

DERIVATIONS ON DERIVATIVE CLAIM COVERAGE

A major trend in D&O litigation over the past decade has been the growth or resurgence of derivative claims. Perhaps fortunately, as settlements in derivative actions are generally considered to be non-indemnifiable, this coincided with the increase in purchasing A-Side D&O insurance, or coverage solely for claims where the organization is legally or financially unable or unwilling to indemnify the director or officer.¹

Derivative claims can pose a challenge for defense counsel (more accustomed to federal securities class actions) and D&O insurance carriers alike. This situation reached a critical point with the hundreds of derivative claims filed over approximately a year's time arising out of legal challenges to stock option dating practices at public firms.² A number of these derivative actions settled for largely prophylactic remedies along with plaintiffs' legal fees. While there is at least one notable exception, in many instances, we had to **forcefully advocate** with several D&O insurance carriers on behalf of our clients to obtain coverage for plaintiffs' legal fees (often in the multi-million dollar range) when the only other form of damages was non-pecuniary, injunctive relief. Our position was that if the purpose of a derivative claim is to put the company back in the position it would have been in but for the alleged breach, then if the company was not reimbursed for plaintiffs' legal fees this would frustrate the very purpose of the law suit.

VINDICATION (?)

In a recent decision on appeal, the court held that plaintiff attorney's fees in a D&O derivative suit are "Loss" under a D&O policy.³ The specific policy being considered contained, in relevant part, fairly standard wording providing coverage for "Loss" resulting solely from any Securities Claim. "Loss" was then defined as "damages, judgments, settlements or other amounts...and Defense Expenses in excess of the Retention that the Insured is legally obligated to pay."



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."

The term “Securities Claim” specifically included shareholder derivative claims. On the surface, this sounds like an easy matter to resolve.

In this specific case, a shareholder derivative action and a related class action lawsuit were combined in litigation arising from a disputed corporate transaction. In resolving this matter, the terms of the transaction were modified, but there was no finding of fault by the insured and no money damages were awarded to the shareholders. But notably, the court awarded the shareholders their attorneys’ fees for both lawsuits, and litigation over coverage for the attorneys’ fee ensued. The trial court denied the insurer’s motion for summary judgment and granted summary judgment in favor of the insureds. The carriers then appealed this decision.

The insurer’s position was that there was no covered “Loss” because the court deciding the underlying dispute had not found fault but merely restructured the transaction. They also argued that fee award for the derivative action was not covered because this litigation produced a benefit for the company, taking the position that since it was a cost the company incurred as part of obtaining a benefit to the company, the fee award was not “Loss” to the firm.

The panel hearing the appeal was split on whether or not the award of plaintiff’s legal fees in the derivative action was covered. In ultimately holding for the insureds, the majority found that coverage for the attorneys’ fees was warranted because there was express coverage for shareholder derivative actions. To the court, “[h]ad the insurers meant to exclude derivative plaintiff’s attorneys’ fees, they could have limited the definition of ‘Loss,’ limited the definition of ‘Securities Claim’ or drafted an exclusion.”⁴

The dissent focused on the phrase “legally obligated to pay” in the definition of Loss and referred to “the Retention,” not to “other amounts.” A fee award in a derivative suit, the dissent observed, represents “the equitable entitlement of the successful derivative plaintiff to recover the expenses of his/her attorneys’ fees from all the shareholders of the corporation on whose behalf the suit was brought.” The dissent observed that “if not spreading the cost of attorneys’ fees sounds an unjust enrichment, the obvious corollary is that shifting the cost to shareholders as a group cannot be characterized as a loss.”

WHERE DO WE GO FROM HERE?

First, this case may itself be further appealed, so stay tuned. Also, the divided holding here may indicate that the issue is far from resolved. With the growing frequency of D&O derivative suits, this is one more issue to consider and discuss with your D&O carriers.

If you find this of interest, other ER publications that you may like include:

- Willis D&O Derivative Claim Study, July 2010
- Picking the Right Lead A-Side D&O Carrier, September 2009
- Details in Delaware (Twist on Derivative Claims), May 2009
- ERISA Derivative Action Permitted, August 2005
- Anatomy of a D&O Derivative Claim, March 2005



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- ¹ It is important to keep in mind that all D&O policies provide “A-Side coverage,” but most do so along with other insuring agreements that potentially dilute coverage and generally include more exclusions and limitations to accessing the A-Side of the contract. But the bottom line is that this issue and the decision being discussed here resonate no matter which form of D&O coverage is being purchased: traditional, A-Side only or Independent Director coverage.
 - ² This was back in 2006 – 2007 when most of the claims were filed. The majority were brought as derivative claims but sometimes this was accompanied by a securities stock-drop case, or, rarely, the sole action brought was a federal securities class action. Regrettably, in a few instances there were also criminal investigations and prosecutions. Options backdating itself is not illegal. It occurs when a company issues stock options on one date, but reports in its financials an earlier issue date to create a “strike” or exercise price equal to the earlier date’s lower price. Consequently, the option is immediately profitable, or “in the money,” to the holder of the option. Problems arise when the company avoids expensing the options as current compensation, thereby increasing earnings in the near term. Additional fallout is that the company potentially under-reports the executive’s compensation.
 - ³ *XL Spec. Ins. Co. v. Loral Space & Comm., Inc.*, 2011 WL 537161 (N.Y. App. Div. Feb. 17, 2011).
 - ⁴ However, the court found that there was no coverage for the attorneys’ fees related to the class action lawsuit because it was not a “Securities Claim” as set out in the policy.