

Anatomy of Derivative Claims

Derivative claims are becoming more prominent in today's changing D&O litigation landscape. What are they? How are they unique? Why does a risk manager today need to worry about them?

Derivative claims present a serious exposure to directors and officers – an exposure that cannot in many cases be indemnified by the directors' and officers' company. As a result, derivative claims provide a clear and immediate incentive for large organizations to consider purchasing D&O coverage for such cases. Sometimes called A-Side coverage, policies can be put in place that protect the personal assets of directors and officers – assets that otherwise may be exposed.

Derivative Actions. Derivative claims are those brought by shareholders in the name of a company, against the company and certain of its executives, in order to enforce a right against these individuals which the company itself has declined to pursue. According to Black's Law Dictionary, the term refers to "a suit by a shareholder to enforce a corporate cause of action. The corporation is a necessary party, and the relief which is granted is a judgment against a third person in favor of the corporation. An action is a derivative action when the action is based upon a primary right of the corporation, but is asserted on its behalf by the stockholder because of the corporation's failure, deliberate or otherwise, to act upon the primary right."

This is different from your typical D&O securities class action where shareholders are suing to recover damages arising from a drop in share price that was allegedly the result of fraud or misrepresentation.

Most if not all D&O policies contain an exclusion for claims brought by insureds against other insureds, which is technically how a derivative claim is considered under most D&O policies that cover both the company and its

executives. Fortunately for insurance buyers, there is a fairly standard exception to the "insured versus insured" exclusion for derivative claims.

Derivative Demands. In many jurisdictions, there is a prerequisite to bringing a derivative claim, known as a *derivative demand*. By way of a demand letter, alleged illegal actions are set out and a demand is made for the company itself to bring the claim. Only if the company refuses to take action can the derivative demand then be brought by the plaintiffs as a derivative claim. A common exception to this legal requirement is *futility* – based on the proposition that if there are no disinterested board members who could consider and accede to the derivative demand, then the plaintiffs should be permitted to bypass the demand requirement. If this requirement is not met (or an exception is not satisfied) a legal claim may be dismissed with prejudice, meaning it cannot ever be brought.

Some recent D&O policies contain express coverage for the legal and other external costs which may be associated with responding to derivative demands, typically providing a sublimit of coverage, on a first-dollar basis without the need to first apply any claim retention.

Allegations. Traditionally, derivative claim allegations were usually related to theft of a corporate business opportunity. Today, derivative claims may include allegations relating to excessive executive compensation. The goal for the plaintiffs, in either case, is to **return these amounts to the company itself** (rather than directly to the shareholders).

For purposes of judicial economy of resources, courts may combine state- or federal-based derivative claims with direct federal securities class actions. Companies may therefore be faced with litigation that combines elements of both derivative and direct claims, even though the

damage calculations, indemnification analysis and procedural issues may be very different for the differing parts of the consolidated claim.

Damages. Derivative claim damages are not measured by the drop or loss in stock value but are based on a fact-and-circumstances test as to the value of the misappropriated opportunity or assets.

Because these damages are paid to the company itself rather than to the shareholders, these claims have traditionally not been a focus of the plaintiffs' bar. It is also true that derivative claims require in-depth knowledge of a transaction or the target company's operations, something not historically necessary in the average securities stock-drop case. For these reasons and others, derivative claims were in the past less common and until recently, evaded the radar screen of most public companies.

Indemnification. Companies are waking up to the consequences of derivative claims because they remain the classic example of claims that are not indemnifiable under many if not most state indemnification provisions (many states permit indemnification of defense costs in derivative actions but **not** court awards or settlements). The states follow a clear argument: if damages are suffered by a company, and any settlement or court award is to be paid to the company, how can the company itself indemnify the individuals ordered to pay these amounts without the results being nullified? The company would simply be paying money to itself.

The assumption that defense costs may be advanced in derivative actions is being challenged today as a result of last year's decision by the Delaware Chancery Court in In re The Walt Disney Derivative Litigation where the court expressly deprived the defendants of corporate indemnification for their defense expenses. Fortunately, coverage for non-indemnifiable claims is a building block of virtually every D&O insurance policy.

Important Procedural Issues. Many of the present rules designed to limit or inhibit frivolous securities class actions can be found in the federal Private Securities Litigation Reform Act of 1995 (SRA). But as most derivative actions are neither federal, class actions nor securities claims, they do not fall within the statutory framework and protections afforded by the SRA.

A key procedural factor arising under the SRA is the exclusive role of the lead plaintiff (and perhaps more importantly, lead plaintiff's counsel). This simply does not exist for derivative claims. Therefore, a shareholder (or potential plaintiff's counsel) who was not awarded the role of lead plaintiff in a federal

securities class action, but who wants to play a role in suits filed against a firm, is free to pursue a claim against a company's directors and officers in the form of a derivative claim. This is often cited as an example of the Balkanization of today's securities litigation world.

Recent Events. Some of the plaintiffs bringing derivative claims today are institutional investors (usually large public pension plans) and/or bankruptcy estates seeking to recover assets from the company's directors and officers. Statistical evidence is beginning to appear suggesting that larger recoveries are being made in derivative claims, and that where both derivative and direct securities claims (federal class actions) are combined, the total recoveries may exceed previous returns for either class individually.

There is no doubt that this little understood area of liability needs to be closely watched.

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