EXECUTIVE RISKS PRACTICE

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ISSUE

Derivative actions can be the bane of corporate executives' existence. Formally, a shareholder derivative action is a lawsuit filed by the shareholders on behalf of a company alleging that the company's directors or officers violated their fiduciary duties to the company and its shareholders. Derivative actions are brought when a corporation possesses, but does not enforce, rights against third parties. The goal of the suit is to put the company back in the position it would have been in but for this alleged breach of fiduciary duty. Monetary recoveries, therefore, go to the corporation itself, not to the individual plaintiff shareholders. This is generally why derivative settlements are thought to be non-indemnifiable (if the company is funding the settlement, it can't be made whole by the settlement).

Shareholder derivative lawsuits are no longer rare: 45% of the securities cases settled in 2006, 55% in 2007 and 40% in 2008 included companion shareholder derivative actions. (*Cornerstone Research Securities Class Action Settlements, 2008 Review and Analysis,* Ellen M. Ryan and Laura E. Simmons)

Derivative lawsuits differ from their companion class action securities lawsuits in several ways:

1. Derivative lawsuits are usually filed in state court.
2. They are brought by current shareholders versus selling shareholders who populate securities class actions.
3. As they arise under state law, derivative claims are exempt from protections and procedures found in the Private Securities Litigation Reform Act of 1995.

IMPACT

Settlements in these suits can reach eight – and even nine or ten – figures. The issue of insurance protection to cover those losses, and the legal expenses incurred in their defense, is complicated. From a Directors & Officers (D&O) Liability standpoint, indemnification by the company for settlements or judgments in a shareholder derivative action is often legally prohibited. Therefore, the only protection available to directors and officers may be their D&O insurance policies, including stand-alone A-Side D&O policies – which provide coverage where indemnification is legally or financially unavailable.

ACTIONS

1. **Maintain best-in-class corporate governance.** Strong corporate governance policies with robust internal controls will help mitigate shareholder derivative actions.
2. **Keep the board active and informed.** Your board of directors should understand all aspects of the business. They should be engaged with senior managers and create a culture of healthy debate on any critical issues and decisions the company may face. Continuous director training should be encouraged and developed.

3. **Establish strong company indemnification for directors and officers.** Legal counsel should review the company's bylaws to ensure that indemnification is provided to the fullest extent permissible by law.

4. **Maintain a broad A-Side Directors & Officers Liability Policy.** This coverage is specifically designed to protect directors and officers in the event of non-indemnifiable claims. Make sure you fully understand the D&O coverage your organization buys. If there are any doubts, call your insurance broker.

CONTACTS

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