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D&O Coverage Insights: Derivative Claims

A derivative lawsuit is a legal action initiated by a shareholder or member of a company, not for their personal benefit, but on behalf of the corporation itself against its officers, directors, or other parties. This type of lawsuit arises when the shareholder believes the corporation has been harmed by a breach of fiduciary duty or other misconduct and the company's own management has failed or refused to take appropriate legal action. The funds or damages recovered in a successful derivative lawsuit are awarded to the corporation, with the shareholder only benefiting indirectly from any resulting improvements in the company's value or management.

Key Aspects of a Derivative Lawsuit

- **Brought on Behalf of the Corporation:** A shareholder or other stakeholders (members of an association, directors, state attorney general, beneficiaries, donors and employees) acts as a representative for the company to address a wrong that belongs to the corporation, rather than a direct harm to the shareholder.
- **Triggered by Management Failure:** The lawsuit is filed because the board of directors or other management failed to act when the company had a valid legal claim against someone, such as directors or officers.
- **Benefit to the Company:** Any damages awarded in a derivative suit are paid to the corporation, not to the individual shareholder who brought the suit.
- **Indirect Shareholder Benefit:** Shareholders are incentivized to file these suits because a successful outcome can lead to higher company share prices, better corporate governance, or increased dividends, all benefiting the shareholders indirectly.
- **Targeted Against Corporate Wrongdoers:** The defendants are typically the corporation's directors, officers, or employees who are alleged to have wasted corporate assets, engaged in self-dealing, or breached their duty of care to the company.

Why They Are Necessary

- **Corporate Control:** Derivative lawsuits provide a mechanism for shareholders to enforce the legal duties owed to the corporation by its directors and officers, who are responsible for the company's affairs.
- **Deterrent to Misconduct:** By holding corporate leaders accountable for breaches of fiduciary duty, derivative suits serve as a check on corporate power and help deter mismanagement and misconduct.

Types of claims asserted in shareholder derivative actions include, for example:

- Breaches of fiduciary duty
- Fraud or other unlawful activity
- Self-dealing or greed by insiders
- Conflict of interest
- Waste of corporate assets
- Insider trading
- Misappropriation
- Options backdating
- Accounting scandals
- Inflated, false, or misleading financial statements
- Improprieties related to executive compensation

Derivative Actions and Indemnification

In a derivative action, a shareholder sues on behalf of the corporation, and the right to indemnification—reimbursement of expenses—for directors and officers is limited to defense costs, not settlements or judgments. Unlike direct claims where broader indemnification for judgments and settlements may be permitted, the company can only indemnify for expenses related to the defense or settlement of a derivative suit if the court finds the action was reasonable and the shareholder had no personal interest

beyond that of a shareholder. Corporations often offer indemnification for these limited expenses through their organizational documents and may also purchase directors and officers (D&O) insurance to cover situations where the company is prohibited from providing indemnification.

How Indemnification Differs in Derivative Actions

- **Limited Indemnification:** In a derivative action, a company can generally indemnify a director or officer only for the expenses incurred in defending against the claim, such as legal fees.
- **Prohibition on Settlements/Judgments:** Unlike third-party claims, companies are often prohibited from indemnifying a director or officer for the cost of a settlement or judgment against the corporation in a derivative action. A few exceptions can occur due to the state of incorporation.
- **Conditions for Indemnification:** Indemnification for expenses in derivative suits is typically contingent on the director or officer acting in good faith and in a manner they reasonably believed to be in the best interests of the company.

The Role of State Law and Corporate Documents

- **State Law:** State laws, such as Delaware General Corporation Law (DGCL), govern the extent to which a corporation can indemnify its officers and directors.
- **Organizational Documents:** A corporation's right to indemnify and advance costs for derivative suits is typically set forth in its bylaws, articles of incorporation, and director/officer agreements.

D&O Insurance and Derivative Actions

D&O insurance can provide crucial protection for directors and officers facing derivative claims, particularly through its "Side A" coverage. The policy covers different types of defense costs associated with the claim:

- **Directors' and Officers' Protection (Side A):** Side A coverage protects the individual directors and officers for defense costs and judgements/settlements in the event the company cannot legally indemnify them.
- **Company Reimbursement (Side B):** The D&O policy's Side B coverage reimburses the company for the legal costs it incurs to defend the derivative action.
- **Entity Coverage (Side C):** Securities Claims for Public Companies and Blanket coverage for Private/Non-Profit Companies, does not provide any coverage for Derivative Actions.
- **Side D (Derivative Investigation Coverage):** Some D&O policies also offer specific coverage for the internal investigations that may precede a formal derivative lawsuit. This is sometimes called "Side D" coverage and helps pay for the costs of hiring outside counsel and other experts to manage the investigation.

How Side A DIC Insurance Provides Protection

Side A DIC insurance is purchased specifically to address the gaps left by traditional D&O policies and provide broader, dedicated coverage for individual directors and officers. In a derivative action, a Side A DIC policy would:

- **Provide Dedicated Limits:** It offers a separate, dedicated pool of insurance money exclusively for the directors and officers. This is crucial because, in large lawsuits like securities class actions, the limits of a standard Side ABC policy can be exhausted by claims against the company, leaving nothing for a later derivative settlement.
- **Provide "Drop Down" Coverage:** A key feature of DIC policies is their ability to "drop down" and provide primary coverage under specific conditions. This includes situations where an underlying insurer refuses to pay, attempts to rescind coverage, or becomes insolvent.
- **Offer Broader Coverage with Fewer Exclusions:** Unlike a standard D&O policy, a Side A DIC policy is often tailored with fewer exclusions, offering broader protection. For example, it can fill gaps for claims excluded under the underlying policy, such as those involving pollution.
- **Cover Non-Indemnifiable Losses:** By design, it covers the costs of defense and settlements for directors and officers when the company cannot legally or financially provide indemnification. This is exactly the scenario that arises from settlements in derivative lawsuits.

The Side A DIC policy is triggered, providing exclusive, "first dollar" coverage to pay for the directors' and officers' defense costs and other covered losses, protecting their personal assets.

Real-World Examples of Derivative Lawsuits

Breach Of Fiduciary Duty

These lawsuits allege that directors and officers failed to act in the company's best interest, prioritizing their own gain over the company and its shareholders.

- **Tesla's Acquisition of SolarCity:** Shareholders filed a derivative suit alleging that the 2016 acquisition of SolarCity primarily benefited Elon Musk, his family members, and other directors who had stakes in the solar company, rather than Tesla. The case settled for $60 million paid by defendants.
- **Wells Fargo Fake Accounts Scandal:** A derivative suit accused the board of directors of breaching their fiduciary duties by failing to stop employees from creating millions of unauthorized accounts. The case resulted in a $240 million settlement paid by the directors and officers.

Corporate Waste and Excessive Compensation

Shareholders may sue to recover assets or excessive payments they believe were unjustly given to insiders.

- **Disney's Executive Compensation:** The landmark *In re Walt Disney Co. Derivative Litigation* case involved shareholders suing the board for approving a massive severance package for a former executive, alleging it was a breach of fiduciary duty and a waste of corporate assets.
- **Tesla's Board Compensation:** A derivative suit challenged a compensation package for the Tesla board of directors that allegedly benefited Musk. The suit was settled for $735 million.

Massive Corporate Fraud

When significant fraud or misconduct at a company is exposed, derivative lawsuits are often filed against directors and officers for failing to prevent or detect it, which damages the company's value.

- **American Realty Capital Properties:** Following allegations of intentional fraud that inflated the company's stock price, the company's former chief financial officer was jailed. A resulting derivative suit settled for nearly $287 million.
- **Goldman Sachs and 1MDB:** Shareholders filed a derivative suit over Goldman Sachs' role in the 1MDB scandal in Malaysia, alleging the company's board failed in its oversight duties. This led to a $79.5 million settlement.

Health, Safety, and Environmental Failures

If a company's leadership fails to adequately monitor or address risks related to public health, safety, or the environment, shareholders may sue them on behalf of the company.

- **Boeing 737 Max 8 Crashes:** After two fatal crashes involving the 737 Max 8 jet, a derivative lawsuit was filed alleging inadequate safety oversight by the company's directors. It resulted in a $237.5 million settlement.
- **PG&E Pipeline Explosion:** A derivative suit concerning an explosion caused by a faulty natural gas pipeline alleged that the company's officers and directors failed to maintain the safety of the pipeline or keep accurate records. The case settled for $90 million.

Data Breaches and Cybersecurity Failures

Significant data breaches can lead to shareholder derivative suits against directors for failing to ensure adequate security measures.

- **Yahoo Data Breach:** In a derivative suit, shareholders claimed that Yahoo's directors knew of a massive data breach but failed to disclose it or implement proper security. This failure resulted in Verizon cutting its purchase price for the company, leading to a $29 million settlement.
- **Equifax Data Breach:** A derivative suit over a breach that exposed the data of millions of Americans alleged that the board failed in its oversight duties. The case settled for $32.5 million.

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