

Shareholder Derivative Suits: A Growing Concern for Corporate Directors and Officers

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Securities class action suits—filed by shareholders when alleged negligence or fraud by a company's directors or officers leads to a loss of shareholder value—are the most significant cause of claims under directors & officers (D&O) insurance policies for public companies. Suits against companies such as Enron and WorldCom have dominated the headlines, but virtually any public company can find itself targeted by disgruntled shareholders and their attorneys. Less prominent, but of growing concern to D&O underwriters, is a similar type of suit known as a shareholder derivative suit or derivative action.

Derivative suits are filed by shareholders on behalf of a company. They allege that the company's directors or officers violated one or more fiduciary duties owed to the company and its shareholders. Typically, plaintiffs don't seek to extract monetary damages, but rather they seek to protect their long-term interest in the company by imposing corporate governance and management changes. If there is a monetary recovery, it runs to the firm, not to the individual plaintiffs.

Attorneys are actively and successfully soliciting institutional investors to be plaintiffs in derivative actions. Advisen's analysis of derivative actions between 1993 and 2004 finds that there has been a material increase in rulings since 2002 after years of comparative stability. These suits are expensive to defend and can be highly disruptive to a company. While relatively few derivative actions result in monetary recoveries, the Cendant case, which resulted in a \$54 million settlement, confirms that these suits hold the potential for very large losses.

Shareholder derivative suits are increasingly filed in tandem with securities class action suits. This trend should be of concern to corporate directors and officers. If the securities class action suit exhausts the insurance recoveries available from a company's traditional D&O insurance policy, directors and officers may find themselves without coverage for the defense costs and any monetary settlement of the shareholder derivative suit. A comparatively new type of D&O policy—the so called Side A-only policy—can provide additional protection in this situation.

The Basis of Liability in Shareholder Derivative Actions

There are two broad categories of breach of fiduciary duty that underlie derivative actions: duty of loyalty and duty of care. Breach of duty of loyalty is typically easier to prove. Basically, duty of loyalty means that a director or officer may not profit at the expense of the company, but instead must put the company's interests first. Suits seeking relief under the duty of care theory allege that a company's directors or officers failed to manage corporate affairs honestly and in good faith. In either case, the burden is on the plaintiff to demonstrate a violation has occurred.

Unlike securities class action suits, derivative lawsuits usually are filed in state court. A company's state of incorporation determines where a derivative action would be filed. Most derivative actions, therefore, are filed in Delaware and other corporate-friendly states.

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Recent Trends in Shareholder Derivative Suits

Analyzing derivative action rulings from 1993 to the present, with a particular focus on rulings since June 2003, we found:

- There is an upward trend in the number of derivative action rulings.
- About half of derivative actions are dismissed. Few of the settled cases result in monetary relief. Defense costs and awards for plaintiff's attorney fees, both of which can be substantial, are the greatest monetary exposure for directors and officers and their insurers.

For cases resulting in monetary relief, values typically are relatively low. A study by the Contracting and Organizations Research Institute (CORI)—now 10 years old—found that the mean monetary settlement is \$4.2 million, and the median is \$2 million. Cendant, with its \$54 million settlement, remains an outlier, but it is a sobering reminder of the magnitude of the liability directors and officers can be subject to under these suits.

The heightened focus on corporate governance issues in the wake of Enron, WorldCom, et al, and the subsequent passage of the Sarbanes-Oxley Act, is grist for the mill for lawyers in search of plaintiffs for derivative suits. Our analysis found that institutional investors are being actively courted by the securities class action plaintiffs' bar. As an example, prominent securities class action attorney William Lerach, speaking at the Council of Institutional Investors 2001 Spring Meeting, encouraged attendees to aggressively pursue litigation as a way to exercise influence over the companies in which they invest. Institutional investors are heeding the advice of the plaintiffs' bar. As a result, there is likely to be a further increase in derivative suits filed in parallel with shareholder securities suits.

Derivative Actions and D&O Insurance

To date, the major monetary exposures resulting from derivative actions to directors and officers and their insurers are defense costs and awards for plaintiff's attorney fees. Since monetary relief is rare, plaintiff's attorneys are motivated to settle quickly, extract their fees from the defendants or their insurer, and move on to the next case. Defendants also are motivated to settle quickly. D&O insurance policies typically do not cover judgments in which there is a determination of dishonesty on the part of management, as often is alleged in these cases. Consequently, many settlements are structured such that management does not admit to dishonesty and thereby can retain insurance coverage. Individual defendants, understandably, may prefer to settle rather than risk the expenses of personal liability in case of an unfavorable judgment.

A surge in derivative actions could result in an increase in claims under Side A-only policies, which can protect directors and officers from losses not otherwise indemnified by the company or its insurers. Side A-only policies typically provide coverage when recoveries under the traditional D&O programs are unavailable because of company bankruptcy, when the company is prohibited by law from indemnifying its directors and officers, if the event is excluded under the traditional policy, or when the limits of the traditional policy have been exhausted. Side A-only policies are especially likely to respond to claims from suits filed in states (including Delaware) that do not permit corporate indemnification of directors and officers for unsuccessful defense or settlement of derivative actions, or for derivative actions filed in tandem with securities class action suits that may exhaust recoveries under the traditional D&O policies.

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