

Recent developments in shareholder derivative suits

The threat of shareholder derivative actions is a growing cause of concern for corporate directors and officers. This type of lawsuit traditionally called only for changes in corporate governance, but increasingly they have resulted in huge monetary settlements. In 2008, for example, Maurice “Hank” Greenberg and three other former American International Group, Inc. executives agreed to pay \$115 million to settle a shareholder derivative suit. Recently, an Alabama court entered a staggering \$2.9 billion judgment against former HealthSouth CEO Richard Scrushy in a derivative action. Board members and company executives need to be aware of the financial risks posed by derivative actions, and they need to take steps to help determine whether properly structured directors’ & officers’ liability (D&O) insurance programs with adequate policy limits are in place.

Overview of shareholder derivative suits

Shareholder derivative suits are brought by shareholders on behalf of a company, typically against the company’s directors or corporate officers. The cause of action for these suits is generally an alleged breach of fiduciary duty of the directors and officers, and can also include allegations of malfeasance such as excessive compensation, proxy violations and option plan violations. Any monies recovered are paid to the company after deduction of attorney’s fees. In order to bring a derivative claim, a shareholder plaintiff must show that he has either made a demand on the corporation’s board of directors that has been wrongfully refused, or that he can prove that such a demand would be futile.

Most shareholder derivative suits are filed in state courts. A company’s state of incorporation usually determines where a derivative action is filed. Therefore, many cases are tried in Delaware Chancery Court and in the courts of other states that are hospitable to corporations.

In the past, shareholder derivative suits demanded corporate governance changes and only rarely monetary awards. Monetary settlements averaged only a few million dollars. Since monetary settlements were comparatively rare and comparatively small, plaintiff’s attorneys were motivated to settle quickly, extract their fees from the defendant’s insurer and move on to the next case.

Analysts have long suggested that the impetus for shareholder derivative suits comes largely from the plaintiffs bar. Studies, however, have demonstrated that these suits nonetheless have been effective in policing corporate governance and implementing governance change.¹ In recent years, responsibility for these traditional roles of derivative actions has shifted in large part to regulators and independent directors. Additionally, the greater presence and heightened responsibilities of independent directors make it less likely that boards will be unresponsive to corporate governance problems, especially when brought to the board’s attention by disgruntled shareholders. As a result, some analysts conclude that shareholder derivative suits are declining in importance.²

¹ Stephen P. Ferris, Robert M. Lawless and Anil K. Makhiga, “ Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings,” Cori Working Paper No. 01 03, September 2001.

² Kevin Lacroix, “Do Derivative Lawsuits Still Matter?” Nov 27, 2007, <http://www.dandodiary.com/articles/shareholders-derivative-litiga/>

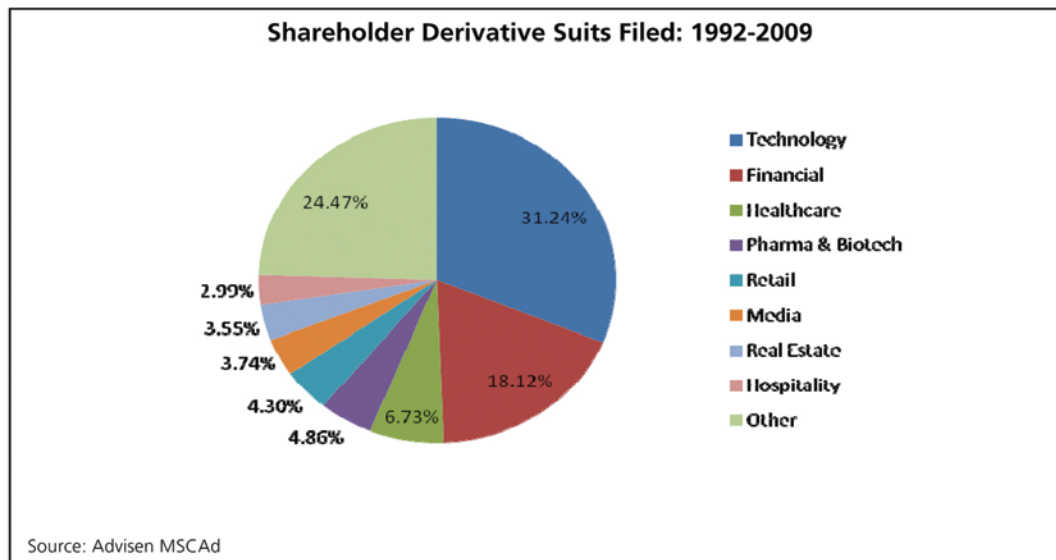
An area identified by one researcher, Wisconsin Law School Dean Kenneth B. Davis, Jr., where derivative actions are likely to be of ongoing value to companies and their shareholders is “cases seeking the return of a substantial benefit” to the company, which “pose a ... threat of personal loss to individual defendants.”³ While still representing a minority of suits filed, a growing number of derivative actions seek large monetary awards for the benefit of the company. In many cases, corporate directors and officers are indeed faced with the threat of a substantial personal loss.

Shareholder derivative suits also may be filed in cases when damages do not justify the expense of a securities class action suit, or where the higher pleading standards applied to federal securities class action suits make it likely that a class action suit will be dismissed. A large number of shareholder derivative suits, but only a comparatively small number of securities class actions suits, were filed in 2006 and 2007 naming the directors and officers of companies accused of backdating stock option grants. Presumably, the difficulty of proving that shareholders suffered material financial losses deterred securities class action filings, but allegations that corporate officers unjustly enriched themselves through the grants provided impetus for filing shareholder derivative suits.

When Centent Corp. settled a derivative action in 2002 for \$54 million, it sent shockwaves through the D&O insurance sector. Subsequently, a number of suits have settled for more than \$100 million. As noted previously, former HealthSouth CEO Richard Scrushy was slapped with a \$2.9 billion award. This most likely is a unique case where the fraudulent activity was especially egregious and extensive and not a harbinger of a new era of billion dollar-plus derivative action awards and settlements. Nonetheless, settlements in the tens of millions of dollars are increasingly commonplace.

Recent trends

As the chart below shows, the technology sector has accounted for nearly one-third of all shareholder derivative suits filed since 1992. Directors and officers of companies in the financial sector also have been frequently sued. The percentage of suits involving financial companies has increased significantly since 2007 largely as a result of the meltdown of the subprime mortgage market and the ensuing credit crisis.



³ Kenneth B. Davis Jr., “The Forgotten Derivative Suit,” *Vanderbilt Law Review*, Vol. 61, 2008, quoted in Kevin Lacroix, “Do Derivative Lawsuits Still Matter?” Nov 27, 2007, <http://www.dandodiary.com/articles/shareholders-derivative-litiga/>

“Follow-on” derivative actions

A not-so-recent trend, but one of continuing significance, is the filing of one or more derivative actions in tandem with a securities class action lawsuit. These often are referred to as “follow-on” derivative suits. Some analysts have concluded that the follow-on derivative action trend has been motivated by plaintiff’s attorneys seeking an alternative source for fees. Plaintiff firms may bring shareholder derivative lawsuits on behalf of a few institutional investors who would otherwise be passive members of the class in the securities class action lawsuit. However, filing a derivative action in tandem with a securities class action suits also can produce certain benefits for plaintiffs in pursuing the securities class action suit. For example, in securities class action suits, discovery is stayed until the court rules on defendants’ motion to dismiss. The derivative lawsuit has no similar stay of discovery. Plaintiffs, therefore, may seek early discovery in the derivative lawsuit in order to help them obtain information they ordinarily would not have access to and use this information to defeat the motion to dismiss in the securities class action.

The legacy of Bernard Madoff

The Bernard Madoff Ponzi scheme has spawned comparatively few derivative lawsuits to date, though some analysts expect an increase as investors weigh their litigation options. Madoff, founder of the respected Wall Street firm Bernard L. Madoff Investment Securities LLC, pleaded guilty to defrauding thousands of investors of billions of dollars. He was convicted of operating a Ponzi scheme that has been characterized as the largest investor fraud ever committed by a single person.

The Madoff derivative actions filed thus far are of a somewhat different character than typical shareholder derivative suits. In some Madoff derivative suits, shareholder and other stakeholder plaintiffs are not targeting individual directors and officers of companies in which they own stock, as often is the case in derivative actions. Rather, they are suing derivatively on behalf of funds in which they invested, parties that may have contributed to the Ponzi scheme losses through negligence or fraud. One example is a lawsuit brought by the Tomchin Family Charitable Trust, a \$7-million California charity, on behalf of the Rye Select Broad Market XL Fund. The suit alleges that the Fund’s general partner, Tremont Partners Inc., other Tremont-related defendants and the Fund’s auditor breached professional, fiduciary and contractual duties owed to the Fund.

Many experts now say with the benefit of 20/20 hindsight that there were many “red flags” about the Madoff operation. For example, other fund managers tried to replicate Madoff’s results and could not. They concluded that it was not possible that Madoff could be earning the return on investment he was claiming. As a result, courts may find that some managers of funds that invested with Madoff are liable for imprudently “putting their eggs in one basket” or for failing to perform due diligence regarding Madoff’s activities.

Subprime-related shareholder derivative lawsuits

The crisis in the subprime mortgage/mortgage-backed securities market was the catalyst for a large number of derivative actions filed in 2007 and 2008. Advisen has identified 51 of these cases. Subprime mortgages are loans to high-risk borrowers at higher interest rates than normal. Lenders sold these mortgages to investment companies who pooled them and created securities based on the performance of the loan pools. Many subprime mortgages had low initial “teaser” rates. When mortgage payments increased, many borrowers could not afford the payments and were unable to refinance because the housing market had crashed.

As defaults on subprime mortgages skyrocketed, companies holding various types of mortgage backed securities suffered massive losses. This in turn triggered shareholder derivative suits. For example, in late 2007, a derivative suit was filed against certain officers and directors of Merrill Lynch related to an \$8-billion write-down on the value of Collateralized Debt Obligations that were secured by subprime mortgages. The action alleged breach of fiduciary duties of care, loyalty and good faith, and also alleged gross mismanagement and the issuance of false and misleading financial statements. This

suit was recently dismissed without prejudice because of the acquisition of Merrill Lynch by Bank of America. The plaintiffs are allowed to file a renewed action based on the same underlying allegations as the dismissed action.

Directors and officers of companies in the financial sector – subprime mortgage lenders and investment banks in particular – overwhelmingly have been the target of subprime-related shareholder derivative suits. Nearly three-quarters of the suits filed involve financial companies. The non-financial sector lawsuits are largely concentrated in the real estate sector.

Backdated stock option shareholder derivatives suits

Stock options backdating occurs when a company grants stock at a date in the past when the stock price was lower than on the date the stock options were actually issued. This usually results in an immediate paper profit. The beneficiary of this practice was typically the CEO, though some companies extended the practice throughout the senior management ranks. Backdating options is not necessarily illegal, but failing to disclose the backdating to the Securities and Exchange Commission and shareholders may be. Questions about backdated options have plagued companies as diverse as Apple and The Cheesecake Factory. Many of the companies investigated and sued are in the technology sector.

Comparatively few securities class action suits were filed over backdating. Plaintiffs' firms apparently concluded that derivative actions were more effective given the limited loss in shareholder value that could be ascribed to this practice. These shareholder derivative suits allege, in many instances, directors and officers breached their fiduciary duties by (i) approving backdated option grants or reaping financial benefits as recipients of backdated options; (ii) permitting either affirmatively or as the result of inadequate controls the grants to be improperly recorded and accounted for on the company's records; or (iii) disseminating false financial statements, all to the detriment of the company. The suits frequently contend that defendants were unjustly enriched, and seek to recover "illegal profits."

Most shareholder derivative lawsuits related to backdated stock options were filed in 2006 and early 2007. Advisen is tracking 182 such suits, of which 55 have been dismissed and 48 have been settled. Another 17 have proposed or tentative settlements.⁴ As is the case in many shareholder derivative suits, a number of strong defenses are available to defendants, and it is likely that many more suits will be dismissed (historically, nearly half of derivative actions are dismissed⁵). However, insurers may still incur substantial defense costs even on dismissed cases.

Litigation against foreign companies to change corporate governance

In 2006, powerhouse class action law firm Lerach Coughlin filed a derivative action suit in Alaska state court in an effort to compel British Petroleum (BP) to change the structure of its board of directors. Only three members of the board of directors at the time of the suit lived in the United States, with two in Georgia and one in Illinois. Twelve of the 16 director defendants lived and worked in Great Britain and another was based in the Netherlands. The suit alleged that some of BP's executives failed to properly oversee BP's US operations, which exposed the Company to significant criminal and civil liability in connection with the 2005 Texas City refinery explosion which resulted in many deaths. At the time of the commencement of litigation, this case was seen as testing the reach of US Courts into the boardrooms of a British business institution. Ultimately, this case was dismissed due to lack of jurisdiction, but the plaintiffs were still able to get concessions from BP relating to its corporate governance. The BP suit raises the specter of shareholder derivative suits, filed in US courts, compelling non-US companies to accept American-style corporate governance structures.

⁴ Per Advisen MSCAd, as of August 24, 2009.

⁵ Xiaoning Li, A Comparative Study of Shareholders' Derivative Actions (2007, Uitgave Vanwege Het Instituut Voor Ondernemingsrecht, Rijksu) p. 101

The role of insurance in shareholder derivative suits

Prior to the recent surge in large settlements, the major exposure to D&O insurance policies resulting from derivative actions were defense costs and awards for plaintiff attorney's fees. While data indicate that nearly half of derivative suits are dismissed, the costs of defending these suits can nonetheless be significant. Now, corporate directors and officers and their insurers also must be concerned about large monetary settlements.

D&O insurance is designed to provide coverage for most derivative action settlements and defense expenses. However, because of certain features unique to derivative actions, certain policy provisions may respond differently than they would to settlements and defense costs for securities class action suits or other types of suits naming directors or officers.

Public-company D&O policies typically have three distinct insuring agreements, often referred to as Side A, Side B and Side C. Side A applies when the company cannot indemnify directors or officers for claims against them. Under Side B, the insurer reimburses the company for indemnifying its directors or officers as a result of claims made against them. Side C coverage insures the company for claims made directly against it. Since companies typically are prohibited by law from reimbursing their directors and officers for monetary judgments and settlements in shareholder derivative suits, Sides B and C usually do not come into play in a shareholder derivative suit. D&O insurance recoveries may be available from Side A of traditional D&O insurance policies. However, directors and officers may find they are competing among themselves, and even against the company, for limited insurance protection if a derivative action is filed in tandem with a securities class action suit or other securities-related suits that may devour D&O policy limits.

Directors and officers can reduce the problems created by standard D&O policies through a stand-alone Side A D&O policy. Side A policies can provide coverage directly to individual directors and officers when recoveries under the standard D&O programs are unavailable, typically when limits have been exhausted by other lawsuits. Side A policies also may provide broader coverage than is available under standard D&O policies. This is especially the case for so-called difference in conditions policies which provide directors with more expansive and sometimes custom-tailored coverage.

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