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Why SPACs Should Consider Captive Insurance

By **Jeffrey Raskin and Lauren Burke** (March 29, 2021, 5:44 PM EDT)

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With special purpose acquisition companies, or SPACs, increasingly being used in initial public offerings and the commercial insurance market continuing to harden, captive insurance could be a solution for offering directors and officers protection against increased shareholder scrutiny and resulting derivative lawsuits.

The use of SPACs, also known as blank check companies, is showing no sign of slowing down. SPACs now make up nearly 70% of initial public offering activity and continue to attract deep-pocketed sponsors, including high-profile athletes and public figures, drawn to market opportunities with potential for big investment returns and liquidity.

SPACs target businesses across multiple sectors and engage in accelerated acquisitions that often expose directors and officers to shareholder scrutiny. To attract and retain qualified directors and officers (both before and after acquisition), SPACs must offer comprehensive directors and officers liability coverage to protect against that increased exposure and resulting derivative lawsuits.

But this insurance hurdle is becoming tougher to clear as the commercial D&O insurance market continues to harden. Captive insurance could be the solution to fill the insurance gap, including any timing gap.

SPAC Life Cycle and Insurance Needs

A SPAC is a nonoperating company created by a sponsor solely to raise funds in the public securities markets to acquire a private operating company in the short term. SPACs present unique insurance needs due to their fast-tracked life cycle and willingness to dabble in hot, emerging sectors marked by high risk/reward and by volatile private company valuations, frequently with no earnings history.

The short life cycle of the insuring relationship can make availability and pricing even more difficult in that SPACs often seek short-term policies (18 months to two years) with no intent to renew.

SPACs involve a three-stage life cycle: (1) initial price offering; (2) business combination; and (3) new public company, with insurance needs at every step of the way.

Once the combined company is fully operating, it carries with it all the risk of a public company, including the risk of public shareholder derivative lawsuits. The combined company will need a new D&O policy to cover operations post-closing, as well as coverage for property and casualty lines, and necessary specialty coverages, such as employment practices, cyber, fidelity and fiduciary policies.

D&O Insurance

D&O insurance protects a company and its corporate directors and officers in the event of a suit for actual or alleged wrongful acts in managing the company. Directors and officers are covered for claims not otherwise excluded made during the policy period for wrongful acts. Public companies are covered for securities claims made during the policy period resulting from wrongful acts.

D&O insurance in the commercial market for newly public companies like SPACs with no track record can be prohibitively expensive or completely unavailable. The recent emergence of post-de-SPAC merger securities suits[1] may cause some D&O insurers to exit this market altogether if they perceive claims will arise within weeks of policy issuance. A perception that a SPAC bubble may soon burst may increase market reticence even further.

With the surge in SPAC IPOs combined with a general hardening of commercial insurance markets and the current hesitance of many commercial insurers to write D&O coverage, SPAC sponsors may be left with a gap in the D&O market that makes it hard for SPACs to get off the ground.

Indeed, high-quality directors will not accept appointment to a SPAC without adequate D&O insurance protection to backstop and supplement the company's indemnification obligations.

The Captive Solution

Captive insurance is a solution to fill coverage gaps or a means to control insurance terms and conditions. A captive insurer is a wholly owned subsidiary that is licensed to insure the risks of its affiliated companies through the issuance of insurance policies in exchange for the payment of a premium.

A specialized actuary retained by the captive typically sets the premium, which is composed of a loss reserve and a risk margin. Captive insurance can be utilized flexibly at any level of the insurance tower, or at varying levels dependent on the risk insured.

Captive insurance offers cost-saving benefits, in addition to filling a market void:

- ***Investment of Risk Premium:*** In the captive setting, the risk premium is retained by the captive and is invested for the benefit of its parent and affiliated businesses. By contrast, in a typical commercial insurance setting, the third-party insurer keeps the risk margin, which is the expected profit from the risk being insured.

- ***Tailored Coverage:*** Insurance coverage counsel can prepare a manuscript policy tailored to the specific needs of the businesses affiliated with the captive. By contrast, a third-party commercial insurer typically uses a standard form policy typically utilized by the issuing insurer with exclusions added to limit the scope of coverage.

- ***Access to Reinsurance:*** A captive provides its insured with access to the broader reinsurance market where opportunities may exist to shift a portion of the captive's risk to reinsurers in a cost-effective manner.

- ***Tax Savings:*** Generally, loss reserves of a captive insurance company can be immediately deductible (on a discounted basis) for tax purposes under Internal Revenue Code Section 832, thus accelerating the tax deduction within the company's consolidated group and monetizing the associated deferred tax asset. Courts look to four criteria in deciding whether an arrangement constitutes insurance for federal income tax purposes: (1) the arrangement involves insurable risks; (2) the arrangement shifts the risk of loss to the insurer; (3) the insurer distributes the risk among its policy holders; and (4) the arrangement is insurance in the common accepted sense.

- ***Potential Risk Transfer Mechanism:*** A captive can serve as a risk transfer vehicle to shift risk over time. This is particularly beneficial for SPACs as they rapidly progress through the three-stage life cycle. One captive could be used to serve the evolving insurance needs of the SPAC, or, if desired, risk could be shifted throughout the life of the SPAC and beyond via loss portfolio transfer; regardless, investment income earned in the captive is captured and maintained through each stage.

Important Delaware Law Considerations

Unique challenges exist to protect directors and officers from Side A claims where commercial insurance is unavailable, particularly for SPACs, which are often formed as Delaware corporations.

Delaware law is highly protective of corporations, including SPACs, and directors and officers of corporations. Delaware has a well-established public policy of encouraging capable qualified officers and directors to serve corporations, and advances that policy by "largely enabling ... the indemnification rights of corporate officers and directors."[2]

Yet, to further a competing policy against circular indemnification, Delaware law prohibits a company from indemnifying its directors and officers directly for derivative settlements and judgments. The company is permitted, however, to purchase insurance to pay for such nonindemnifiable claims.[3]

A captive arrangement may offer an attractive solution provided the arrangement is properly structured such that it qualifies as insurance, applying the four-part test set forth above.

Delaware courts are experienced in handling complex corporate transactions and their insurance ramifications. Because of the importance of Delaware law and its unique indemnification law that favors a captive solution for protecting directors and officers, we encourage considering a captive option whenever feasible to do so.

Captive Options

There are several captive funding options that should be carefully considered when exploring a potential D&O coverage captive solution:

- ***Pure Captive***: The captive is owned and operated for the benefit of a single parent company. An unrelated, third-party captive manager can be appointed to manage the administrative side of the captive. Formation and operating costs are high compared to other captive funding options.

- ***Cell Captive/Rent-a-Captive***: The captive is owned, managed and controlled by an unrelated entity for a fee. Cell captives provide for a fast startup and a quick dissolution with no liquidation costs — attractive features for the accelerated SPAC life cycle.

- ***Group Captive***: The captive is owned proportionally by a group of entities with similar risks. The scope of risk insured is limited to what the group will agree to insure. Group members must work cooperatively in the life of the captive.

The captive funding option most suited for SPAC insurance needs may depend upon the phase of the SPAC life cycle at issue.

Pre-business combination or de-SPAC, the pure captive option may be least desirable from cost-benefit perspective because of the expense and time required to get the captive established to serve a short-term need.

The group captive option is attractive in theory with its cost-sharing benefits and a growing pool of similarly situated SPAC players with comparable insurance needs. In practice, however, this option requires close coordination among unrelated entities and potentially competitors on an accelerated basis; herding the cats to get the captive in place in time to fill insurance needs may present a prohibitive challenge.

The cell captive is perhaps the most viable solution for this phase of the SPAC lifecycle because of the speed and relative low cost in which the captive can be set up to serve its time-sensitive insurance purpose.

Post-combination, the captive funding options are on more equal footing. In theory, the new public company will operate like a traditional company and have long-term needs that could benefit from any captive funding investment.

Regardless of the option selected, using a proper actuarial study, implementing claims procedures and following insurance accounting practices are critical to demonstrating that the captive should be treated as an insurance company.

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[1] https://www.dandodiary.com/2021/03/articles/securities-litigation/electric-engine-technology-company-hit-with-post-de-spac-merger-securities-suit/.

[2] Hermelin v. K-V Pharm. Co., 54 A.3d 1093, 1094 (Del. Ch. 2012); see also VonFeldt v. Stifel Fin. Corp.,

714 A.2d 79 (Del. 1998) (recognizing that Del. Code Ann. tit. 8, § 145 serves the policy of "encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity").

[3] See TLC Beatrice Intern. Holdings, Inc. v. CIGNA Ins. Co., No. 97-Civ. 8589 (MBM), 1999 WL 33454, at *6 (S.D.N.Y Jan. 27, 1999) ("The apparent rationale for choosing insurance over indemnification [for settlement payments in a derivative action] is that it strikes a balance between the employment concerns of corporations and the Delaware legislature's wish for a 'non-circular' solution in a derivative action.").