SPACs:
Insurance Issues, Opportunities and Concerns

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Introduction

Fueled by the surge in leveraged buyouts, mergers and acquisitions activity reached record heights in 2006.[1] As cheap debt and easy access to capital continue to intensify competition for deals, many market players are turning to alternative, non-traditional acquisition strategies. Among the increasingly popular avenues is a unique vehicle known as a special purpose acquisition corporation, more commonly called a "SPAC."

SPACs are public corporations created for the sole purpose of acquiring a future, as yet unidentified, company. The anticipated transaction is funded by an initial public offering of securities purchased by investors willing to financially back the acquisition strategy and management's ability to implement it. Given the "blind pool" nature of the investment, SPACs contain structural protections for shareholders, including holding most (85% to 90%) of the offering proceeds in trust for exclusive use in the acquisition. Before the transaction ultimately can take effect, it must conform to specific rules and conditions and be approved by a majority of the shareholders.[2] Further, a SPAC's founders and management are required to hold a 20% ownership in the company, with that ownership typically including warrants that trigger upon completion of the transaction. Failure to follow these rules will result in dissolution of the SPAC and the return of proceeds to shareholders (and *not* management).

These protections have given mainstream financial buyers confidence in SPACs sufficient to support their deployment for high profile acquisitions as well as larger offerings overall.[3] With SPACs expected to continue gaining prominence, it is important to understand how insurance can both protect the interests of management and founders, as well as enhance the overall value of the future transaction.

D&O: Rightsizing a program for your SPAC

The management risk profile of a SPAC can be complicated, and due diligence is required to ensure that a SPAC's directors and officers (D&O) insurance needs are adequately addressed. The good news is that the pricing environment for D&O remains soft, as an excess of capacity is driving significant competition among insurance companies. This is true despite a number of indicators that

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[1] The value of global deals rose 30% over 2005 to $3.7 trillion, with almost 40% of that total involving companies in the U.S. "Global M&A at All Time High in 2006: $3.7 trillion," *Metrics 2.0* (December 21, 2006). http://www.metrics2.com/blog/2006/12/21/global_ma_at_all_time_high_in_2006_37_trillion.html.

[2] The transaction must also be completed within 18-24 months of the IPO, involve a target that competes within the specific industry or category described in the Registration Statement, and the value of that target must be at least 80% of the value of the SPAC. Dissenting shareholders have the right to convert their shares to cash under the trust and, if greater than 20%, demand such rights the deal is blocked.

[3] More than $1.2 billion in SPAC capital was raised in 2005 alone—a dramatic rise from the $500 million seen in 2004. Kit Roane, "Business Buffet: When Hungry Investors Want to Make a Meal of a Company, They Can Pool Their Millions in Something Called a SPAC," *USNews.com* (January 30, 2006). http://www.usnews.com/usnews/biztech/articles/060130/30spacs.htm.

suggest legitimate cause for concern, from record re-statements to executive compensation to increased exposure outside the United States.

Despite its soft pricing, however, D&O continues to be one of the most intricate areas of insurance, necessitating considerable time and attention to deal with a myriad of intersecting terms and issues. This is particularly true for SPACs, given their unique structure and operational mandate. The fact is that most D&O forms require considerable revision to meet the needs of the SPAC community. Accordingly, a SPAC's management and insurance brokers typically need to aggressively negotiate with underwriters to make the appropriate coverage modifications.

Among the central concerns that should be kept in mind are:

- **Pre-IPO communications:** While the D&O insurance becomes effective upon the IPO, management's risk predates that event, so the D&O policy should include express provisions regarding representations made during the offering road shows.

- **Policy term*:*** Most D&O insurance policies are written for 12-month terms. SPACs, however, by definition operate for at least 18 months (possibly 24 months under certain circumstances). Most carriers competing seriously in this sector will offer an 18-month policy term. The policy should also be structured to account for a possible extension to address an acquisition, or dissolution and liquidation.

- **Acquisition threshold:** Since merger and acquisition (M&A) activity is a key D&O risk driver, many carriers will only automatically cover acquisitions valued below a defined threshold during the policy period. SPACs, by rule, have to acquire a company or companies whose fair market value is at least 80% of the SPACs' net assets. The asset threshold thus needs to be waived, at least for the initial policy term.

- **Change of control:** D&O policies are designed to convert into run-off[4] in the event the Named Insured is acquired by another entity or otherwise undergoes an event deemed a change of control. This provision needs to be waived or amended.

- **Section 11 claims:** Characterization of damages arising from misrepresentations in the registration statement can have enormous

[4]When a D&O policy converts into run-off, the insured may continue to notice claims until the end of the policy period, but only for Wrongful Acts that occurred prior to the event that triggered the change of control. Coverage for Wrongful Acts occurring after that date would be provided under the acquirer's going forward coverage.

implications for a D&O program. While this issue continues to evolve, corrective language can be negotiated with certain carriers.

- **Program Structure:** While not specific to SPACs, careful consideration should always be given to the type of program selected. D&O programs can be highly customized and should be structured to meet your specific risk philosophy, taking into account overall limits, as well as equalizing the balance between protecting the corporate balance sheet and your individual assets.

Insurance as a strategic tool

Often overlooked is the strategic role insurance can have in the M&A context. Insurance has become an essential tool of significant value beyond traditional risk management. From due diligence to risk products, insurance coverages and services can provide critical insight into the underlying value of any transaction and can remove obstacles that threaten a deal's closure.

Due Diligence: As insurance-related risks are among the expenses tallied in the discounted cash flow and the "earnings before interest, taxes, depreciation and amortization" (EBITDA) measurements upon which strategic and financial acquisitions are valued, insurance due diligence should be an integral part of any financial due diligence analysis. This should include both a qualitative and quantitative assessment of the impact on earnings, where hidden under-funding, over-funding or pricing of insurance issues can significantly impact results.

Transaction Risk Insurance: Specialized products deploy insurance capital to facilitate transactions by addressing both known and unknown exposures. They can greatly enhance the value of any transaction and help close a deal by replacing uncertainty with certainty, thereby driving overall shareholder value. These complex products include:

- **Representations and warranty insurance:** protects against risks associated with breaches of the seller's representations and warranties in the purchase and sale agreement
- **Environmental:** protects against undisclosed and/or undiscovered pollution exposures
- **Tax indemnity:** provides protection for a particular tax treatment in an underlying opinion
- **Litigation buyout:** caps or transfers liabilities associated with a known, but not yet quantified, loss event

Conclusion

SPACs offer a company's management and investors a unique way to capitalize on the current M&A boom. These creative structures, however, pose a number of insurance challenges as well as opportunities. A SPAC's management should work with their insurance brokers to both create an appropriate D&O program and explore how insurance can strategically help derive the most value from the enterprise.

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