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Underwriters of D & O and Professional Liability Insurance

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In this issue … A look at Shareholder Derivative Lawsuits.

Introduction

In 2007 the UnitedHealth Group derivative lawsuit over options backdating settled for around $900 million, making it at the time the largest ever derivative settlement. In 2008 an AIG derivative lawsuit settled for $115 million, and this year there has been both a $2.87 billion derivative settlement against Richard Scrushy, former CEO of HealthSouth Corp. and a $118 million settlement in the Broadcom derivative litigation. These cases have turned a spotlight on a lesser-known type of shareholder litigation: the derivative action.

Securities Class Action Lawsuits versus Derivatives

Media and industry attention is typically focused on Securities Class Action (SCA) lawsuits. Brought by shareholders who generally allege that their investment has been damaged by wrongful acts of the corporate executives, these actions are an attempt by plaintiffs to obtain a measure of financial compensation for their losses. The tally of SCA lawsuits is closely watched, and the Stanford University SCA Clearinghouse web site is generally recognized as the unofficial scorekeeper. The Clearinghouse's weekly announcements of new SCA filings are read intently by industry pundits looking for underlying causes and trying to spot trends. These SCA lawsuits are where the majority of insured D&O liability losses occur.

Derivative lawsuits, in contrast, are ostensibly exercises in shareholder altruism. Initiated not for the recouping of their own financial loss, derivative lawsuits are brought by shareholders in the name of the company and allege that damage has been done to the company and that the company—not the suing shareholders—must obtain redress.

Some Characteristics of Derivative Lawsuits

- While a derivative lawsuit may be brought in tandem with a SCA lawsuit, it can also be brought in isolation, either in federal court or state court. However, derivative suits can demonstrate an extra level of complexity, as it is possible for suits to be filed in multiple state jurisdictions in addition to the federal forum. While these state suits may eventually become consolidated into one venue, this multi-jurisdictional element, often with non-concurrent timing, can initially cause confusion and drive up the attendant legal expenses.

- Derivative lawsuits have to overcome some significant hurdles if they are to survive a motion to dismiss them. In Delaware, domicile state of most publicly- traded companies, these hurdles include the "Business Judgment Rule." This rule is a pragmatic recognition that corporate executives have to make decisions, and that those decisions are generally made in good faith even if the results are sometimes unfortunate. This "right to make honest mistakes" can be a powerful defense against allegations of wrongful acts by executives.

A second obstacle to derivative actions is the requirement that shareholders must appeal to the board of directors before litigating, asking the board to take action to repair the alleged damage done to the company. If the company responds with a reasonably independent evaluation of the alleged wrongdoing and concludes that there are insufficient reasons for a derivative claim to be pursued, the complaining shareholders are usually prevented from proceeding with a derivative suit.

However, plaintiffs can sidestep an actual appeal by instead claiming "demand futility." This plea essentially states that because the board is so compromised, any such appeal would be a waste of time.

Both the Federal Rules of Civil Procedure and case law require "particularity" for a "demand futility" plea to succeed, which is a formal way of saying that plaintiffs have to explain exactly why such a demand would be futile.

- The settlement value of derivative settlements is typically lower than for SCA settlements; part of the settlements often include an undertaking by the company to implement certain corporate governance reforms and practices to help ensure the alleged shortcomings do not recur. Although these reforms have no monetary value, what do have monetary value are plaintiffs' attorneys' legal fees which are generally awarded as part of a settlement. In the past this has led some observers to feel that the imperative for derivative actions comes less from unselfish shareholders looking out for their company than from opportunistic lawyers looking for revenue.

- Derivative actions are not governed by the Private Securities Litigation Reform Act (PSLRA) of 1995 which applies to federal securities class action lawsuits. A feature of the act is a provision that imposes an automatic stay on discovery while a motion to dismiss a SCA lawsuit is under consideration. The main reason for this is to protect defendants from incurring significant expenses in complying with discovery (the process where parties to a lawsuit can request documents and other evidence from each other) in a situation where the lawsuit is eventually dismissed. Because derivative actions do not generally have this restriction, discovery can commence almost immediately, generating additional costs that must be paid even if the derivative suit is dismissed.

The PSLRA does allow exceptions for the stay to be lifted, and the very fact that a simultaneous derivative suit is proceeding with its own discovery process has helped persuade at least one judge to grant that request.

Non-Indemnifiability

For the D&O insurance market perhaps the most significant feature of derivative actions is that resulting liability is generally not permitted to be indemnified by the company. This is largely a matter of common sense: If an executive is found liable for a derivative award that award is typically payable to the company. If the company then indemnifies the executive with the money it receives from the executive, the money is simply going around in circles, and the exercise becomes meaningless.

Being non-indemnifiable, any derivative liability is therefore pushed into Insuring Agreement A ("Side-A") of the typical D&O policy. In this way the money given to the executive by the insurers is passed to the company—and stays there.

This non-indemnifiable exposure from derivative suits means that individuals can face the threat of personal liability. Increasing competition among plaintiff attorneys may result in extraordinary efforts to demonstrate their value to the shareholders who hired them, and such efforts might include specifically requiring executives to make a personal financial contribution to any settlement. A determination by attorneys to prove their worth in dollars might also serve to reduce the use of governance reforms in favor of the more substantive monetary compensation to the company.

Summary

The multi-million dollar sums mentioned at the beginning of this newsletter are eye-opening exceptions to the usual assumptions about derivative settlements. It will take more than a handful of extreme and possibly anomalous cases to indicate a systematic alteration of the derivative landscape, but these events will almost certainly have an impact on D&O insurance. Insurance buyers and their brokers will probably re-evaluate their level of Side-A protection, especially the need for a separate and secure Side-A / DIC program. Such high settlements and the ever-burgeoning cost of defense will likely make the providers of insurance reconsider their exposure, and wonder whether the premiums they are getting are sufficient for the risk. Conventional wisdom has been that Side-A / DIC coverage is generally guarding against financial insolvency; that may be changing.

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Chicago Underwriting Group, Inc.
Web: www.cug.com
Email: info@cug.com
Phone: (312) 750-8800
Fax: (312) 750-8965

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