SHAREHOLDER DERIVATIVE LITIGATION
A Primer for Insurance Coverage Counsel

By John D. Hughes, Gregory D. Pendleton and Jonathan Toren

I. Introduction

The recent spate of mergers, acquisitions, leveraged dividends and regulatory investigations has led to a much higher frequency of shareholder derivative actions. Shareholder derivative actions have unique and complicated procedural requirements which this article discusses in detail. Two other corporate procedures, books and records demands and special litigation committees, are frequent companions to shareholder derivative litigation. Accordingly, this article discusses these as well, and the important roles they play in the context of shareholder derivative litigation. Finally, the article also contains a discussion of the types of indemnification permitted under Delaware law, as well as how directors' and officers' insurance interacts with these indemnification provisions.

II. Purpose of a Derivative Suit: *Policing Behavior of Corporate Directors and Officers*

Corporate directors and officers owe the corporations they serve the fiduciary duties of loyalty and due care. When shareholders believe that either of these duties has been breached to the detriment of the corporation, the available remedy is a shareholder derivative suit. In other words, the purpose of a derivative suit is to redress damage done to the corporation by wayward directors and officers. *See, e.g.*, *La. Mun. Police Emples. Ret. Sys. v. Pyott*, 46 A.3d 313, 340 (Del. Ch. 2012) ("A breach of fiduciary duty claim that seeks to hold directors accountable for the consequences of a corporate trauma is known colloquially as a *Caremark* claim [after]…*In re Caremark Int'l Inc. Deriv. Litig*., 698 A.2d 959 (Del. Ch. 1996).

Because it is safe to say that non-sociopathic directors never consciously choose for the entity they oversee to suffer a disaster, a *Caremark* claim contends that the directors set in motion or allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in doing so they violated a duty to be active monitors of corporate performance."). Shareholder derivative suits are brought to "hold directors accountable" for a variety of corporate traumas, including self-dealing, waste of corporate assets, "regulatory sanctions, criminal or civil fines, environmental disasters, accounting restatements, misconduct by officers or employees, massive business losses, and innumerable other potential calamities." *Id*.

Shareholder derivative suits should not be confused with shareholder direct actions or class actions. While shareholder derivative suits are brought for the benefit of the corporation, shareholder direct and class actions address unique, direct harms to the particular shareholder plaintiff(s). *Feldman v. Cutaia*, 951 A.2d 727, 732 (Del. 2008).[1] That is, "the plaintiff in a stockholder's derivative suit does not sue in an individual capacity, but as the representative of the corporation. Such a suit is distinguishable from one in which the plaintiff has a personal claim at issue and brings an action either individually or as the representative of other stockholders who have been similarly injured." *Duncan v. National Tea Co*., 14 Ill. App. 2d 280, 294 (1st Dist. 1957).[2]

In order to determine whether or not a suit is properly categorized as derivative or direct, courts in New York and Delaware apply the "*Tooley* Test." Pursuant to this test:

> A court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.

Yudell v. Gilbert, 949 N.Y.S.2d 380, 384 (N.Y. App. Div. 1st Dep't 2012) (citing *Tooley v Donaldson, Lufkin & Jerette, Inc*., 845 A.2d 1031, 1039 (Del 2004)). Thus, "under *Tooley*, a court should consider '(1) who suffered the alleged harm (the corporation or the stockholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)'." *Id.* The decision on whether a claim for breach of fiduciary duty by a director must be pursued should be pursued by a shareholder directly or derivatively cannot be based on to whom the director's fiduciary duty was owed. This is because directors owe fiduciary duties to both shareholders and the corporation itself. Therefore, the claim should be brought derivatively when the harm suffered is corporate in nature and the benefit sought will inure directly to the corporation (and only indirectly to its shareholders). *See Protas v. Cavanagh*, 2012 Del. Ch. LEXIS 88, *17-18 (Del. Ch. May 4, 2012).

II. Special Pleading Requirements for a Shareholder Derivative Suit

"In order to sue derivatively on behalf of the corporation, a plaintiff shareholder must overcome a number of procedural hurdles and demonstrate that he or she, rather than the

---

[1] A class action arises "if the parties who have a direct claim against a corporation are too numerous to be joined in a direct action." *See* 19 Am. Jur. 2d Corporations § 1934. Accord *Parnes v. Bally Entertainment Corp*., 722 A.2d 1243 (Del. 1999) and *Brill v. Blakeley*, 281 A.D. 532, 537 (N.Y. App. Div. 1953) ("[These] actions are representative and not derivative. […] The right to bring a representative class action arises from necessity where the parties are too numerous to be joined.")

[2] Practitioners are cautioned that the courts and commentators may use the term "representative" action to refer to both shareholder derivative suits and class actions. *See* 19 Am. Jur. 2d Corporations § 1936 ("In appropriate circumstances, a stockholder may sue as a representative of a class of stockholders to seek relief for direct injuries that are independent of any injury to the corporation. A representative action arises if the parties are too numerous to be joined, in which case one shareholder or a few shareholders are permitted to sue on behalf of all the shareholders. An action is representative if it is based on a primary or personal right belonging to the plaintiff stockholder and those of his or her class. Frequently, however, and in a different sense, a derivative action, which is based on a primary right of the corporation, is referred to as a representative action, in that the stockholder sues on behalf of or as representative of the corporation.").

corporation itself, should control the litigation." *Regions Morgan Keegan Sec. v. Sullivan*, 2011 U.S. Dist. LEXIS 102967 *23 (W.D. Tenn. Sept. 9, 2011). These hurdles are set forth in Fed. R. Civ. P. 23.1, which provides:

> (a) Prerequisites. This rule applies when one or more shareholders or members of a corporation or an unincorporated association bring a derivative action to enforce a right that the corporation or association may properly assert but has failed to enforce. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.
>
> (b) Pleading Requirements. The complaint must be verified and must:
>
>> (1) allege that the plaintiff was a shareholder or member at the time of the transaction complained of,[3] or that the plaintiff's share or membership later devolved on it by operation of law; (2) allege that the action is not a collusive one to confer jurisdiction that the court would otherwise lack; and (3) state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.

FRCP 23.1. *See also Regions*, 2011 U.S. Dist. LEXIS 102967 at *20-21 ("The [derivative] complaint must allege that the plaintiff was a shareholder at the time of the transaction complained of and that the action is not a collusive one to confer jurisdiction on the court. The complaint must also 'state with particularity' all of the efforts undertaken by the plaintiff to demand that the corporation's board of directors take the desired action and 'the reasons for not obtaining the action or not making the effort.'").[4]

As indicated above, Rule 23.1 contemplates that before filing a derivative suit, the shareholder plaintiff must either: (i) make a demand on the corporation (through its directors) that the corporation act directly to address the alleged corporate trauma; or (ii) demonstrate that making such a demand would be futile. *Regions*, 2011 U.S. Dist. LEXIS 102967 at *23. The United States Supreme Court described the rationale for the foregoing rule in *Kamen v. Kemper Fin. Servs.,* 500 U.S. 90 (1991):

> [T]he demand requirement implements 'the basic principle of corporate governance that the decisions of a corporation – including the decision to initiate litigation – should be made by the board of directors or the majority of

[3] This requirement has been interpreted to mean that "a plaintiff [must] not only be a stockholder at the time of the alleged wrongdoing, but…[must also] maintain stockholder status in the corporate defendant throughout the litigation." *Feldman*, 951 A.2d at 731 (construing Court of Chancery Rule 23.1).

[4] For a state law analog, see, e.g., Mass. Gen. L. c. 156D, § 7.42 and *Halebian v. Berv*, 457 Mass. 620 (Mass. 2010) (discussing Massachusetts' pleading requirements for shareholder derivative suits).

> shareholders.' To the extent that a jurisdiction recognizes the futility exception to demand, the jurisdiction places a limit upon the directors' usual power to control the initiation of corporate litigation.

Id. at 101-03. *See also Pyott*, 46 A.3d at 339 ("In a derivative suit, a stockholder seeks to displace the board's authority. To do so, the complaint must allege with particularity that the board was presented with a demand and refused it wrongfully or that the board could not properly consider a demand, thereby excusing the effort to make demand as futile.").

If the shareholder plaintiff makes a demand on the board but the board, after investigation and an adequate time to respond, nonetheless refuses to take the requested action, the shareholder may bring a "demand refused" action. *Regions*, 2011 U.S. Dist. LEXIS 102967 at *23. "Demand refused" actions are less attractive to plaintiff shareholders for two principal reasons. First, a shareholder who first makes a demand on the board waives his right to later claim that demand was futile. *Spiegel v. Buntrock*, 571 A.2d 767, 774-75 (Del. 1990). Second, and perhaps more importantly, a board's decision to refuse to bring suit is generally insulated from judicial review by the "business judgment rule" ("BJR"). *See Kamen*, 500 U.S. at 103 ("In most jurisdictions, the board's decision to…[oppose the shareholder's litigation demand] is subject only to the deferential 'business judgment rule' standard of review.").

The BJR creates a presumption that corporate officers and directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company [and its shareholders]." *In re Walt Disney Co. Derivative Litig*., 907 A.2d 693, 747 (Del. Ch. 2005) (parenthetical in original). Under the BJR:

> [I]t is not enough for a plaintiff simply to second-guess the reasonableness or prudence of a business judgment. Instead,…a plaintiff must [show] that the process applied by a board in making a business decision was so egregious as to constitute 'reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.' This is an onerous standard.

Zimmerman v. Crothall, 2012 Del. Ch. LEXIS 64, *23-25 (Del. Ch. Mar. 5, 2012).[5] Therefore, "demand refused" actions are generally dismissed by courts so long as the board's decision to refuse the shareholder's demand to institute litigation was made in good faith. *See Zapata Corp. v. Maldonado*, 430 A. 2d 779, 784 n.10 (Del. 1981) ("when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's

---

[5] As the court noted in *In re Citigroup Shareholder Deriv. Litig.,* 964 A.2d 106, 125 (Del. Ch. 2009), the BJR is necessary to foster the kind of innovative decision making critical to the long-term success of a company to benefit its shareholders: "[The Business Judgment Rule] is designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly. Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and the burden to show bad faith is even higher."

decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met.").[6]

In light of the onerous BJR standard, many shareholders, rather than making a demand on the board, elect to plead "demand futility." "[D]emand typically is deemed to be futile when a majority of the directors have participated in or approved the alleged wrongdoing, or are otherwise financially interested in the challenged transactions." *Kamen*, 500 U.S. at 103. *Accord Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (holding that courts must determine whether or not: "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."). The test is slightly different in situations where "the board that would be considering the demand did not make [the] business decision which is being challenged in the derivative suit." *Rales v. Blasbank*, 634 A.2d 927, 934 (Del. 1993). In such situations, because application of the *Aronson* test would not sufficiently measure a board's impartiality, courts instead examine whether or not "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Pyott*, 46 A.3d at 338-39.[7]

Demand futility has been found in a variety of situations. In *McKee v. Rogers*, 156 A. 191, 192 (Del. Ch. 1931), for example, it was held that where the corporate president controlled the board of directors, "there can be no expectation that the corporation would sue him, and if it did, it can hardly be said that the prosecution of the suit would be entrusted to proper hands." Similarly, in *Fleer v. Frank H. Fleer Corp.*, 125 A. 411, 415 (Del. Ch. 1924), the court wrote: "where the demand if made would be directed to the particular individuals who themselves are the alleged wrongdoers and who therefore would be invited to sue themselves, the rule is settled that a demand and refusal is not requisite." *See also St. Clair Shores Gen. Emples. Ret. Sys. v. Eibeler*, 2006 U.S. Dist. LEXIS 72316 (S.D.N.Y. Oct. 4, 2006) (under "traditional rules governing derivative litigation,…no deference is owed to board decisions concerning the

[6] "Demand refused" actions are addressed more fully below in connection with the discussion of Special Litigation Committees ("SLC"), which boards frequently appoint to investigate the merits of a shareholder's demand and to determine whether or not litigation is in the corporation's best interests.

[7] See *Rales v. Blasbank*, 634 A.2d 927 (Del. 1993) for a detailed discussion of which shareholder derivative cases call for application of the *Aronson* test, and which call for the test employed in *Pyott*. Briefly, *Rales* held that "a court should not apply the *Aronson* test for demand futility where the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit. This situation would arise in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where…the decision being challenged was made by the board of a different corporation [e.g., the parent corporation or a pre-merger board]." *Id*. at 933-34. In such a situation, it is [instead] appropriate…to examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile." *Id*. at 934.

termination of litigation if a majority of board members are interested in the litigation."). Emerging from these decisions is a rule "that where officers and directors are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct litigation on behalf of the corporation. Thus, demand would be futile." *Aronson*, 473 A.2d at 814.

IV. Books and Records Demands

It will come as no surprise, then, that a frequently contested issue in derivative suits is the sufficiency of the shareholder plaintiff's allegations of demand futility. Because mere conclusory allegations do not pass muster under Rule 23.1, *In re Regions Morgan Keegan Sec. v. Morgan Asset Mgmt., Inc*., 694 F. Supp. 2d 879, 883 (W.D. Tenn. 2010), plaintiff shareholders often first make "books and records" demands. *E.g., Security First Corp. v. U.S. Die Casting & Dev. Co*., 687 A.2d 563 (Del. 1997). The information obtained in response to these demands is then used to demonstrate that demand upon the board would be futile. *See King v. VeriFone Holdings, Inc*., 12 A.3d 1140, 1145 (Del. 2011) (citing, *inter alia*, *Beam v. Stewart*, 845 A.2d 1040, 1056 n.51 (Del. 2004)).

The parameters of books and records demands were discussed in *Compaq Computer Corp. v. Horton*, 631 A.2d 1 (Del. 1993):

> In Delaware, a shareholder's common law right to inspect the stock ledger is codified in Del. C. § 220(b). It provides…: 'Any stockholder…shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger…. A proper purpose shall mean a *purpose reasonably related to such person's interest as a stockholder*.' Under Section 220, when a stockholder complies with the statutory requirements as to form and manner of making a demand, then the corporation bears the burden of proving that the demand is for an improper purpose. If there is any doubt, it must be resolved in favor of the statutory right of the stockholder to have an inspection.

Id. at 3 (emphasis in original). *See also VeriFone Holdings,* 12 A.3d at 1145 ("Section 220 expressly grants a stockholder of a Delaware corporation the right to inspect that corporation's books and records. That right is not absolute, however, because to obtain inspection relief the stockholder must demonstrate a proper purpose for making such a demand. A 'proper purpose' is defined as 'a purpose reasonably related to such person's interest as a stockholder.' To cite one example, investigating corporate mismanagement…is a proper purpose for seeking a Section 220 books and records inspection.").

Illustrative is *La. Mun. Police Emples. Ret. Sys. v. Countrywide Fin. Corp*., 2007 Del. Ch. LEXIS 138, *48 (Del. Ch. Oct. 2, 2007). In that case, a shareholder brought a books and records action alleging that there was a statistical correlation between stock option grants to corporate executives and subsequent positive short-term performance of the corporation's stock price. Specifically, the shareholder argued that the statistical correlation "suggest[ed] the possibility of 'backdating' or 'springloading' of certain stock options granted to corporate executives." *Id*. at *2.[8] The shareholder's Section 220 demand sought access to, *inter alia*, materials produced by the corporation's board to governmental investigative bodies and "minutes, notes, presentations, [or] slides,…provided to the board of directors…." *Id*. at *9.

The court deemed these demands to be of a permissible scope because they went "to the heart of [the plaintiffs'] stated purpose of investigating possible wrongdoing with respect to the granting of stock options to Countrywide corporate executives." *Id*. at *49. *See also Rock Solid Gelt Ltd. v. SmartPill Corp*., 2012 Del. Ch. LEXIS 234, *26 (Del. Ch. Oct. 10, 2012) (discussing twenty-two categories of records demanded and holding that the plaintiff has "demonstrated a proper purpose for some of its books and records requests and has demonstrated that it is entitled to inspect some of those books and records in aid of its proper purposes.").[9]

Delaware courts have repeatedly endorsed the use of books and records demands as a means of obtaining particularized facts which may satisfy the demand futility pleading requirement. *Verifone Holdings* is again instructive:

> Delaware courts have strongly encouraged stockholder-plaintiffs to utilize Section 220 before filing a derivative action, in order to satisfy the heightened demand futility pleading requirements of Court of Chancery Rule 23.1. To show demand futility, a stockholder-plaintiff in a derivative suit must allege with particularity why the stockholder was justified in having made no effort to obtain board action. By first prosecuting a Section 220 action to inspect books and records, the stockholder-plaintiff may be able to uncover particularized facts that would establish demand excusal in a subsequent derivative suit.

[8] As explained by the court: "The practice of 'backdating' involves a company issuing stock options to an executive on one date while providing fraudulent documentation asserting that the options were actually issued earlier. These options may provide a windfall for executives because the falsely dated stock option grants often coincide with market lows. Such timing reduces the strike prices and inflates the value of stock options, thereby increasing management compensation. This practice allegedly violates any stock option plan that requires strike prices to be no less than the fair market value on the date on which the option is granted by the board. […] The practice of 'spring loading' stock options involves making market-value options grants at a time when the company possesses, but has not yet released, favorable, material non-public information that will likely increase the stock price when disclosed." *Id*. at *2, n. 2 & 3.

[9] The *Horton* court contrasted "proper purposes" with those deemed to be improper. *See* 631 A.2d 1 at 11 ("Previous cases provide valuable examples of the degree to which a stated purpose is so indefinite, doubtful, uncertain or vexatious as to warrant denial of the right of inspection. In *State ex rel. Linihan v. United Brokerage Co*., Del. Super., 101 A. 433, 437 (1917), the trial court held that instituting annoying or harassing litigation against the corporation was an improper purpose. In *Carpenter v. Texas Air Corp*., 1985 Del. Ch. LEXIS 452, *10 (April 18, 1985), the court ruled improper the stockholder's plan to use a stocklist in furtherance of a scheme to bring pressure on a third corporation. In *General Time Corp. v. Talley Indus., Inc*., Del. Supr., 240 A.2d 755, 756 (1968), it was recognized that obtaining a list for purposes of selling the stockholder's names was also improper. Finally, in *Insuranshares Corp. of Delaware v. Kirchner*, Del. Supr., 5 A.2d 519, 521 (1939), the Court stated that neither conducting a "fishing expedition" nor satisfying idle curiosity were proper purposes to justify inspection. On the whole, a fair reading of these cases leads to the conclusion that where the person making demand is acting in bad faith or for reasons wholly unrelated to his or her role as a stockholder, access to the ledger will be denied.").

12 A.3d at 1145-46.[10]

Delaware courts also embrace Section 220 as a means of discouraging so-called fast-filers. As noted in *Pyott*, "[f]or publicly traded Delaware corporations, the enforcement of fiduciary obligations is largely carried out by specialized plaintiffs' firms who bring claims on a contingent basis." 46 A.3d at 366. These firms "only can obtain a fee if [they] first obtain[] a result. A firm cannot obtain a result if a competitor gains control of the case." *Id*. Accordingly, an incentive exists to be the first firm to the court house. Delaware has attempted to eliminate this incentive by adopting a rule that "[b]eing the 'first to file' does not automatically confer lead-plaintiff status." *Id*. at 338. "Outside of Delaware, [however,] the answer is far from clear." *Id*. Indeed, as the *Pyott* court noted:

> Many jurisdictions are perceived to follow a "first-filed" rule that gives control within that jurisdiction to the first stockholder plaintiff and associated law firm to file a representative action. Many jurisdictions likewise are perceived to give precedence to a "first-filed" action versus later-filed actions in other jurisdictions. When an event occurs that could provide grounds for a representative action, the first-filed rule incentivizes plaintiffs' lawyers to file as fast as possible in an effort to gain control of the litigation. Motivated by first-to-file pressure, plaintiffs' firms rationally eschew conducting investigations and making books and records demands, fearing that any delay would enable competitors to gain control of the litigation and freeze-out the diligent lawyer. No role, no result, no fee."

Id. at 337-338. Put another way:

> Because a plaintiff must plead a connection to the board, only the extremely rare complaint will be able to establish the necessary linkage without referring to internal corporate documents. To obtain the necessary documents, the Delaware courts have long exhorted potential derivative plaintiffs to use Section 220 to investigate their claims and obtain corporate books and records before filing derivative litigation. The Delaware courts have dismissed a steady stream of *Caremark* claims where the plaintiffs have not first used Section 220 to obtain books and records. In bringing these actions, "plaintiffs seem to hope the Court will accept the conclusion that since the Company suffered large losses, and since a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses." The Delaware courts consistently have rejected "such general *ipse dixit* syllogisms." Not surprisingly, without first obtaining books and records,

[10] This is not to say, however, that proceeding in this order – i.e., a Section 220 books and records demand before a derivative suit – is a hard-and-fast requirement. Indeed, Delaware courts permit the filing of a Section 220 action even after a previously filed derivative suit has been dismissed for failure to adequately plead demand futility, so long as the dismissal was granted with express leave to replead. *See Cent. Laborers Pension Fund v. News Corp*., 2011 Del. Ch. LEXIS 188, *6-7 (Del. Ch. Nov. 30, 2011).

stockholders have not been able to link the trauma to the directors, and their *Caremark* complaints have been dismissed. By contrast, stockholders who have

> used Section 220 and obtained documents showing board consideration or involvement have been able to survive Rule 23.1 motions. Put simply, fast-filing generates dismissals.

Id. at 342-344.

While Delaware courts clearly favor the use of books and records demands, such demands must nonetheless be narrowly drawn. Courts have held that "Section 220 is also not a way to circumvent discovery proceedings, and is certainly not meant to be a forum for the kinds of wide-ranging document requests permissible under Rule 34." *Highland Select Equity Fund, L.P. v. Motient Corp.*, 906 A.2d 156, 165 (Del. Ch. 2006). In other words:

> The procedures [of Rule 34 discovery requests and Section 220 books and records demands] are not the same and should not be confused. A Section 220 proceeding should result in an order circumscribed with *rifled precision*. Rule 34 production orders may often be broader in keeping with the scope of discovery under Court of Chancery Rule 26(b).' Our Section 220 cases hold, therefore, that while the right to books and records is an important stockholder protection, it is not unlimited.

Id. (emphasis in original). *See also Espinoza v. Hewlett-Packard Co.*, 32 A.3d 365, 372 (Del. 2011); *Security First*, 687 A.2d at 569 (Del. 1997) ("The plaintiff bears the burden of proving that each category of books and records is essential to the accomplishment of the stockholder's articulated purpose for the inspection.").

V. Special Litigation Committees

As previously indicated, when confronted with a demand from a disgruntled shareholder to remedy an alleged corporate trauma, the corporation's board has two choices: take over the litigation or oppose it. *Kamen*, 500 U.S. at 101. "In most jurisdictions, the board's decision to do the former ends the shareholder's control of the suit, while its decision to do the latter is subject only to the deferential 'business judgment rule' standard of review." *Id*. If the board decides to take over the litigation, it may delegate control to an independent and disinterested special litigation committee ("SLC"). *See generally Maldonado v. Flynn*, 413 A.2d 1251, 1255-56 (Del. Ch. 1980). *See also Aronson v. Lewis*, 473 A.2d at 813 ("even in a demand-excused case, a board has the power to appoint a committee of one or more independent disinterested directors to determine whether the derivative action should be pursued or dismissal sought.").

SLCs are charged with investigating the merits of the disgruntled shareholder's allegations and determining whether or not litigation is in the corporation's best interest. *Id.* (citing *Zapata* 430 A. 2d 779). The factors that SLCs should consider in deciding whether or not to pursue the litigation include:

> [t]he magnitude and merits of the claims; [t]he size and likelihood of a recovery of damages or other relief; [t]he possible detriment to the company from the

> assertion of any claims, as well as the indirect costs, such as the effect upon other potential litigation to which the company is a party, and relationships with customers or suppliers; and [t]he remedial steps already taken and that, in the future, could be taken by the corporation to prevent a reoccurrence of the challenged actions.

Pyott, 46 A.3d at 339. Upon examining these factors, the SLC produces a detailed, non-confidential report that describes why the SLC does, or does not, recommend that litigation be pursued. *See Zapata*, 430 A. 2d at 788.

If the SLC determines that litigation should not be pursued, the board will move to dismiss the suit. That motion will generally be granted where: (i) SLC members do not have an interest in the challenged transaction; (ii) SLC members are independent from corporate management; (iii) the SLC reasonably and in good faith investigated the shareholder's claims; and (iv) the SLC had a reasonable basis for recommending that the corporation move to dismiss the litigation. ALICE A. SEEBACH, *Special Litigation Committees, A Practitioner's Guide*, 24 Loy. L.A. L. Rev. 1, 6-7 (1990). *See also id*. at 25 (courts dismiss actions "where a challenged transaction achieved proper corporate goals and did not waste corporate assets, where a shareholder's action is unnecessary to "police the board," or where the cost of pursuing of the shareholder's claims – though meritorious – would outweigh whatever the corporation would gain) (citing *Rosengarten v. ITT*, 466 F. Supp. 817, 822 (S.D.N.Y. 1979), *Abbey v. Control Data Corp*., 603 F.2d 724 (8th Cir. 1979), and *Stein v. Bailey*, 531 F. Supp. 684, 690 (S.D.N.Y. 1982)).

Note, however, that in some states, including Delaware, dismissal is not a certainty even if all of the foregoing factors are satisfied. Indeed, in "demand excused" cases, Delaware courts "take a discretionary 'second step' and evaluate the merits of the shareholder's suit as well. If these courts find that litigation is in the corporation's best interests, or that 'law and public policy' favor the litigation, the shareholder's suit will proceed despite the [SLC's] recommendation." SEEBACH, 24 Loy. L.A. L. Rev. at 7. *See also Aronson*, 473 A.2d at 813 ("Under *Zapata*, the Court of Chancery, in passing on a committee's motion to dismiss a derivative action in a demand excused case, must apply a two-step test. First, the court must inquire into the independence and good faith of the committee and review the reasonableness and good faith of the committee's investigation. Second, the court must apply its own independent business judgment to decide whether the motion to dismiss should be granted."). Taking this "second step" provides what Delaware courts consider to be "the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee." *Zapata*, 430 A. 2d at 789.

By contrast, other states, such as New York, do not take the second step to examine the merits of a shareholder's suit. Instead, New York courts look only at whether or not the SLC used reasonable procedures. *See Auerbach v. Bennett*, 393 N.E.2d 994, 633-34 (N.Y. 1979) (holding that the SLC's "substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach."). If the corporation tasked an independent, disinterested SLC to properly investigate the shareholder's claims, courts in New York, relying on the BJR, will not pass judgment on the appropriateness of the SLC's decision. *See id.* ("While the court may properly inquire as to the adequacy and appropriateness of the committee's investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment.").[11]

With respect to timing, SLCs are usually established only after the corporation makes standing or jurisdictional objections to the shareholder derivative suit (*e.g.*, after corporation has moved to dismiss the suit for the shareholder's failure to make a pre-suit demand, own stock at the time of the challenged transaction, or assert a corporate [rather than a personal] injury). Corporations must make such objections before appointing an SLC because once the board has appointed an SLC, courts generally hold that the board has conceded that it cannot make a unbiased decision about whether or not the suit should be pursued, and thus that the plaintiff need not make a pre-suit demand. *See Abbey v. Computer Comm. Tech. Corp*., 457 A.2d 368, 373 (Del. Ch. 1983) (further nothing that upon SLC appointment, the individual directors lose standing to move to dismiss until the SLC issues its recommendation). *See also In re FirstEnergy S'holder Derivative Litig*., 320 F. Supp. 2d 621, 627 (N.D. Ohio 2004) ("If a board responds to a derivative suit by appointing a special litigation committee with the sole authority to evaluate whether to pursue the litigation before making a motion to dismiss for failure to make a demand, then a court may conclude that the board has conceded its disqualification and therefore demand may be excused."). The board can, however, move to stay the shareholder's litigation until the SLC has acted. *Abbey*, 457 A.2d at 375.

VI. Damages

With respect to damages available in shareholder derivative litigation, the Delaware Supreme Court has held that "[t]he Court of Chancery has the historic power 'to grant such relief as the facts of a particular case may dictate.'" *Ams. Mining Corp. v. Theriault*, 2012 Del. LEXIS 459 (Del. Aug. 27, 2012). In *Theriault*, for example, the shareholders alleged that the board of Southern Peru Copper Corporation ("Southern Peru") caused the corporation to acquire a 99.15% interest in a Mexican mining company (Minera México) for much more than it was

[11] The contrast between how New York and Delaware treat SLC decisions was described thusly in *Kamen*:

> In many (but not all) States, the board may delegate to a committee of disinterested directors the board's power to control corporate litigation. Some of these jurisdictions treat the decision of a special litigation committee to terminate a derivative suit as automatically entitled to deference under the "business judgment rule." *See, e. g., Auerbach…*, 47 N.Y.2d [at] 631-633…. Others, including Delaware, defer to the decision of a special litigation committee only in a "demand required" case; in a "demand excused" case, these States first require the court to confirm the "independence, good faith and…reasonable investigat[ory]" efforts of the committee and then authorize the court to exercise its "own independent business judgment" in assessing whether to enforce the committee's recommendation…. Thus, in these jurisdictions, "the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability." *Aronson…*, *supra*, at 812.

Kamen, 500 U.S. at 101-03.

worth. The Chancery Court agreed, awarding more than $2 billion in damages "based on the difference in value between what was paid (the 'give') and the value of what was received (the 'get')." *Id*. at *98-99 (also stating that "the Court of Chancery has greater discretion when making an award of damages in an action for breach of duty of loyalty than it would when assessing fair value in an appraisal action."). The Chancery Court further stated that Southern Peru's controlling shareholder, which had "extracted" from Southern Peru the above-market deal for Minera México (which, not coincidentally, the controlling shareholder also owned), could satisfy the judgment by agreeing to return to Southern Peru "such number of its shares as are necessary to satisfy this remedy." *Id*. at *95.

Disgorgement is another available remedy. Instructive is *Ohio Drill & Tool Co. v. Johnson*, 625 F.2d 738, 742 (6th Cir. 1980), where the Sixth Circuit held that "disgorgement of profits [is] the appropriate standard for measuring the liability of a corporate director for his breach of fiduciary duty." In contrast, punitive damages are generally not recoverable in derivative litigation. *See, e.g., Chemplex Fla. v. Norelli*, 790 So. 2d 547, 549 (Fla. Dist. Ct. App. 4th Dist. 2001) ("A plaintiff in a shareholder's derivative action against officers and directors of corporation cannot recover punitive damages in the absence of any statutory authority.").

Attorney fees are, of course, recoverable in shareholder derivative litigation. Informative – and rather incredible – is the recent *Theriault* decision, *supra*. Therein, the court affirmed a fee award of $304 million, which was 15% of the $2.031 billion total damages awarded in the case. According to the defendants, the fee award equated with a billable rate of over $35,000 per hour for the plaintiff's attorneys. The Court justified its award with the following reasoning:

> Under the common fund doctrine, "a litigant or a lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole." The common fund doctrine is a well-established basis for awarding attorneys' fees in the Court of Chancery. It is founded on the equitable principle that those who have profited from litigation should share its costs. "Typically, successful derivative or class action suits which result in the recovery of money or property wrongfully diverted from the corporation…are viewed as fund creating actions.

Id. at 101-02. The *Theriault* opinion continues:

> In *Sugarland Industries, Inc. v. Thomas*, this Court rejected any mechanical approach to determining common fund fee awards. In particular, we explicitly disapproved the Third Circuit's "lodestar method." Therefore, Delaware courts are not required to award fees based on hourly rates that may not be commensurate with the value of the common fund created by the attorneys' efforts. Similarly, in *Sugarland*, we did not adopt an inflexible percentage of the fund approach. Instead, we held that the Court of Chancery should consider and weigh the following factors in making an equitable award of attorney fees: 1) the results achieved; 2) the time and effort of counsel; 3) the relative complexities of the litigation; 4) any contingency factor; and 5) the standing and ability of

> counsel involved. Delaware courts have assigned the greatest weight to the benefit achieved in litigation.

Id. at 105-06.

The *Theriault* Court concluded its analysis by setting forth the following guideposts for determining the amount of an attorney fee award in derivative suits:

> Delaware case law supports a wide range of reasonable percentages for attorneys' fees, but 33% is 'the very top of the range of percentages.' The Court of Chancery has a history of awarding lower percentages of the benefit where cases have settled before trial. When a case settles early, the Court of Chancery tends to award 10-15% of the monetary benefit conferred. When a case settles after the plaintiffs have engaged in meaningful litigation efforts, typically including multiple depositions and some level of motion practice, fee awards in the Court of Chancery range from 15-25% of the monetary benefits conferred. 'A study of recent Delaware fee awards finds that the average amount of fees awarded when derivative and class actions settle for both monetary and therapeutic consideration is approximately 23% of the monetary benefit conferred; the median is 25%.' Higher percentages are warranted when cases progress to a post-trial adjudication.

Id. at 119-20.

VII. Indemnification

Section 145 of Title 8 of the Delaware Code governs indemnification of corporate directors and officers. Section 145(a) applies only to third party actions – not to actions brought by the corporation or derivatively on the corporation's behalf. Under Section 145(a), the person seeking indemnification must have acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interests of the corporation. In criminal cases, directors or officers may be indemnified for fines and costs if, in addition to the foregoing standard of conduct, they did not have reasonable cause to believe that their conduct was unlawful.

Section 145(b) pertains to actions brought by the corporation or derivatively. Unlike Section 145(a), Section 145(b) permits indemnification *only for* defense costs (not judgments or settlements). Furthermore, Section 145(b) does not permit indemnification when the person seeking indemnification has been adjudged to be liable to the corporation, unless, a court determines that that person is nevertheless entitled to indemnity for such defense costs as that court deems proper. Accordingly, there is legislative intent in Delaware to prohibit indemnification by Delaware corporations of judgments or settlements of derivative suits.

Under Section 145(c) of Title 8, if a director or officer is successful on the merits or otherwise in defense of a suit, under Subsections (a) or (b) of Section 145, he or she must be indemnified against expenses including attorney's fees incurred in connection with a defense. This section deals with indemnification only after the suit is over, having been won by the director or officer.

Section 102(b)(7) of Title 8 of the Delaware Code permits a corporation, which adopts a provision in its Certificate of Incorporation, to insulate its directors (but not officers or employees) from liability for duty of care violations. Thus, if a derivative suit alleges simply a duty of care violation without more, a director would be entitled to advancement of defense costs by the corporation pursuant to Section 145(b), and then would direct his or her counsel to assert the charter provision adopted pursuant to Section 102(b)(7), by way of an affirmative defense to the breach of duty of care derivative claim. If that affirmative defense was not successful, however, the corporation would not be permitted to indemnify the director with respect to either a judgment or settlement of the derivative suit. Rather such indemnification would have to come from A-Side insurance coverage.

VIII. Insurance

As noted above, Delaware prohibits corporate indemnification of judgments or settlements of derivative suits. Those amounts therefore are covered under A-Side coverage of a directors and officers ("D&O") insurance policy, assuming an exclusion, such as a misconduct exclusion, does not apply. Section 145(g) of Title 8 of the Delaware Code permits the insuring of judgment or amounts paid in settlement of a derivative suit, as well as defense costs incurred even when a director has been adjudged liable in some respects.

The nominal plaintiff in a derivative action is the company itself. Under most D&O insurance policies, both the company itself and, of course, the directors and officers are insureds under the policy. Most D&O policies also contain a so-called "Insured vs. Insured" exclusion, which excludes coverage for any claim by any insured against any other insured. At first blush, this exclusion would appear to preclude coverage for any derivative action, assuming the nominal identities of the parties are respected. Most D&O policies, however, exempt from the Insured vs. Insured exclusion claims brought derivatively on behalf of the corporation (but without any participation of any directors or officers).[12]

[12] If – theoretically speaking – directors of a corporation were to actually capitulate to a shareholder demand and file suit against other directors, the suit would not be covered, because it would have been filed with the involvement of the individual insureds. Some derivative plaintiffs have attempted to use that very fact as a basis for demand futility, as follows: by filing suit against themselves, the directors would have forfeited their insurance coverage, which they would never do, so demand was futile. Courts have *not* been receptive to this argument, which would essentially destroy the demand requirement. *See In re Coca-Cola Enterprises, Inc. Derivative Litig*., 478 F. Supp. 2d 1369, 1377 (N.D. Ga. 2007) *aff'd sub nom. Staehr v. Alm*, 269 F. App'x 888 (11th Cir. 2008) ("Courts applying Delaware law have addressed and refuted this argument on several previous occasions.").

Thus, broadly speaking, D&O policies usually provide some coverage for derivative claims.[13] Derivative actions and the related disputes and procedures raise several coverage issues, however. A few of those issues have come to the fore in recent case law.

A. Special Litigation Committees

As discussed in Section V above, many derivative actions commence with the issuance of a demand against the board. As previously explained, in order to consider the demand and obtain the protection of the "business judgment rule," the directors often form a Special Litigation Committee composed of independent directors.

The issue then arises: are the costs of a Special Litigation Committee's "investigation" covered Defense Costs under a D&O policy? The SLC is not – at least formally – defending a "Claim," rather it is determining whether such a Claim should be pursued in the first instance. There also may be a question as to whether the SLC itself is an "Insured" or "Insured Person" under the Policy.

The Second Circuit addressed this issue in the controversial case of *MBIA Inc. v. Federal Ins. Co.*, 652 F.3d 152 (2011). *MBIA*'s infamy among insurers lies primarily in its expansive interpretation of the definition of "claim" as it relates to regulatory investigations and subpoenas. But the case also contains an analytically debatable analysis of coverage for SLC costs, as well.

In *MBIA*, after regulatory investigations of the insured company came to light, the board received two shareholder demands. 652 F.3d at 157. The board formed a Demand Investigation Committee ("DIC") to investigate the demands. *Id.* The insurer reimbursed $200,000 of the DIC's costs, thereby exhausting the policy's special sublimit for demand investigations. *Id*. at 157-58 & n.1. When the board failed to act within the statutorily prescribed time, the shareholders filed derivative suits. *Id.* at 157-58. The board then "reconstituted" the DIC as a Special Litigation Committee ("SLC") which hired outside counsel to determine whether maintaining these suits was in the best interests of the company. *Id.* at 158. After the SLC's recommendation came back "no," the suits were dismissed. *Id.*

The insurer denied coverage for the SLC's costs. First, the insurer asserted that the SLC was not an "Insured Person," defined as "any past, present or future duly elected director or duly elected or appointed officer of [MBIA]." *Id.* at 163. The insurer argued that the SLC was obligated to operate independently of MBIA and, therefore, "took on an identity and exercised powers separate and apart from those granted to MBIA." *Id.* at 164. The Second Circuit, however, rejected this argument, pointing out that the SLC was only "independent" insofar as its members could not have a conflict of interest with regard to the subject matter of the shareholders' claims. *Id.* The SLC was still part of the MBIA board and, pursuant to Connecticut

[13] But not always – some D&O policies specifically exclude derivative claims from coverage, for example. *See Foodtown Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa*, 412 F. App'x 502, 505 (3d Cir. 2011) (analyzing derivative claims exclusion).

law, acted on behalf of MBIA when it determined that the suits were not in the best interests of the corporation. *Id.*

Second, the insurer asserted that the SLC's costs were subject to the $200,000 sublimit applicable to the separate insuring agreement specially designated for Shareholder Derivative Demands (Insuring Clause 4). *Id.* at 165. The insurer argued that if the costs were covered under the larger limit for defending Claims or Securities Claims, then this would nullify the $200,000 sublimit, violating the principle that every clause of a contract should be given effect. *Id.*

The Second Circuit construed this coverage defense as the equivalent of an "exclusion of coverage," which an insurer bears a "heavy burden" to establish applies under "clear and unmistakable language." *Id.* The court then found that although Insuring Clause 4 – and only that clause – clearly pertains to demand investigations occurring *before* a derivative action is filed, its application once a lawsuit is actually filed is "less obvious." *Id.* At that point, a "Claim" has been made, thereby triggering insuring clauses 2 and/or 3. The SLC's investigation could be deemed part of the investigation and defense of the Claim. *Id.* This overlap between insuring clauses does not completely nullify Insuring Clause 4, which still caps all *pre-suit* costs at $200,000. *Id.*

The insurer then had one last argument. The policy did not simply have separate, but potentially overlapping insuring agreements. The policy ostensibly eliminated the overlap by *expressly* carving out from the definition of Loss (which is covered under Insuring Clauses 2 and 3, as distinct from Investigation Costs, covered under Insuring Clause 4) "any amount incurred by [MBIA] (including its board of directors or any committee of the board of directors) in connection with the investigation or evaluation of any Claim or potential Claim by or on behalf of [MBIA]." *Id.* at 165-66. This language appeared to plainly and precisely describe the activities of a Special Litigation Committee formed to evaluate derivative claims.

But this language was not plain and precise enough for the court. The court noted that although MBIA was the nominal plaintiff in the derivative suit, it was the nominal defendant as well, and therefore the "on behalf of" language provided only "equivocal support" for the insurer's position. *Id.* 166. The opinion did not, however, explain why that conclusion followed, or why the exclusionary language did not nonetheless precisely describe the activities of the SLC.

The court then posited: "we think that the exclusion in the definition of 'Loss' is not clearly applicable to the costs incurred by the SLC because those costs were, at least to some extent, related to litigation, not investigation." *Id.* The significance of this distinction between "investigation" and "litigation" is unclear. The court seemed to be concluding that the SLC's "investigation" was essentially a sham – that the SLC was not actually investigating the viability of the claim, but was directly defending the derivative lawsuit. But there is nothing else in the opinion to support that conclusion. Although SLC investigations frequently (but not always) result in a recommendation against the pursuit of a derivative claim, there was nothing in the court's opinion to indicate that this SLC's investigation was intertwined with the defense of the derivative suit. The opinion states that the SLC hired its own outside counsel, presumably not the same outside counsel hired to defend the derivative suit.

When shareholders issue demands on the board as a prelude to a derivative suit, and an SLC is formed to investigate the shareholders' claims, D&O insurers generally take the position that the SLC's costs are not covered because they are not in defense of a "Claim." Many policies expressly exclude or carve out Special Litigation Committee activities and investigations of shareholder demands from coverage. But as *MBIA* shows, these issues are complex, and there is no guarantee that a court will mechanically apply that language. Note, however, that the parties and the court in *MBIA* agreed that the costs incurred by the DIC *before* suit was filed were covered *only* under the special insuring agreement applicable to investigation costs. Thus, the *MBIA* case does not necessarily spell doom for the insurers' position in the common scenario where the SLC investigation occurs prior to the filing of the derivative lawsuit.

B. Damages, Settlements, and Attorneys' Fees

As noted, many D&O policies do afford some coverage for derivative claims. As such, defense costs for derivative claims will often be covered under these policies. When derivative suits are settled or when damages or other remedies are awarded in such suits, the coverage problems bubble back to the surface. In the end, due to the inherent nature of derivative suits, the liability will often not entail a covered "Loss."

1. <u>Disgorgement</u>

One issue involves disgorgement. In many cases, the remedy as against individual directors and officers, particularly for breach of the duty of loyalty, is the return of ill-gotten gains. Most courts hold that disgorgement is not an insurable loss, either as a matter of public policy or as a matter of logic. That principle is exemplified by the case of *Level 3 Communications, Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001), which reasoned: "An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return." *Id.* at 911.

For example, the court in *Reliance Group Holdings, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 294 N.Y.S. 2d 20 (1993) held that the settlement of a derivative suit did not constitute a "loss" when it "was essentially equivalent to a determination" that the insured was "unjustly enriched" by $21.1 million, especially considering that the insured still gained a profit on the transaction when all was said and done. Liability for other typical derivative claims, such as corporate waste or other types of improper payments, will likewise often fail to constitute a covered "Loss." The standard "personal profit" exclusion will also generally apply.

On the other hand, courts have on occasion found that directors' settlement of a derivative suit constitutes a "loss" to them. *See, e.g.*, *International Ins. Co. v. Johns*, 874 F.2d 1447 (11th Cir.

1989). In *Johns*, the corporation created a "performance incentive plan" or "PIP" to create deferred compensation for certain officers of the company. *Id.* at 1451. Then, as part of a merger, the corporation entered into a 5-year consulting agreement with its outgoing CEO for $225,000 per year. *Id.* at 1451. A disgruntled shareholder later filed a derivative suit, arguing that the PIP and the consulting agreement constituted corporate waste. *Id.* at 1452. As part of the settlement, the directors returned $600,000 awarded under the PIP and the CEO's consulting agreement was reduced to 2.5 years. *Id.*

The insurer argued that return of the PIP funds did not constitute a "loss" -- after all, the directors still received a bonus, just a lesser amount. *Id.* at 1454. They further argued that the reduction of the CEO's consulting agreement was essentially the "foregoing of future payments to which [the CEO] was not entitled." *Id.* The court rejected these arguments, although it found the consulting agreement to be a more difficult question. *Id.* at 1455. In its analysis of the "loss" issue, the court simply examined the settlement itself and whether the directors lost money in the settlement. *See id.*

For subsequent cases, however, it was significant that later on in the opinion, the *Johns* court found that the PIP payments and consulting agreement did *not*, as a matter of fact, constitute corporate waste, and therefore the insureds were entitled to those funds before losing them in the settlement. *See CNL Hotels & Resorts, Inc. v. Houston Cas. Co.*, 505 F. Supp. 2d 1317, 1325 (M.D. Fla. 2007) *aff'd in part sub nom. CNL Hotels & Resorts, Inc. v. Twin City Fire Ins. Co.*, 291 F. App'x 220 (11th Cir. 2008); *Level 3*, 272 F.3d at 910. Although that discussion was in the context of the policy's exclusions, it was logically important for the finding that the settlement constituted covered "loss." Since the directors were legally entitled to the compensation in the first instance, foregoing those funds constituted a "loss."

Other derivative claims, on the other hand, allege that directors or officers damaged the corporation through their actions (whether through lack of loyalty or care), without exclusively benefiting themselves in the process. The recent spate of derivative claims relating to Foreign Corrupt Practices Act violations fit that description. In those cases, the shareholders are claiming that the directors were asleep at the switch and failed to notice or prevent the violations, which ended up forcing the companies to incur massive penalties and losses. Liability in such cases could involve actual damages, rather than disgorgement, and is more likely to trigger coverage.

2. <u>"Bump-Up" Claims and Attorney's Fees</u>

A more fundamental problem arises when the insured company itself claims to have incurred an insured "loss" in the course of a derivative suit. Again, the shareholder plaintiff brings suit on behalf of the corporation, claiming that the board's actions harmed the corporation, such that the corporation is nominally both a plaintiff and a defendant. Sometimes these suits take the form of so-called "bump-up" claims – suits claiming that a transaction does not provide sufficient value to the corporation. If the shareholder prevails, the resulting remedy necessarily compensates for the harm to the corporation and thus *benefits* the corporation.

The case of *Safeway Stores, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 64 F.3d 1282 (9th Cir, 1995) illustrates this problem. In *Safeway*, the company announced it would enter into an LBO, and was then scheduled to pay its regularly quarterly dividend shortly thereafter, such that the acquirer would receive most of the dividend. *Id.* at 1284. After the LBO was announced, several derivative suits were filed, and then eventually settled. *Id.* As part of the settlement, the record date for a portion of the dividend ($11.5 million) was moved to before consummation of the LBO, such that the pre-LBO shareholders would receive it. *Id.* at 1285. The company also agreed not to oppose plaintiffs' application for $1.825 million in attorney's fees. *Id.*

The company claimed that both the $11.5 million dividend and the attorneys' fees as covered "loss" under its D&O policy. Turning first to the dividend, the court held that it was not a "loss." The court observed:

> It is difficult to see how a corporation's payment of a dividend could ever be a "loss" under the terms of an insurance policy. Neither the owners of that corporation nor its directors suffered a loss. The effect of a dividend is simply to transfer corporate profits from one part of the corporation to another, that is, from the purse of the corporate entity into the pockets of the corporation's owners, the shareholders. In this context, it is absurdly formalistic to view the corporation and its shareholders as separate entities.

Id. at 1286. Rather, the court found that payment of the dividend essentially amounted to the acquirer "upping its purchase price" for the insured company by $11.5 million. *Id.* Thus, the dividend, if a "loss" to anyone, was a loss to the acquirer, not to the company. *Id.* The court held that the attorneys' fees, however, constituted a covered "loss" to the insured. *Id.* at 1286-87.

Similarly, in *XL Specialty Ins. Co. v. Loral Space & Communication, Inc.*, 918 N.Y.S.2d 57 (App. Div. 1st Dep't 2011) shareholders filed derivative suits claiming that a prospective merger would shortchange the existing shareholders of the corporation. *Id.* at 60. After trial, the Delaware Chancery Court restructured the merger, and awarded attorney's fees to the plaintiffs' attorneys. *Id.* The corporation, which paid the attorney's fees, sought coverage for the fees as an insured under its D&O policy. The insurer pointed out that the restructuring diluted the value of the acquirer's shares and thus actually provided a benefit to the insured company. *Id.* at 61. The attorneys' fees, meanwhile, simply reduced the benefit that the company otherwise received. *Id.* Like in *Safeway,* the court held that although the restructuring actually benefited the corporation, the attorneys' fees stood alone as a covered "loss" under the D&O policy. *Id.*

IX. Conclusion

As the introduction to this article stated, the law pertaining to shareholder derivative actions is unique and complex. Hopefully, this article has increased the reader's understanding of these complexities and the interplay of corporate indemnification and directors' and officers' insurance coverage with derivative actions generally. In these challenging economic times, we can anticipate more situations in which boards of directors attempt in unique ways to maximize shareholder return. Since not all shareholders will agree with the approach boards will take, shareholder derivative actions will be in the news more often than ever before.