Litigation Risks and Insurance Issues for SPAC Sponsors[i]

Over the past two years, special purpose acquisition companies ("SPACs") have become a popular means of taking private companies public. SPACs accounted for 247 public listings in 2020 (52% of all initial public offerings ("IPOs") for that year) and 613 in 2021 (59% of all IPOs that year).[ii] While the SPAC craze has cooled somewhat in recent months, SPACs are likely to account for a significant number of public listings in 2022 as well.

As one would expect, the eruption in SPAC transactions over the last two years has given rise to a corresponding uptick in SPAC-related lawsuits. These include securities class actions, shareholder derivative lawsuits, and breach of fiduciary duty actions. SPACs have also been in the crosshairs of the SEC.

This article analyzes SPAC-related litigation and regulatory risks from the perspective of the private equity firms that increasingly sponsor SPACs, as well as the insurance coverage implications associated with such risks.

Overview of SPACs

SPACs, also known as "blank check" companies, are shell companies without any operations or revenue, which serve as investment vehicles through which retail investors partner with the SPACs' "sponsors" to invest in private companies seeking to go public.[iii] Generally, SPAC transactions proceed as follows:

- The sponsor takes the SPAC public on the promise that the SPAC will use the capital raised in the IPO to seek out and acquire an unspecified target.[iv]
- Following a SPAC's IPO, investors' capital is held in trust while the SPAC's management team searches for a suitable target to acquire. SPACs are given a limited timeframe (typically 18-24 months) to locate a target and close a deal.
- SPACs that fail to make an acquisition within the pre-set timeframe must return the money raised in the IPO to its investors.
- However, if a SPAC does identify a target that it believes would make for a lucrative investment and the target is amenable to being acquired on the terms proposed by the SPAC, the SPAC and the target will merge to produce a single public company, with the SPAC investors' shares being converted into shares of the post-acquisition company. The merger of the SPAC and the target is referred to as the "de-SPAC" transaction.

In exchange for their investments, retail SPAC investors are given shares in the SPAC, which are converted into shares of the go-forward entity at a set price (usually $10/share) should the SPAC succeed in making a deal. As an added incentive to invest, investors are also given warrants to purchase additional shares in the post-acquisition company. Meanwhile, the SPAC sponsor generally receives a 20 percent ownership stake in the go-forward entity if they succeed in accomplishing a deal.

Shareholder Litigation Concerning SPACs

SPAC-related litigation has been on the rise in the last two years. The nature of these suits varies based on the defendants named and whether they are brought before or after the de-SPAC transaction.

Claims brought following the de-SPAC are similar to securities lawsuits brought against other public companies, arising under Section 10(b), Section 14(a) and/or Section 20(a) of the Securities Exchange Act. Often, plaintiffs allege that the surviving entity made material misstatements or omissions and, upon

making a corrective disclosure, the share price dropped, causing loss to the shareholders. These suits differ from traditional shareholder litigation insofar as the potential defendants include not only the surviving public company and its directors, but also the SPAC, its sponsor, and their principals. Liability against the sponsor is generally premised upon its control over the SPAC and the go-forward entity. For example, in *Camelot Event Driven Fund v. Alta Mesa Resources, Inc.*, Plaintiffs sued the surviving entity (Alta Mesa), the SPAC's sponsor (Riverstone Holdings), and several individuals that served as directors and officers of Alta Mesa, including those who were also Riverstone partners.[v] Plaintiffs alleged the SPAC's management team, including multiple Riverstone partners, made misleading, overly optimistic financial projections in its pre-merger proxy statement, which were then dramatically reduced in Alta Mesa's first 10-K filed post-merger. The suit, which is ongoing at the time of this article's publication, seeks to impose liability on Riverstone for pre- and post-merger misconduct based on its control over the SPAC and the go-forward entity and its alleged pursuit of a merger that benefited its interests but not those of the retail shareholders.

Shareholders may also bring direct or derivative claims for breach of fiduciary duty. These claims typically arise out of an alleged conflict between the SPAC sponsor and the other investors. Plaintiffs claim that the way SPACs are typically structured may lead the SPAC sponsor to prioritize any acquisition rather than seek out the best deal for investors. Often, SPAC sponsors stand to benefit financially regardless of whether the transaction is a success. SPAC sponsors typically invest a relatively minor sum of cash in the SPAC, but are entitled to receive a large equity stake (normally 20%) in the surviving entity following a successful SPAC merger. This often represents a significant financial windfall to SPAC sponsors even if the surviving entity's share price performs poorly, resulting in losses for the SPAC's retail investors. But, if no deal is closed, SPAC sponsors walk away empty-handed. Based on the foregoing potential for conflicting incentives, shareholders sometimes allege that the SPAC's sponsors and their management teams were motivated to perform inadequate due diligence prior to agreeing to the merger, leaving the other investors left to deal with the fallout post-closing. This was the gist of the allegations in *Delman v. GigAcquisitions3, LLC*.[vi] There, GigCapital, a Silicon Valley private equity firm, formed GigCapital 3, Inc. (SPAC) and GigAcquisitions3, LLC (Sponsor) and completed a de-SPAC transaction with Lightning eMotors, Inc. The suit named the sponsor, as well as several individuals who are members of GigCapital and exercised control over the SPAC, including Avi Katz, GigCapital's founder, who owned the sponsor and served as CEO and Chairman of the SPAC. The sponsor allegedly stood to lose $6.5 million if no de-SPAC transaction occurred. Plaintiffs claim this motivated the SPAC's board to withhold material information from investors and recommend the deal without proper due diligence. While shareholders claim significant losses, the SPAC sponsor purportedly received $39 million from the deal.

While not unique to SPAC litigation with private equity sponsors, one trend becoming more common is the reliance on short seller reports. Investors taking a short position in the de-SPAC entity (that is, they stand to benefit if the stock price drops) may issue reports challenging statements made by the SPAC promoting the transaction. If the short sellers prove to be correct, their report may serve as roadmaps for subsequent lawsuits. According to Cornerstone, more than 20 percent of filings in 2021 referenced a short-seller report.[vii] Private equity firms entering the SPAC space should be aware of this trend.

SPACs may also face exposure before the de-SPAC transaction. Following its IPO, the SPAC must hold investor funds in trust until a target company is acquired. In some instances, investors have filed suit against the SPAC and its sponsor during this interim period, asserting claims under the Investment Company Act of 1940 and the Investment Advisors Act of 1940. These suits claim that the SPAC is an "investment company" because its only activity following the IPO is to invest the capital raised. Likewise, they claim the sponsor is an "investment advisor." Investment companies and investment advisors must register and are subject to various restrictions, including on compensation. Pershing Square Capital Management, L.P.

found itself in this situation when a shareholder of its sponsored SPAC filed suit after more than one year passed with no de-SPAC transaction.[viii] During that time, funds raised through the SPAC's IPO were invested in treasury bills and money market accounts.

There is also litigation risk associated with PIPE (private investment in public equity) funding of SPACs post-IPO. In some instances, capital raised during the IPO may be insufficient to complete the desired de-SPAC transaction. In such situations, the SPAC may raise additional funds through a private placement of SPAC securities. Unlike retail investors, PIPE investors are able to conduct their own due diligence and negotiate the terms of their investment, including various concessions from the SPAC. These transactions, though, are not without risk. For example, in *Sustainable Opportunities Acquisition Corp. v. Ramas Capital Management, LLC*, Ramas Capital Management and its affiliates were sued from more than $200 million after allegedly failing to fund its investment.[ix]

Conflicts of interest also pose potential problems for private equity sponsors of SPACs. One obvious case is when a private equity firm sponsors a SPAC and then finances a PIPE. More generally, SPAC transactions may raise concerns for investors in a private equity sponsor's traditional portfolio, including that the firm is prioritizing SPAC deals and diverting valuable attention and resources away from its other funds. Private equity firms' involvement in SPACs may also raise concerns that the firms are diverting their management fees toward SPAC-related operations that the traditional investors have no part in, and from which they do not stand to benefit.[x]

Regulatory Risk Affecting SPACs

Shareholder litigation is not the only risk facing SPACs. In the past year, regulators in and outside the US have indicated that they are devoting special attention to SPAC transactions.[xi] Most notably, SEC Chairman Gensler expressed concern about SPACs on several occasions in 2021, and in January 2022, he explicitly called on the SEC staff to develop rules addressing several concerns about SPAC investments—namely, conflicts of interest between sponsors and public investors, information asymmetries among SPAC investors, and the use of fraudulent or misleading marketing materials in SPAC IPOs. He indicated an intent to bring de-SPAC transactions in line with traditional IPOs, subjecting them to the same disclosure requirements. The SEC has also supported draft legislation that would exclude SPACs from the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.[xii]

The SEC has also undertaken several enforcement actions in connection with SPAC deals. For instance, the SEC charged a SPAC and its sponsor (among others) for allegedly making misleading claims about the target entity, a space transportation company known as Momentus Inc.[xiii] According to the SEC, investors were misled to believe that Momentus had successfully tested its space propulsion technology. In reality, Momentus' space test had failed to achieve the primary mission objectives or demonstrate the viability of its technology. Following an investigation, the SEC determined that the SPAC had violated the negligence-based antifraud provisions of the federal securities laws. Ultimately, the SPAC and its sponsor consented to an order enjoining future securities violations and agreed to pay a civil penalty of $1 million and $40,000, respectively. The SEC enforcement action spawned a securities class action and a shareholder derivative action against the SPAC, its sponsor, and other parties involved in the transaction.[xiv]

Given the SEC's apparent heightened vigilance regarding SPAC investments, we expect its efforts to identify and prosecute instances of SPAC-related misconduct to continue or increase in 2022.

Insurance Coverage & SPAC-Related Claims

From an insurance coverage perspective, SPAC-related lawsuits and enforcement actions are notable because they often involve multiple insurance towers and raise complex questions regarding capacity and allocation. Claims arising from a SPAC investment may implicate several insurance programs, including the management policies issued to (1) the SPAC itself, (2) the target company, and (3) the go-forward entity.[xv] Claims arising from SPAC investments also frequently name the SPAC's sponsor and/or its directors, officers, or partners, which means that the sponsor's insurance program could also be implicated by a SPAC-related claim. Private equity SPAC sponsors, for example, are most often covered by general partnership liability policies, which afford: (1) primary coverage in connection with claims that name the sponsor or the sponsor's individual partners or officers in their capacity as such, and (2) "double excess" coverage for the sponsor's individual partners or officers who are named solely in their capacity as officers or directors of the SPAC.[xvi] While the landscape is constantly evolving, typically, a private equity firm could expect its partners to be covered under the SPAC's or surviving entity's D&O program because any alleged misconduct would likely be, at least in part, in their management roles of same. An issue may arise, however, if the SPAC fails to carry adequate limits. In that case, the private equity policy will usually provide outside director liability coverage, with no retention, for the individual partners. Conversely, the private equity firm will not be covered under the SPAC's or surviving entity's D&O program (unless it is affirmatively written into the policy). As a result, the private equity firm's GPL policy will generally respond where the SPAC-related lawsuit names the private equity firm and/or its principals in their capacity as such.

Regulatory investigations likewise have the potential to implicate one or more of these four insurance programs that are typically associated with a SPAC transaction. However, because D&O and general partnership liability policies vary with regard to whether and to what extent they cover investigations, this analysis will be dependent on the nature of the investigation and the specific policy language. Where the policy does cover the kind of regulatory investigation being prosecuted, the same policy placement and allocation issues will apply.

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As the SPAC boom continues, private equity SPAC sponsors and their insurers are advised to closely review their GPL polices, the scope of coverage afforded under same, and adequacy of policy limits to ensure that the expectations of all implicated stakeholders are protected.

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[ii] Phil Mackintosh, *A Record Pace for SPACs in 2021*, NASDAQ (Jan. 6, 2022 5:55 PM) https://www.nasdaq.com/articles/a-record-pace-for-spacs-in-2021.

[iii] SPACS are distinguishable from the shell companies that had been used to perpetrate penny stock and pump-and-dump scams in the 1980s, which were also occasionally referred to as "blank check" companies.

[iii] Ramey Layne & Brenda Lenahan, *Special Purpose Acquisition Companies: An Introduction*, HARV. LAW SCHOOL FORUM ON CORP. GOV. (July 6, 2018), https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/.

[iv] *Id.*

[v] *Camelot Event Driven Fund, A Series Of Frank Funds Trust v. Alta Mesa Resources, Inc. F/K/A Silver Run Acquisition Corporation II et al.*, 4:19-cv-957 (S.D. Tex.).

[vi] *Delman v. GigAcquisitions3, LLC, et al.*, 2021-0679-PAF, (Del. Ct. Ch.).
[vii] *Securities Class Action Filings: 2021 Year in Review*, 32 CORNERSTONE RESEARCH (last viewed Feb. 15, 2022), https://www.cornerstone.com/wp-content/uploads/2022/02/Securities-Class-Action-Filings-2021-Year-in-Review .pdf.
[viii] *Assad v. Pershing Square Tontine Holdings, Ltd., et al.*, 21-cv-6907 (S.D.N.Y.)
[ix] *Sustainable Opportunities Acquisition Corp. v. Ramas Capital Management, LLC*, 1:21-cv-07642 (S.D.N.Y.).
[x] Julie Segal, *'Frustrated' Limited Partners Are Questioning PE-Sponsored SPACs*, Institutional Investor (Apr. 12, 2021), https://www.institutionalinvestor.com/article/b1rcrgrnwy2dp0/Frustrated-Limited-Partners-Are-Questioning-PE-Sponsored-SPACs.
[xi] *Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies*, U.S. SECURITIES & EXCHANGE COMMISSION (Mar. 31, 2021), https://www.sec.gov/news/public-statement/division-cf-spac-2021-03-31.
[xii] John Coates, *Statement: SPACs, IPOs and Liability Risk under the Securities Laws*, U.S. SECURITIES & EXCHANGE COMMISSION (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.
[xiii] *SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination*, U.S. SECURITIES & EXCHANGE COMMISSION (July 13, 2021), https://www.sec.gov/news/press-release/2021-124.
[xiv] *See In re Stable Road Acquisition Corp. Securities Litigation*, 2:21-cv-5744 (C.D. Cal.); *Ciccotelli v. Stable Road Acquisition Corp. et al.*, 066895/2020 (N.Y. Sup. Ct., N.Y Cty.).
[xv] SPAC-related litigation may also trigger representations and warranties coverage maintained by the SPAC (if any).
[xvi] Where coverage is afforded on a "double excess" basis, coverage would only be available in excess of (1) any other insurance coverage afforded to such individuals via the SPAC's and/or the go-forward entity's insurance policies, and (2) any indemnity available to such individual insureds from the SPAC or the go-forward entity.