The Rise of Shareholder Derivative Actions

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Overview

In recent years, the risk from derivative lawsuits has risen substantially, making it more important than ever for companies to procure a comprehensive D&O insurance program. Just 15 to 20 years ago, many derivative lawsuits were filed as nuisance suits, presumably for leverage in some cases, and often alongside securities class actions. They typically resolved for nominal amounts or non-monetary solutions, such as corporate governance or therapeutic changes, though often accompanied by payment of plaintiffs' defense fees. We tracked derivative settlements from 2005 to 2023 and found that the total cost of settlements has indeed risen to new heights in recent years. For example, looking at a sample of 40 "large" (claim values of ~$30 million or more) derivative action settlements, we found only two large cases from the first four years (2005 to 2008), and they generated settlement costs totaling $237 million.

Compare that to the most recent four years and we see a dramatic change as we note that 22 of these 40 large derivative action settlements were from 2020 to 2023, and had settlement costs totaling almost $4 billion, including the largest case settled last year for a whopping $735 million.[1] Such severity is relatively new to standalone derivative action settlements, as nine of the top 11 most costly cases are also from these same last four years. Sources of settlement amounts include The D&O Diary, as footnoted below, but also Advisen, Institutional Shareholder Services publications, and press releases and articles from leading law firms in this space. When viewed together, this data confirms an important trend, sending a clear message for companies to adjust their D&O insurance coverage appropriately.

This paper discusses five important insurance considerations in light of the changes in the landscape for derivative claims. First, we explain the anatomy of derivative lawsuits, distinguishing them from securities class actions as relevant for coverage. Second, we address how key venues govern public company indemnification of director and officer defendants in derivative lawsuits, including the different coverages for defense costs and settlement costs. Third, we describe D&O policy language relevant to derivative claims. Fourth, we offer additional data on the frequency and severity trends of derivative lawsuits over the last 20 years. Finally, we highlight the implications of this data for public company D&O programs.

1. Anatomy of a derivative suit

The hallmark of a derivative claim is that it remedies harms to an entity. As the Delaware Supreme Court has explained, "[d]erivative suits enforce corporate rights and any recovery obtained goes to the corporation."[2] In contrast, securities class actions remedy direct harms, such as harms to individual shareholders. This key difference affects an entity's legal ability to indemnify directors and officers in connection with derivative claim settlements and judgments. That, in turn, impacts the availability of insurance coverage.

Derivative lawsuits are traditionally creatures of the common law that enforce corporate rights. Stockholders typically bring derivative actions in state court with the entity as a nominal defendant.[3] Courts often struggle to distinguish between a derivative claim and a direct action. In Delaware (the leading venue for incorporation), the Delaware Supreme Court recently reaffirmed that it applies a two-part test to distinguish a direct from a derivative claim, as follows: (1) who suffered the alleged harm (the corporation or the stockholders individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually).[4] The New York courts have adopted the same approach.[5]

The classic derivative cause of action is one against directors or officers, brought on behalf of the business entity, for breaches of fiduciary duties (e.g., due care, loyalty, good faith, candor, or oversight), waste of corporate assets, or unjust enrichment.[6] In recent years, there has been a rise in event-driven derivative litigation, seeking to hold directors and officers personally liable for alleged mismanagement leading to corporate liabilities.

In layman's terms, plaintiffs allege that directors and officers failedto supervise by not taking sensible precautions that would have prevented all or most of the loss. Of course, fiduciary duty claims may also arise in direct actions, and some recent cases involving those claims have resulted in large settlements.[7]

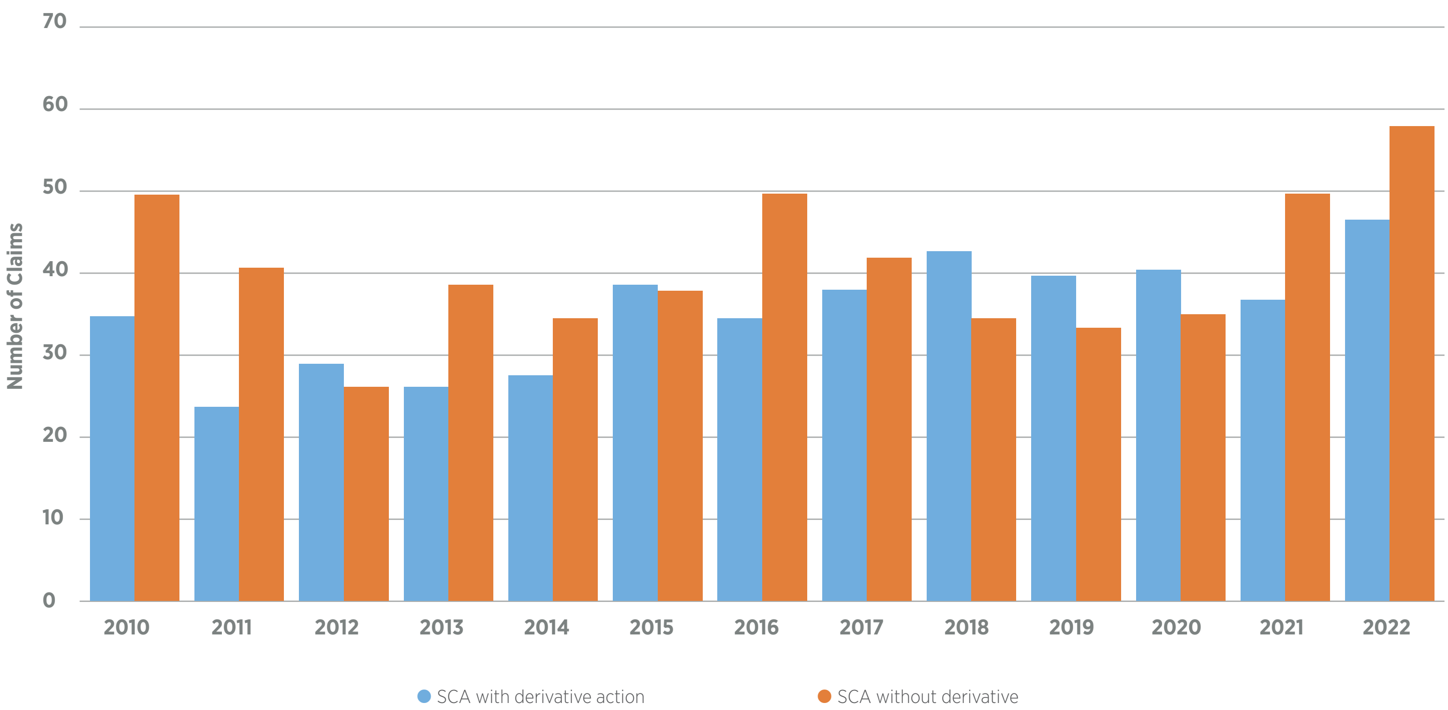
Most states impose pre-suit requirements for filing derivative complaints, requiring shareholders to make a pre-suit demand that the entity's Board of Directors investigate and decide whether to assert a claim. In general, if the Board wrongfully refuses a demand, or a demand would be futile, then a stockholder may file suit over the objections of the corporation. Demand futility is often the subject of litigation when stockholders go straight to court.

In contrast to derivative claims, securities class actions are typically brought directly by equity holders against business entities to address individual injuries under various federal statutes, rules, and regulations, such as the Federal Securities Act of 1933 (the '33 Act) or the Securities Exchange Act of 1934 (the '34 Act). The vast majority are brought in federal court.[8] The primary causes of action are based on alleged material misrepresentations or omissions in certain public filings, and stockholders often include tag-along claims against individual defendants for controlling person liability relating to the same allegations. Many securities class actions of significant concern allege violations of Section 10(b) of the '34 Act and Rule 10b-5 promulgated thereunder, and the financial recovery flows directly to the equity holder.

Corporate M&A transactions are routinely a target for both derivative claims and securities class actions. For example, in connection with a recent merger, the buyer's shareholders sued it under Sections 14(a) and 20(a) of the '34 Act, seeking to enjoin the transaction or, in the event that the transaction was consummated, awarding damages. The shareholders also made derivative demands, both before and after the merger, alleging that individual director defendants breached their fiduciary duties by agreeing to the sale for an inadequate price, among other allegations. This common scenario exemplifies how derivative claims often accompany securities class action lawsuits involving the same underlying allegations.[9]

In fact, the 2023 Cornerstone Research publication, Securities Class Action Settlements 2022 Review and Analysis, tracks these accompanying or parallel derivative actions. Based on their research, we created the following graph, which illustrates how often we see derivative suits accompanying securities class actions (or "SCA"), which is 50% of the time based on the last five years of closed claims. Further, the SCA median settlement cost for SCAs with an accompanying derivative action is 28% more costly than those without an accompanying case.

Trends for SCAs with derivative actions



The parallel derivative action often settles for a nominal amount, sometimes just plaintiff's attorney's fees, but as we've already noted, they have substantially increased the cost of the SCA that they accompany. See also Cornerstone Research's Parallel Derivative Action Settlement Outcomes (2022) for their in-depth analysis of the topic.

2. Impact of indemnification rights

Derivative claims raise questions about director and officer indemnification that do not typically arise in securities class actions. Directors and officers typically seek company indemnification for defense fees, and potentially also for the cost of any settlement or judgment, when they are named as defendants in claims arising from their service to the corporation. State law varies in terms of a corporation's ability to indemnify or advance costs to directors and officers in derivative claims. Indemnity and advancement rights are typically set forth in the corporation's organizational and governing documents, such as bylaws and certificates of incorporation, director/officer agreements, employment contracts, and state law. Corporations often enact governing provisions, or contractually agree, to provide indemnification and advancement to directors and officers to the fullest extent permitted by law.

In Delaware, for example, the Delaware General Corporation Law ("DGCL") requires a corporation to indemnify persons made a party to a proceeding because of their service to the corporation where there is success on the merits, but prohibits company indemnification of a corporate official who is found to have acted in bad faith upon final judgment.[10] For any claims falling between "the extremes of 'success' and 'bad faith,' the DGCL leaves the corporation with the discretion to determine whether to indemnify its officer or director."[11] Delaware also allows companies to provide for advancement of defense costs before resolution of the litigation.[12] The trend has been for corporations to adopt governing provisions requiring advancement of defense costs so long as the defendant was acting in capacity as a corporate officer and subject to providing an undertaking to repay amounts advanced if it is determined that indemnification standards were not met.[13]

Delaware places a key limitation, however, on indemnification in derivative suits. Significantly, Delaware law does not allow corporate indemnification of directors or officers for the cost of a settlement or judgment on a derivative claim.[14] The underlying logic is that reimbursement by the corporation to the directors and officers for derivative damages would be circular because the damages are owed to the corporation. Many other states apply the same principle. This keen logic also leads to the vast popularity of Side A D&O liability insurance, since without it, individuals would be footing the bills for such derivative action settlements and judgments.

3. Insurance coverage for derivative suits

Public company D&O policies typically provide three categories of coverage, referred to as the Sides A, B, and C insuring agreements. Side A protects the directors and officers where an entity is unable, unwilling, or not permitted by law to indemnify them, and Sides B and C reimburse the entity. In more detail, Side A provides "first-dollar" coverage for individual director and officer out-of-pocket loss because of claims for wrongful acts that are not indemnifiable by the entity. Side B reimburses the entity's loss for the costs of indemnifying director and officer defendants in connection with covered claims. And, Side C covers the entity's loss for securities claims (and the term "securities claim" is a defined term that typically includes shareholder derivative lawsuits brought against the entity as a nominal defendant). As a result, Side A typically has no retention, providing coverage from the first dollar, while there may be a significant retention before Sides B or C apply.

In addition to the traditional Side ABC structure described above, many companies purchase standalone Side A insurance to provide additional limits to protect individual directors and officers where the entity is unable, unwilling, or not permitted by law to indemnify them. The standalone Side A coverage ensures that corporate liabilities will not erode the policy's limit on liability, and there will be coverage left for the individuals. Standalone Side A policies often include "difference in condition" ("DIC") terms that provide broader coverage, with fewer exclusions, than traditional Side ABC policies and may drop down to fill coverage gaps in certain circumstances. In short, the recommended structure for publicly traded companies is to have significant standalone Side A insurance that is dedicated to the individual directors and officers in addition to the Side ABC cover. This approach protects for the fact that the traditional ABC insurance allows sharing of limits among the Sides A, B, and C insuring clauses, whereby a Side B/C claim could exhaust the ABC tower, leaving nothing for a follow-on Side-A derivative claim, if not for the standalone Side A policy limits.

Many Side ABC policies also offer coverage enhancements relevant to the stages of a derivative claim. For example, most policies cover the company's investigation of a pre-suit derivative demand, such as reimbursing the costs of engaging independent counsel to investigate and respond to allegations in a derivative demand letter. This coverage is often subject to a lower retention or no retention, and a sublimit may apply. However, coverage for derivative demand investigations can vary, and sublimits should also be negotiated throughout the excess layers within a D&O tower.

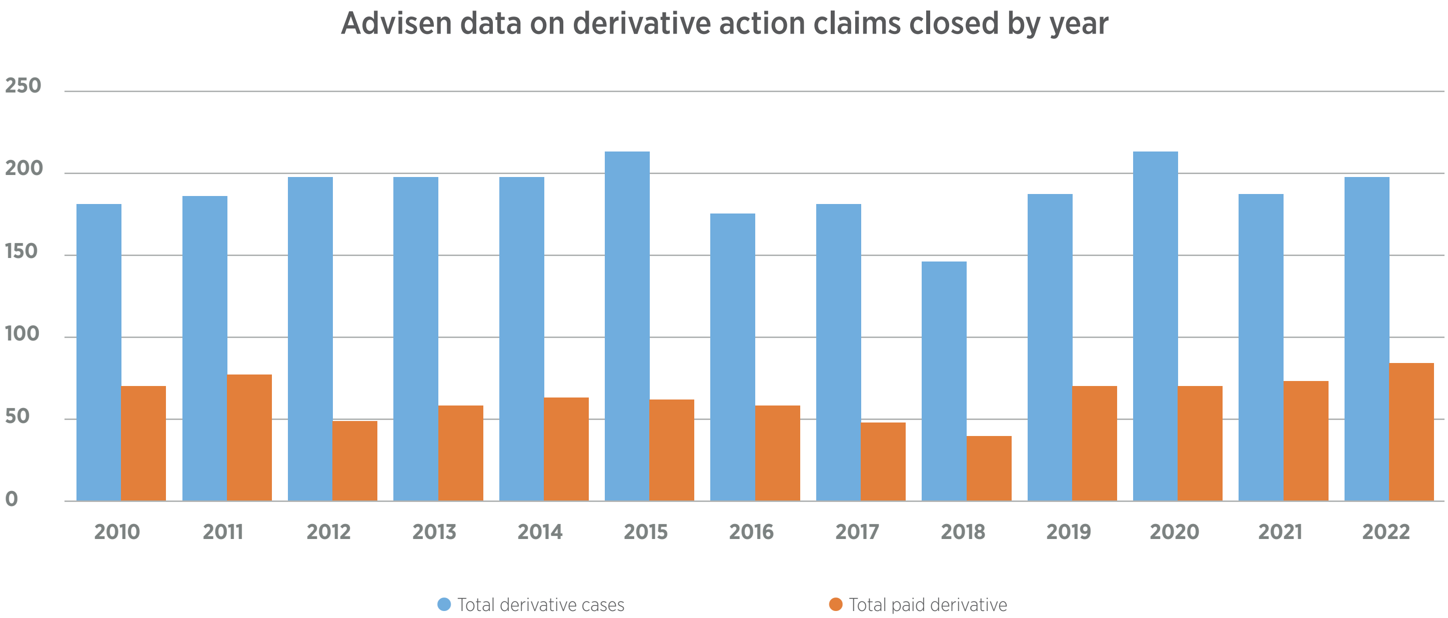
Many carriers will extend the derivative demand investigation coverage to include coverage for the defense of books and records demands under Section 220 of the DGCL or any parallel statute in another jurisdiction. Pursuant to Section 220 of the DGCL, any stockholder, upon written demand under oath stating the purpose thereof, has the right to inspect books and records for any proper purpose.[15] Books and records demands typically serve as a tool for potential claimants to gather information before filing a derivative claim or securities class action. They have become increasingly prevalent and costly, as we note toward the end of this paper.

As a result, the applicable retention and sublimits for books and records demand coverage is a critical subject of negotiation with carriers. Many carriers will extend the same treatment to books and records demands as applies to derivative demand investigation costs (no retention but with a sublimit on coverage). Recently, some carriers have been seeking to narrow coverage for books and records demands, offering forms that cover defense costs only where the demands are relevant, or related, to a securities claim and subject to the Side C retention (at a much higher cost than the retention for derivative demand investigation coverage).

Another potentially significant cost — one that has been the subject of coverage disputes — is that portion of a derivative settlement or judgment awarding plaintiff's attorney's fees. Delaware courts may award attorney's fees to successful derivative plaintiffs, typically reasoning that the attorneys are entitled to a reasonable fee award because they recovered a common fund for the benefit of others.[16] Courts may also award fees in derivative cases involving equitable or non-monetary relief, often under the "corporate benefit doctrine."[17] Insurance coverage disputes have arisen with respect to coverage for these fees, with some courts ruling in favor of coverage.[18] Many D&O policies now explicitly cover them in the policy's definition of "loss," though complexities continue to arise in the derivative context. If coverage is established, the question of which retention applies may also be complex. In our experience, carriers often seek to apply the Side B or Side C retention to the fee award aspect of any settlement or judgment, though there may be arguments to apply the much smaller Side A retention depending on the facts of the case.

4. Frequency and impact of derivative suits

While securities class actions have traditionally been the larger exposure, risk from derivative lawsuits has been trending upward. Historically, derivative actions settled for non-monetary relief, such as corporate governance changes. More recently, there have been an increasing number of large monetary settlements or awards in derivative lawsuits. Consider the following graph of the number of derivative action cases closed by year, according to Advisen.



Despite major distractions for the securities plaintiff attorneys, such as the hundreds of Merger-Objection claims, especially during 2017–2019, the number of derivative action claims closed overall has been very consistent at about 190 per year. But the frequency of non-zero [paid] derivatives has trended up substantially in 2019–2022. Let's face it, most cases are dismissed or settled at no monetary cost, as noted previously, but the number of cases with real value has been surging. And, the average cost of these cases is very significant, at $16 million per claim in 2022.

A very recent edition of AIG's Claims Intelligence Series (the public D&O portion available at www.aig.com/content/dam/aig/america-canada/us/documents/claims/aig-public-d-and-o-claims-report_3324p.pdf; released February 7, 2024), shared their insights on derivative actions. In this report, D&O claims data on 10,500 matters noticed from 2016 through 2020 allowed for an in-depth analysis of paid D&O losses. Their emphasis is consistent with our own lengthy research presented herein, namely the growing importance of derivative actions. By their count, SCAs represent only 62% of D&O losses paid, meaning 38% of D&O losses came from "non-traditional SCAs", derivative actions, books and records (B&R) demands, and a few other miscellaneous D&O cases. Their conclusions are: "Standalone derivative actions are driving up D&O exposure, accounting for 15% of the total losses during the period studied" and "B&R demands should be taken very seriously." Their concern with B&R demands stems from the 81% increase in claim costs when a standalone derivative action has at least one associated B&R demand. They also noted that paid losses from B&R demands without an SCA or a derivative action averaged $1.3 million, with their largest B&R loss reaching $10 million.

Finally, we recognize that AIG defined "mega-derivatives" in their report as derivative action claims with a settlement in excess of $90 million. Using that definition, we identified 25 such mega-derivatives in our own study, with 15 settled in just the last four years — quite the trend!

These frequency stats above, combined with the severity trend discussed earlier, suggest we should reconsider the impact of this type of claim, especially in light of the lack of indemnification available for settlements and judgments.

5. Insurance considerations for derivative suits

In light of the increasing risk from derivative claims, companies should work with their broker teams and legal counsel to consider the potential risks at each stage and ensure appropriate coverage. In the beginning stages, after receipt of a books and records demand or a derivative demand, a D&O policy's derivative demand investigation coverage can provide first-dollar coverage for defense costs. There may be additional extensions to cover related costs. Policies can differ substantially as to retentions, sublimits, and terms offered with respect to these coverages.

If a derivative demand proceeds to a lawsuit, it is important to consider whether the policy includes coverage for the entity as a nominal defendant. Most entities, even if only named as a nominal defendant, will incur a level of defense spending in connection with derivative lawsuits. Public company D&O policies limit entity coverage to "securities claims," so it is important to ensure that the definition of that term includes shareholder derivative lawsuits brought against the entity as a nominal defendant or that it is otherwise covered.

Companies should be aware that the Side B retention will apply before an entity will be reimbursed for its cost of indemnifying directors and officers for defense attorney's fees and costs in derivative lawsuits. To the extent the policy extends coverage to an award or settlement of plaintiff's attorney's fees, many carriers also seek to apply the Sides B/C retention to that portion, though there may be arguments otherwise. This could be a big deal, particularly in derivative cases involving non-monetary relief, because Sides B and C are entity coverage provisions, and their retentions are significantly higher than the Side A coverage retention for non-indemnifiable loss (which we expect to be $0). For example, in a recent derivative claim that settled for corporate governance changes plus millions in attorney's fees, the carrier did not contribute because the total loss was below the company's $5 million Sides B/C retention.

The applicable retention can also become the subject of a coverage dispute where the company refuses to indemnify the individual defendant. If the carrier believes that the entity has wrongfully denied indemnification, often times the primary carrier will apply Side A, or the standalone Side A DIC carrier will drop down, to cover the director or officer's defense in the derivative claim, and either carrier may then pursue the entity for reimbursement of the Side B retention. In this way, Side A coverage and standalone Side A DIC policies can provide significant protection for directors and officers when an entity wrongfully refuses to indemnify or advance defense costs.

In facing a settlement or judgment in a derivative lawsuit, standalone Side A coverage is critical to protect individual defendants from personal liability. A derivative settlement or judgment would not be indemnifiable by an entity incorporated in Delaware or in the many states following Delaware's approach. Side ABC limits of liability are shared between the insured entity and insured persons. If the entity has eroded the Side ABC policy's limits through defense costs or other claims, the policy's limits may be insufficient to protect individuals from personal liability. As a result, standalone Side A and Side A DIC policies serve to ensure coverage is available to individuals faced with large derivative settlements or damages awards.

As discussed above, derivative claims can lead to significant individual liability. And, there are increasing options for building Side A programs, including the use of captives or group captives, to protect directors and officers and ensure appropriate limits are available. However, such options are not cost-efficient for the vast majority of client companies given the attractive pricing currently in the marketplace for standalone Side A and Side A DIC policies, and the breadth of features that come with such policies when they sit on top of a traditional Side ABC program.

Companies should work with an experienced broker team and legal counsel to consider the potential risks at each stage of a derivative claim and ensure appropriate coverage. It is important to review policy terms, retentions, and sublimits to ensure coverage for defense costs, settlement payments, judgments, and plaintiff's attorney's fees. Standalone Side A coverage is critical to protect individual defendants from personal liability for derivative settlements or judgments.

In conclusion, the increasing risk from derivative claims highlights the need for companies to adjust their D&O insurance coverage. It is important that you are working with a D&O specialist who understands the risks that public companies encounter and the insurance solutions available to mitigate potential losses. Gallagher has a vast network of specialists that understand your industry and business, along with the best solutions in the marketplace for your specific challenges.

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Prior to joining Gallagher, Jennifer spent eight years as an associate and then partner in the complex commercial litigation group of a large law firm in Chicago. There, she focused on representing policyholders in insurance coverage litigation while also maintaining an active general commercial litigation and securities law practice, which included defending clients against securities lawsuits, derivative demands, fiduciary duty claims, SEC and DOJ investigations, and class action lawsuits. After leaving big law in 2019, Jennifer spent two and a half years at a litigation boutique in Denver, where she continued to advise policyholders on insurance recovery and honed her trial skills as lead trial counsel in small business litigation and contract disputes. She is admitted to practice in Colorado and Illinois, and her experience spans state and federal court, trial and appellate levels, and mediation and arbitration.

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Sources

[1] LaCroix, Kevin. "Largest Derivative Lawsuit Settlements," *The D&O Diary, 5 Dec. 2014, (last updated 20 July 2023).*

[2] Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981); see also In re Fairpoint Ins. Coverage Appeals, Nos. 478 2022, 479 2022, 480 2022, C.A. No. N18C-08-086 (N), at 14 (Del. 2023) ("[A]n equity holder who satisfies certain procedural requirements can bring a suit derivatively on behalf of the entity for harm done to the business entity, with any recovery going to the entity."), https://courts.delaware.gov/Opinions/Download.aspx?id=356980.

[3] In re Fairpoint, at 14. Interestingly, however, courts have disagreed as to whether claims under Section 14(a) of the Securities Exchange Act of 1934 (which can be direct or derivative, see id. at 21) may be brought derivatively in federal court (which has exclusive jurisdiction over claims under the '34 Act). This is particularly true where companies have enacted forum selection bylaws mandating that shareholder derivative lawsuits be brought in Delaware state court. See generally, Peter Morrison, Virginia Milstead, & Raza Rasheed (Skadden, Arps, Slate, Meagher & Flob LLP), "Circuits split on whether derivative Section 14 claims are subject to Delaware Court of Chancery forum bylaws," (Thomson Reuters, June 2, 2022), available at https://www.skadden.com/-/media/files/publications/2022/06/circuits_split_on_whether_derivative_section_14_claims.pdf; Mohsen Manesh and Joseph A. Grundfest, "Abandoned and Split, But Never Reversed: Borak and Federal Derivative Litigation," The Business Layer, Vol. 78, Issue 4 (ABA Fall 2003), available at Abandoned and Split, But Never Reversed: Borak and Federal Derivative Litigation (americanbar.org).

[4] In re Fairpoint, at 13 (citing Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004)).

[5] Yudell v. Gilbert, 949 N.Y.S.2d 380, 381 (N.Y. App. Div. 2012) ("[w]e adopt the test the Supreme Court of Delaware developed in Tooley.")

[6] In re Fairpoint, at 16 ("the derivative claims were for breach of fiduciary duty against directors and officers – claims that are undisputedly derivative when brought on behalf of the business entity").

[7] See, e.g., Stipulation and Agreement of Settlement, Compromise, and Release, *In re Dell Tech. Inc. Class V Stockholders Litig*., Consol. C.A. No. 2018-0816-JTL (Del. Ch., Dec. 22, 2022) (settling direct breach of fiduciary duty claims for $1 billion in cash), available at www.dellclassvstockholderlitigation.com.

[8] While state courts have concurrent jurisdiction over claims brought solely under the '33 Act, the enforcement of federal forum selection provisions in key states (e.g., Delaware, California and New York) has significantly reduced the number of state securities class action filings. See Federal Forum Provisions Proving to Be Valuable in Post-Cyan | Gallagher USA (ajg.com). For example, according to Cornerstone Research, Securities Class Action Filings: 2023 Year in Review, there were only 4 state '33 Act filings in 2023, down from 12 in 2022.

[9] See also In re Fairpoint, at 21 n.65 ("[F]ederal securities lawsuits are sometimes accompanied by follow-on state law derivative suits based on the same underlying allegations.")

[10] 8 Del. C. § 145(c); Hermelin v. K-V Pharm. Co., 54 A.3d 1093, 1094-95 (Del. Ch. 2012); see also Nwaeze, Oderah, "The Corporate Guide: Directors and Officers' Indemnification Rights," Faegre Drinker, 16 Feb. 2022,

[11] Hermelin, 54 A.3d at 1095; see also Paul J. Lockwood & Arthur Bookout, Skadden, Arps, Slate, Meagher & Flom LLP, "Legal and Practical Limits on Indemnification and Advancement in Delaware Corporate Entities" (Harvard Law School Forum on Corporate Governance, July 2, 2018)

[12] 8 Del. C. § 145(e).

[13] See Nwaeze, supra note 10.

[14] 8 Del. C. § 145(b); Arnold v. Society for Sav. Bancorp, Inc., 678 A.2d 533, 540 n.18 (Del. 1996); see Lockwood & Bookout, supra note 11.

[15] Del. C. § 220(b).

[16] Americas Mining Corp. v. Theriault, 51 A.3d 1213, 1252-53, 1262-63 (Dec. 2012) (affirming award of over $304 million in attorney's fees in derivative lawsuit involving $2 billion judgment); id. at 1253 ("Typically, successful derivative or class action suits which result in the recovery of money or property wrongfully diverged from the corporation ... are viewed as fund creating actions." (quoting Tandy-crafts, Inc. v. Initio Partners, 562 A.2d 1162, 1164-65 (Del. 1989))); see also Joseph M. McLaughlin, Simpson Thacher & Bartlett LLP, "Directors' and Officers' Liability: Insurance for Attorney's Fees in Derivative and Class Actions," at 2 (discussing New York law on the award of attorney's fees in derivative actions)

[17] See, e.g., XL Specialty Insurance Co. v. Loral Space & Communications, Inc., 918 N.Y.S.2d 57, n.2 (N.Y. App. Div., 1st Dep't 2011) (citing Tandy-crafts, Inc., 562 A.2d at 1166-67).

[18] See id. at 61-62 (holding that an $8.8 million plaintiff's fee award in a derivative action was covered "Loss" as an "other amount" the company was "legally obligated to pay" even though the "Loss" definition did not expressly include plaintiff's attorney's fees and the underlying judgment on the merits was for an equitable, non-monetary remedy).