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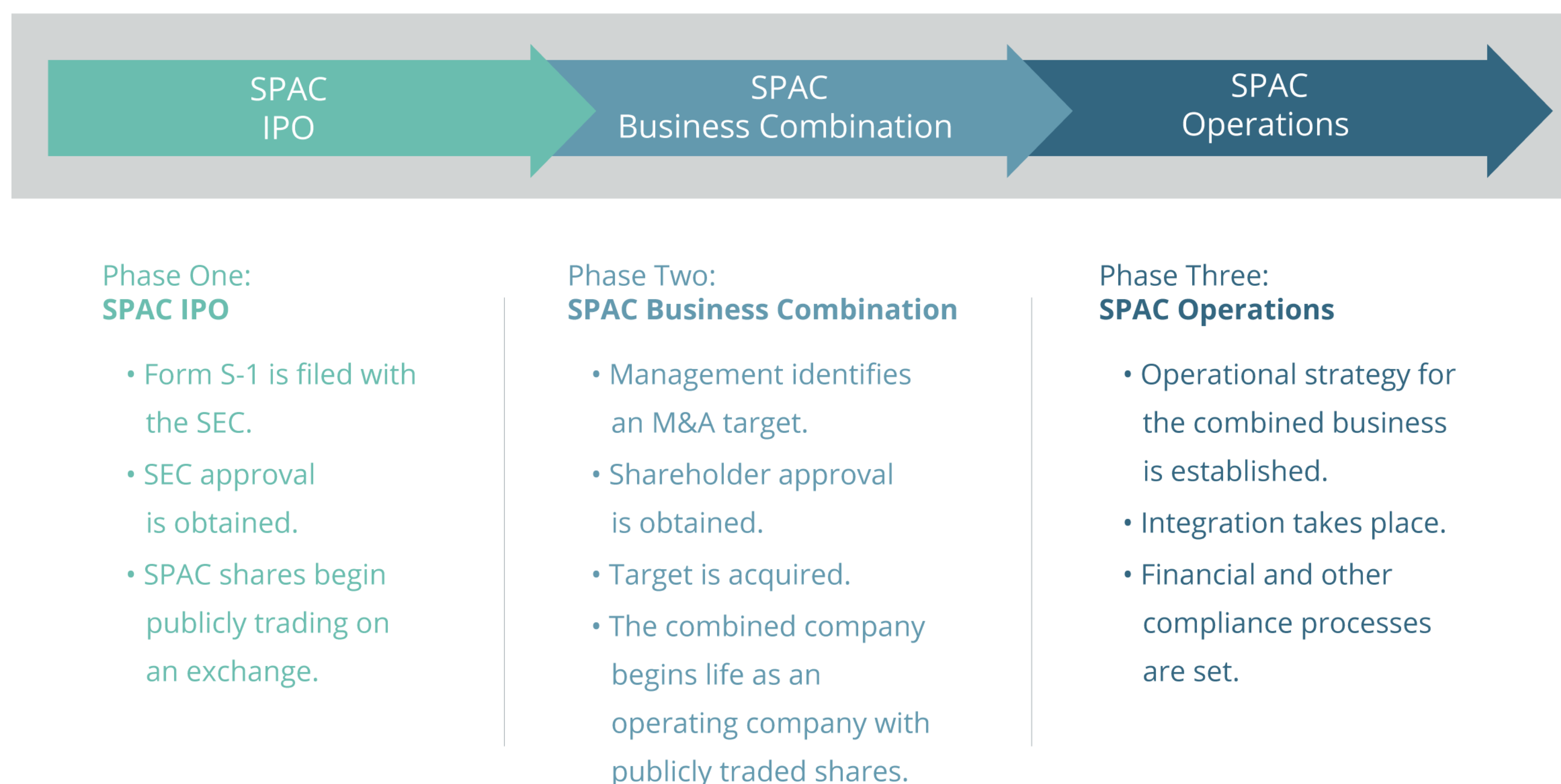
A Guide to Insurance for SPACs

SPACs (special purpose acquisition companies) face many hurdles as they go through the IPO and the subsequent M&A process. With some smart planning and the help of the right advisors, insurance can move from being a hurdle to a strategic asset.

Woodruff Sawyer is the market leader for placing Directors and Officers (D&O) insurance for IPO companies. Woodruff Sawyer is also a nationally recognized leader when it comes to Representations and Warranties (RWI) insurance, a critical element of the SPAC M&A process.

SPAC Life Cycle

When thinking about insurance for a SPAC, it is helpful to think in terms of the SPAC's life cycle. From an insurance perspective, there are three main phases:



The insurance needs of the SPAC are different at each of these phases, as illustrated and further discussed below.

Phase One: IPO

The main assets of a SPAC as it goes through the IPO process are its management team, the management team's investment strategy, and the SEC's approval of the SPAC Form S-1 registration statement.

Need for D&O Coverage

The SPAC's sponsor selects the SPAC's directors before the IPO, and other directors are appointed soon after. The fact that the common stock of the SPAC is publicly traded after the IPO makes the management team and the SPAC's directors particularly vulnerable to lawsuits from public investors. Operating companies that go through an IPO process are sued frequently and for a variety of reasons. Lawsuits are brought by stockholders against a company's management and directors and usually allege material misstatements and omissions in the IPO registration statement. Given that SPACs are not operating companies, their IPOs see far less litigation than most—but lawsuits are still a possibility. (e.g., *Welch v. Meaux et-al.*).

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The vulnerability brought on by public company exposure creates a need for directors and officers (D&O) liability insurance coverage for the SPAC's management team and its existing board. Moreover, a majority of a SPAC's board must consist of independent board members to satisfy stock exchange listing rules. Professionals who serve as independent board members typically do not accept a board appointment without a good D&O insurance already in place.

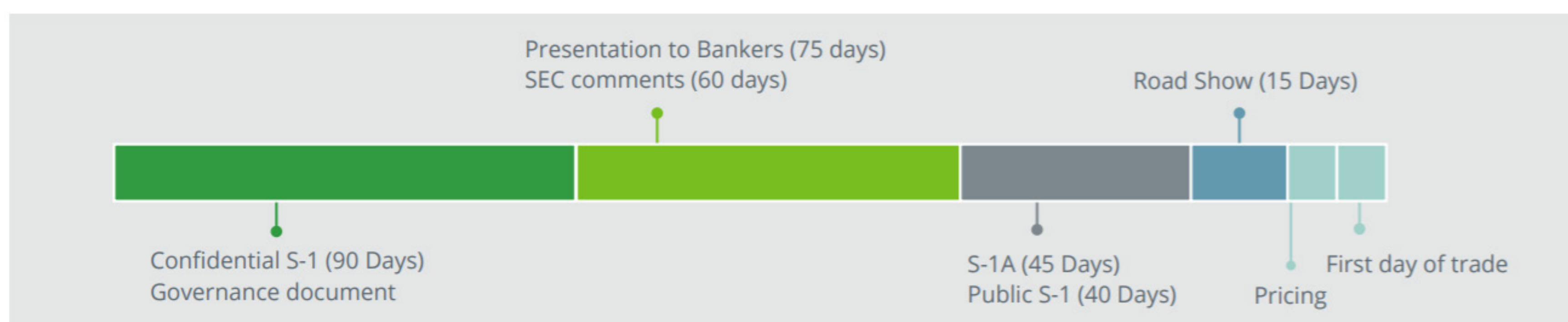
D&O Costs are Increasing

The litigation environment has gotten much worse recently as a consequence of a 2018 Supreme Court decision, *Cyan v. Beaver County Employees Retirement Fund*. Lawsuits are now brought in multiple jurisdictions, including federal and state courts. Plaintiff law firms have been quick to capitalize on the Supreme Court's ruling, which in turn has driven up the cost of D&O insurance dramatically for new IPO companies compared to the cost for mature public companies.

What Your Insurance Broker Must Know

Given the quickly changing nature of the D&O insurance market, the peculiarities of SPAC IPO companies, and the high cost of D&O insurance for IPO companies, choosing the right insurance brokerage is a must. Working with an insurance broker who merely works with a lot of public companies will not optimize your outcome. To get the best D&O insurance coverage at the best possible price, it is critical that your D&O insurance broker has extensive and current experience working with IPO companies. In addition to having the expertise to recommend the best insurance policy placement options, it will benefit you if your broker also has extensive experience managing claims for IPO companies.

It is no surprise that placing D&O insurance for an IPO company is a complicated process. Starting early makes a critical difference to the outcome, so you will want to involve your trusted D&O insurance broker in your IPO planning process from the very beginning.



For a more detailed look at this process, check out our *Guide to D&O Insurance for an IPO*.

Furthermore, the insurance broker must understand and guide the SPAC management team through the milestones in its D&O insurance coverage as the SPAC proceeds through its life cycle. A knowledgeable broker will be able to pre-negotiate the cost of the SPAC's D&O insurance coverage for the 18-24 months of its pre-business combination lifespan prior to the first day of trading.

Phase Two: SPAC Business Combination

After the IPO, the SPAC has the funds to purchase or merge with another company. The SPAC's management team must find an attractive target and complete the merger or acquisition, typically within 18 to 24 months after the IPO. When the management team approaches potential acquisition targets, which are typically private companies, M&A representations and warranties insurance (RWI) comes into play. However, the management team must also consider and plan for D&O insurance coverage of the post-business combination entity. Let's take these one at a time.

M&A RWI Insurance Coverage

More and more SPACs are folding RWI into their acquisition strategies. For a relatively low premium, RWI provides an insurance backstop to the buyer if the seller's representations and warranties turn out to be flawed. Buyers also typically prefer not to sue the management of the target that may have produced the flawed representations if that management now works for the combined company. Looking to the RWI for compensation and leaving management out of a lawsuit goes a long way towards maintaining a productive employee environment.

RWI is also a very attractive option for the seller because it allows the seller to reduce the amount of the purchase price that would otherwise be held in escrow.

In addition, RWI can be an important differentiator for a SPAC that is courting a reluctant private company or a private company with multiple suitors. The availability of private funds ready for deployment and looking for investment opportunities has created a very competitive M&A environment over the last few years. Added competition from private equity, venture capital, and strategic buyers has resulted in a strong seller's market, in which buyers grasp at any opportunity to differentiate themselves from the pack of eager suitors.

Indeed, a well-designed RWI policy allows a SPAC to offer the same purchase price, but with minimal or no seller indemnity and with minimal or no escrow. Because RWI is now almost a market standard in auction processes and is likely to be offered and used by the rest of the competition. Excluding RWI from its offer effectively puts a buyer at a serious disadvantage.

Moreover, for SPACs that are under extra pressure to close their acquisition transactions before their post-IPO 18- or 24-month deadline runs out, spending management time and efforts on failed auction processes can be fatal.

RWI Market Trends

The insurance market, now a lot more familiar with the M&A representations and warranties product than even just four or five years ago, has changed and adjusted to consumer demand and competition. It has gone from just a handful of carriers offering the product in 2016 to over 20 insurers competing for the same business in 2020.

Competition and familiarity have significantly driven down the policy premiums. What would once have cost 4%–4.5% of the policy limit has now dropped down to 2.5%–3.0%, dipping even lower for larger deals. The self-insured retention (a.k.a. a deductible) built into the policy has been pushed to 1% or just under 1% of the enterprise value of the transaction, making the policies even more attractive.

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RWI policies aren't just for big deals anymore. The minimum limits for these policies have come down from $5 million to, in some cases, $2.5 million. Minimum premiums now range between $150,000 to $200,000. RWI insurance being placed for transactions having an enterprise value as low as $20 million is no longer unheard of.

Insurance carriers are also more efficient in their diligence review process, which allows them to reduce the processing time of the policy to between one and two weeks. In addition, some of the policy exclusions that used to be standard a couple of years ago have been curtailed or even eliminated.

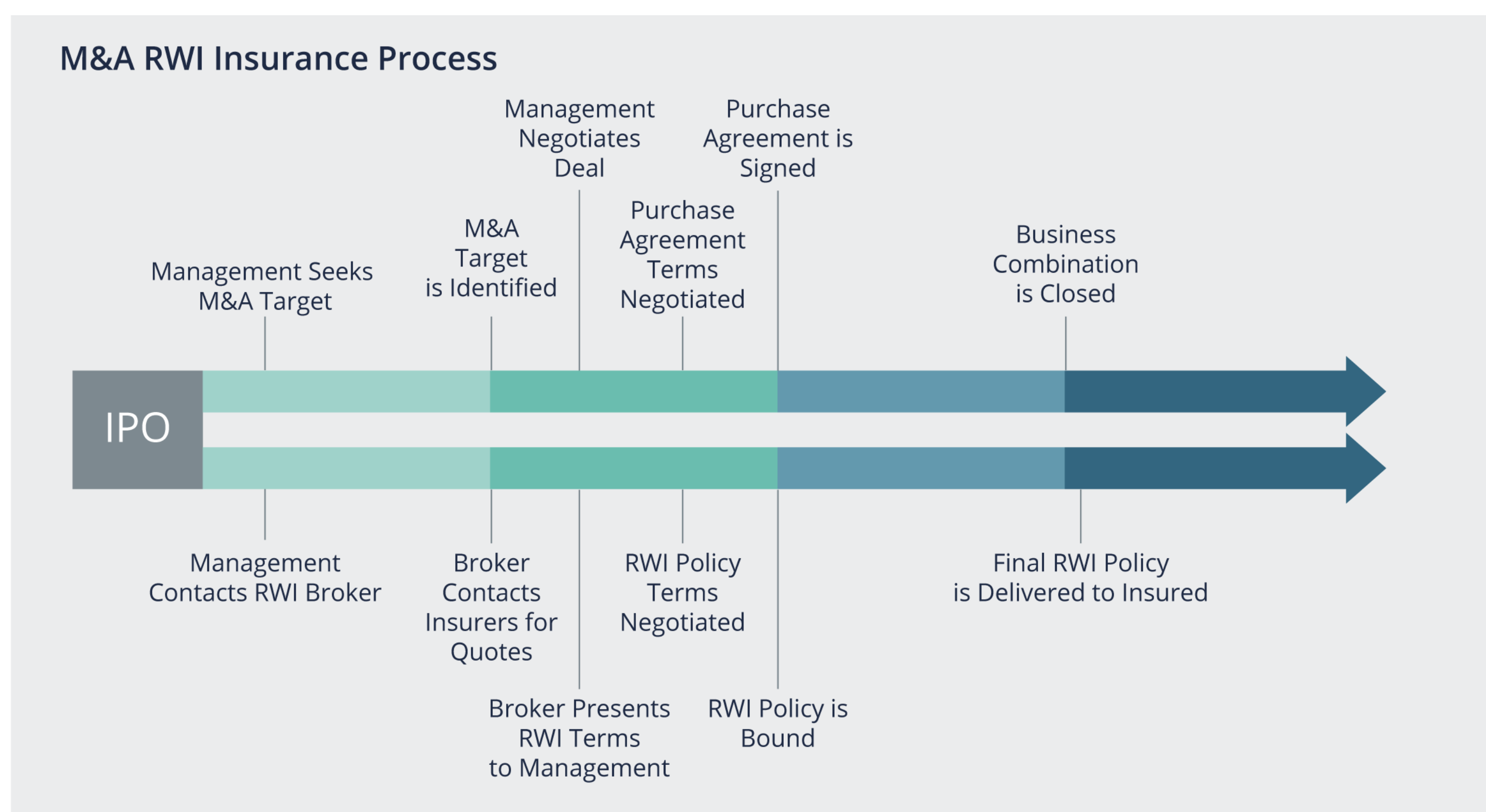
These factors have created the environment in which SPAC management teams can now take advantage of the RWI market.

Woodruff Sawyer's RWI placement process is highlighted below.

RWI Insurance Placement Process

Placement of an RWI policy can be accomplished in about two weeks.

If planned for in advance, the insurance placement process can run along the acquisition timeline so as to avoid holding up the acquisition schedule.



D&O Insurance Coverage

The D&O and the RWI insurance policies need to be approached in concert. As soon as the parties close on the business combination, the D&O coverage of the SPAC and that of the target entity are no longer in effect. The new entity's directors and officers must be covered by a new D&O insurance policy.

Specifically, there are three different D&O policies that need to be addressed before the transaction closes: (1) the SPAC company's D&O Policy, (2) the target company's D&O policy, and (3) the D&O insurance that needs to be put in place for the new combined entity (which is, of course, a new publicly traded company).

The issue with the first two policies is making sure that there is coverage if a claim arises after the merger transaction closes but the activities in question took place before the closing date. These two policies need a "tail policy" added to them, which is to say that additional premiums have to be paid to the D&O insurance carriers so that the policies will continue to respond after the closing date. This cost is typically a one-time payment of 150% to 300% of annual premium. The tails for both the SPAC and the target company will cover past acts from the date of inception for a 6-year going forward period and will require a one-time premium to be paid at the closing of the business combination for each respective policy. Note that the cost of the D&O tail for the SPAC is typically negotiated when placing the initial D&O insurance policy for the SPAC IPO.

The D&O policy for the going-forward public company will cover the newly combined company for claims based on actions taking place after that transaction closes. This looks and feels like the D&O insurance policy of any new, publicly traded operating company.

Phase Three: SPAC Operations

At this point the combined company is up and running—and carrying with it all the attendant risks of an operating public company. As such, the company needs to be ready for public company scrutiny, which calls not only for ongoing compliance with all necessary regulations, but for a review and usually an upgrade of the company's overall insurance coverage. This can mean upgrading everything from the company's property insurance to the company's *cyber liability insurance*.

Ongoing D&O Coverage

The operating company must establish a process around its annual D&O insurance renewal. Starting the renewal process early with an expert D&O insurance broker saves on time, aggravation, and premiums. Companies optimize the process when they are prepared. Getting up to speed on the litigation environment and the current state of the insurance market is a key step. A great resource for this can be found in the *Woodruff Sawyer 2020 D&O Looking Ahead Guide*. Having trusted advisors on your side ensures your success.

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As one of the largest insurance brokerage and consulting firms in the US, Woodruff Sawyer protects the people and assets of more than 4,000 companies. We provide expert counsel and fierce advocacy to protect clients against their most critical risks in property & casualty, management liability, cyber liability, employee benefits, and personal wealth management. An active partner of Assurex Global and International Benefits Network, we provide expertise and customized solutions to insure innovation where clients need it, with headquarters in San Francisco, offices throughout the US, and global reach on six continents.

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