buzz and credibility that you can get as being a public company, but also doing this through a SPAC. And also you're getting sponsor expertise where in theory there is rather than a bunch of underwriters that kind of disappear, the sponsor will often leave people on the board and in management occasionally. So you're getting a different set of expertise.

And then for the public SPAC investors, they have some unusual downside protection because that cash, the pot that I was talking about that's in the trust account, that's being stored so that in a couple situations, but mainly the business combination, they can redeem their money and take it back. So it gives them some flexibility that also, for looking at the cons, if you're the target, that's some deal side risk because there's uncertainty as to how much is coming out of the trust account. And you really don't know until two days before that shareholder meeting. So it's risky in that respect.

And like I was saying, you get some sponsor expertise, but keep in mind that that means, unlike an IPO, it's not a neutral tool, but it's a partnership. So you have to think about it that way. It also has a shorter timeline for the SPAC. There's two years that they have to get these deals done in. And then when you're looking at the target side, traditionally there's a lot of time for you to get in front of this company and start preparing them to go public. And you're thinking about the IPO, these SPACs have gotten on the scene fairly recently. They typically do less diligence than an IPO. There's less time to prep the companies in an IPO. And that can get a little bit dicey at times, depending on how quick you're pushing things, how prepared the company is.

And then lastly, in terms of cons, there is the consideration of dilution. The sponsors are getting 20%, there's warrant coverage, there's PIPEs. So all those things are something to think about.

Lynda Bennett: This is a little bit of an alphabet soup. You've mentioned it a couple of times. So we've explained IPO's, SPAC and De-SPAC. Just give us the acronym for PIPE. What is that?

Valeska Pederson Hintz: PIPE is public investment in private equity. So what we talk about with that is when we have a public company or a company that can register shares, sometimes we'll do the investment privately and then they'll just do it based on they'll say, "Hey, we're going to do a resell registration statement in a short period of time and we'll get you on there." So usually it's something like 90 days, it could be shorter, like 30.

Lynda Bennett: There's a little chill going down my insurance spine. As things happen very quickly, it seems like maybe there might be a lot more risk factor and a lot more claims coming out of this. But we'll get to that in a couple of minutes, but first I'd like to know Valeska, do you think that we're at the beginning, in the middle or near the end of this SPAC De-SPAC wave? Where are we at in the process, you think?

Valeska Pederson Hintz: Yeah. So I think we're more towards the beginning. Like you were mentioning February numbers were kind of crazy, but to put that in a little bit more context from what I've been seeing recently, from 2020, it was supposed to be the year of the SPAC. Everybody said this is the capital market story of 2020, but so far in 2021, if you're looking even not just at February, but just from January 1 to date, SPAC IPOs have raised almost $65 billion over 231 deals compared to all of last year, raising approximately 80 billion across 237 deals. So that gives you a sense of how many, and I'm working online actively right now, where we're doing an IPO for a SPAC and that's one. There's so many of these things going on.

BlackRock CEO, Larry Fink, everybody's looking out for his annual letter to see what he has to say. So he kind of captivates the market and his take from what he said, he was suggesting that SPACs could come to replace the traditional IPO process. Now I don't know if that's true. That's a little aggressive, but the popularity has definitely been propelled by involvement with credible, experienced and backers like Michael Klein, Bill Ackman. So it's something that doesn't seem like it's going to fade anytime in the near future. You have Goldman Sachs suggesting that it could be something north of 300 billion worth of SPAC stock they'd be issued in the next two years. So it's kind of shocking. On the back end of that, this is the front end, everybody's raising money then they're going out and looking at a target. If they don't get that target within a two year period, they can extend. But at some point they have to wind down.

And so the real question, I think, at the end of the day is, are there really enough good prepared private companies out there that are ready to do this transaction, that aren't ready on their own IPO track and want to do that. And even with IPO's traditionally, you'd have companies that were dual tracked where they would file an S-1 or a DRS. And once they became publicly known that they were going public, you'd have somebody swoop in and buy them. So who's the pool left because a lot of them have been picked over and over this next year, a lot more will be picked over. So I guess one of the questions in my mind is, are we going to run out of targets that are kind of ready and want to use this process?

Lynda Bennett: And that's going to transition us beautifully into my next question. Because as I said, I'm an insurance lawyer who is skeptical and sees all of the pain and suffering of deals that have gone wrong. So what are the risk factors? The speed with which this is happening and you just touched on a perfect additional risk factor, which is, as you're nearing your two year end period coming up, you're going to get desperate and just scoop up whatever's around and maybe not the best. So what are some of the risks that we need to be thinking about? And I'm particularly interested in whether regulators are starting to have their ears perk up and maybe look at these deals a little bit closer, given their proliferation.

Valeska Pederson Hintz: Yeah. So I look at it kind of in two groups, one is, what's the main risk in my mind for SPACs that are going public? And one thing that I like to remind people is that you have to make sure when you're in the IPO process for your SPAC, that you're not having meaningful conversations with targets before you close that IPO, just as like a shout out, please remember that. And then with respect to the De-SPAC transaction, there's a lot of risks. And I think the risk is in diligence and undisclosed risks. Investors have thought to hold SPACs and their sponsors liable for a variety of alleged misstatements recently. Some of them, or a lot of them have kind of included the financial outlook of target companies and lack of the level of diligence that you'd be performing by the SPAC.

There's a lot of ways to mitigate this risk if you're looking at that and I think it's like, go back to your IPO. How would you do this in an IPO? In an IPO you're conducting, like you were saying, Lynda, thorough due diligence. And that's what you traditionally would do in an IPO. You have many right now, potential security claims that could be brought, but you have to show negligence or recklessness or knowing wrongdoing and others have a due diligence, defense, not all of them, but there's a lot. And so that does provide a lot of help. And then also doing due diligence helps with the next point, which is be cautious about what you say in your proxy statement, prospectus. If you're going to include the appropriate caveats concerning the source of the information, what kind of disclosures you're making, are there disclaimers for forward-looking statements?

What are those forward-looking statements based on and do your risk factors properly cover that? Are you letting them know what assumptions you're making?

And then also, the SEC has been really focused on full disclosure of potential conflicts of interest and Jay Clayton, I can't remember his last year, but somewhat recently, has said that one of the areas in the SPAC space that the SEC was particularly focused on is the incentives and compensation that the SPAC sponsors are receiving. And he listed out a couple of questions. It was how much equity do they have now, how much of the equity do they have at the time of the IPO transaction and what are their incentives?

And just to kind of round it out, these risks aren't just theoretical, claims have really been asserted against SPACs. For example, [inaudible 00:12:27] right now is in a litigation and it was a SPAC target in 2018, the deal closed. What they did is they claimed that they were at or near profitability. And then right now they're currently subject to a lawsuit that alleges that the company created an illusion of profitability through illicit means, which isn't really what you want to see in a press release. It's not great news. But if you look at what happened, it's a textbook case. They did a lot of stuff that they shouldn't, and this is still working its way through the court. So who knows, but a lot of people kind of been pointing to this case and saying, "Oh, this might be a model for further securities action litigation down the road." But these guys provided a bunch of financial projections and didn't disclose that these projections and a lot of the statements and their perspectives really relied on them drastically increasing prices to their customer base in order to support all of this.

And it also required them to refuse to honor existing contracts that were at those low rates. And so instead, the perspectus said, "Hey, we have this great competitive advantage because of these really low rates we're charging our customers." And their customers we're an underserved, small restaurants, they're basically sort of trying to operate, DoorDash, ChowNow, Grubhub space, they were saying, "Hey, we can undercut everybody, retain all these small underserved customers." And then after raising money, the company basically admitted, not even just after the SPAC transaction, but after they raised money again, they came out almost a year later and said, "Oh yeah, those little rates, we really couldn't maintain those, those small underserved customers can't really afford it. And we're going to have to increase prices substantially."

Valeska Pederson Hintz: And what was interesting is the allegations, when you're looking at the complaint, they talked about the SPAC sponsor had really touted in their S-1 when they went public saying, "Hey, we're great at restaurants. We really understand the restaurant industry. In fact, we have this billionaire restaurateur who has done all these massive chain restaurants that are super popular. And a lot of them are in the prime locations, prime markets, amazing restaurants, and he's really going to help." And they said he did nothing. He barely did anything. There's a button at the bottom of this website that you can attribute to the other restaurants in his space have, but he even admitted himself that the rates that they have to charge to make this company profitable, his prime customer or restaurants couldn't afford it. And so what you ended up seeing was over a five month period, the stock went from a $15 high to a dollar and 89 cents. It closed and they lost 800 million in market cap. So it was shocking and of course that results in lawsuits.

Lynda Bennett: So Robert, I bet you got a call for a claim like that. So tell us, Rob, is that kind of a fact pattern insurable, and just give us the bigger, the broader view of what is the state of play for getting coverage for specks in these De-SPAC transactions.

Robert Crocitto: It's not easy and it's not easy because the market is saturated. So let's look at it like this, there are, I don't know, maybe a little more than a dozen insurance companies that can really insure a SPAC correctly. And then you say there's probably a handful of those can do a primary correctly. And what I mean correctly, I mean with the right coverage. Many insurance companies have limitations because the SPAC's a two year transaction. So you need a two year D&O policy. Companies that are heavily reliant on re-insurance, some of them don't have the ability within their re-insurance treaties to offer a two year policy. So they're not viable options, right? When you look at the number of SPACs that have come out of the 650 that took place in the last whatever, 10 years, 437 of them came out in the last 14 months.

And we're looking at 143 of the last 190 billion raised coming out in the last 14 months. What else is the plaintiff's bar going to focus on? This is in the white hot spotlight. And I'm thinking from an underwriter's perspective, because those are the people I have to try to get these quotations from. So it's challenging, but there are a number of very good players, [inaudible 00:16:48], Beazley, QBE, Axis, AIG. If they like the SPAC, they'll quote it. And what makes them like the SPAC? It's a combination of the industry that they're going to focus in, the level of quality with regards to the sponsor, what the sponsor's track record is in similar type entities and how well they've performed. If they have prior SPAC experience, how well it turned out. And they also look at the size of the SPAC.

So it's a lot easier getting a SPAC place that's a hundred or 200 million versus we have ones we're working on now that are over half a billion in the [inaudible 00:17:28], they're not easy to get done, that's a task. So those are some of the challenges we see. And underwriters are fearful. They're fearful in a sense that the way the SPACs are set up, because if they don't get a deal done, they're not getting paid. You have to return this money if you don't get this deal done. So what happens is you have so many SPACs out there chasing, like Valeska said earlier, there's only a limited number of quality targets. And the fear becomes, are we going to do a deal with an inferior target because we just want to get the deal done? Or are, in some cases, are we going to do a deal with a target that's not in line with the way we said we were going to come out in our perspectives? A different industry.

I think the other fear in the minds of underwriters is some of the targets they're not ready to enter, like Valeska said, the public space. It's happening so quickly. An IPO takes six to 10 months to do.

Valeska Pederson Hintz: Plus all the prep time, right Rob? Beforehand, where you're getting these guys ready and telling them all this stuff they should be thinking about. That's gone, there's no time for that here.

Robert Crocitto: No. It's, "I want my money. Well, how fast can I get my insurance? And how much is it going to cost me?" And what happens is, some of these companies they're not ready culturally, to be public. They don't know how to communicate information to the street. I did one a while back, they didn't have a CFO in place with public experience until two weeks before the business combination. So these things tend to raise the eyebrows of the underwriters and what is happening as of late, and if you look at the [inaudible 00:19:09] case, and you look at the [inaudible 00:19:12] case and the Nikola case, on those three cases, you have situations where the SPACs D&O policy, the tail is in play from a claim perspective, the private company's tail is in play from a claim perspective and the De-SPAC going forward, public companies D&O insurance is in play. The plaintiff's bar has three limits to go after.

Lynda Bennett: Yeah, the insurers aren't going to be loving that. And it will get very complicated when you have three different insurers issuing each one of those policies. Let the finger-pointing begin. All right, Rob, before we wrap up here, can you just talk briefly about how you get your D&O policy to align with the lifecycle of the SPAC. One of the concerns that I have in investigating this area is making sure that you've got full prior acts coverage. And then you just touched on the tail, how do we put this cradle-to-grave coverage in place?

Robert Crocitto: So the first thing we do, let's focus on the public SPAC first. So we put in place a public D&O policy for the SPAC entity. And that policy will be written for a three-year period. There'll be a predetermined runoff or a tail in that policy. And that policy will run until such time as the business combination has been consummated with the target. So there's policy number one.

Policy number two, in most cases is the private company that targets D&O insurance that's in place. And usually the target has a D&O policy in place. Sometimes it doesn't and we have to make provisions to get them coverage, to cover anything that happened from that targets, from the inception of its corporate existence forward. And that targets D&O insurance will run until also when the business combination is consummated.

And then we have the third policy that comes into play, which is the De-SPAC, the going forward public company, D&O policy. And that policy will typically be written with prior [inaudible 00:21:30], but it will usually pick up the road show activities of the private company because of the SEC exclusion that would take place in the private companies D&O insurance.

So we have three platforms, De-SPAC, D&O and it's life cycle, the private company, or the target companies, D&O and its life cycle. And then we have the going forward, public De-SPAC company and its lifecycle. And it's very important that when this deal is being done, that your attorneys are making certain that the effective dates line up, that the coverages lineup. Because if you have a one day gap between the going forward policy for the public entity and the private company's tail, you could have no coverage for the entire transaction because you have a gap and the underwriters, if they can find it, if the claims folks can find a gap, they're going to point it out and it's going to create all kinds of problems, very important that you get your corporate attorneys to review that transaction from an insurance perspective. It needs to be done with someone who has an insurance background, especially someone who's proficient in directors and officers liability.

Valeska Pederson Hintz: And also to start it early, I'm a deal attorney. So one of the first things I do when we start a deal, De-SPAC, or the SPAC IPO, is to reach out to Lynda and her team and Rob and start getting the right coverage in place because you really have to start very early. And if you don't, it's going to delay the deal.

Lynda Bennett: Great. Well, I'd like to thank both Valeska and Rob for joining us today. There's one thing that's certain from this discussion, which is we're at the front end of the insurance issues. So the deals are going to keep happening. And as Rob, you mentioned, the lawsuits tend to lag a couple of years behind after the deals have happened and expectations haven't been met. So we'll certainly be happy to have you both come back and we'll do maybe a snapshot year in review this time 2022, but I really do appreciate your time and your knowledge today, and we'll see everybody next time. So thanks for joining us.

Robert Crocitto: Thanks for having me, Lynda. Thanks Valeska.

Valeska Pederson Hintz: Thank you, both.

Kevin Iredell: Thank you for listening to today's episode. Please subscribe to our podcast series at lowenstein.com/podcasts, or find us on iTunes, Spotify, Pandora, Google podcasts, and SoundCloud. Lowenstein Sandler podcast series is presented by Lowenstein Sandler and cannot be copied or rebroadcast without consent. The information provided is intended for a general audience. It is not legal advice or a substitute for the advice of counsel. Prior results do not