

# North America Financial Lines: Public Company D&O Liability Claims

Public company Directors & Officers (D&O) Liability exposures have long been synonymous with securities class action (SCA) litigation. While this litigation makes headlines, it isn't the only driver of D&O losses. In fact, focusing exclusively on SCAs may ignore substantial sources of exposure. In this edition of AIG's Claims Intelligence Series, we contemplated AIG claims data on D&O liability losses from 10,500 matters noticed on policies issued from 2016 through 2020 to North American D&O insureds, including both financial institutions and commercial accounts. The result is a uniquely insightful view of the nature of D&O liability risk.



## At a glance

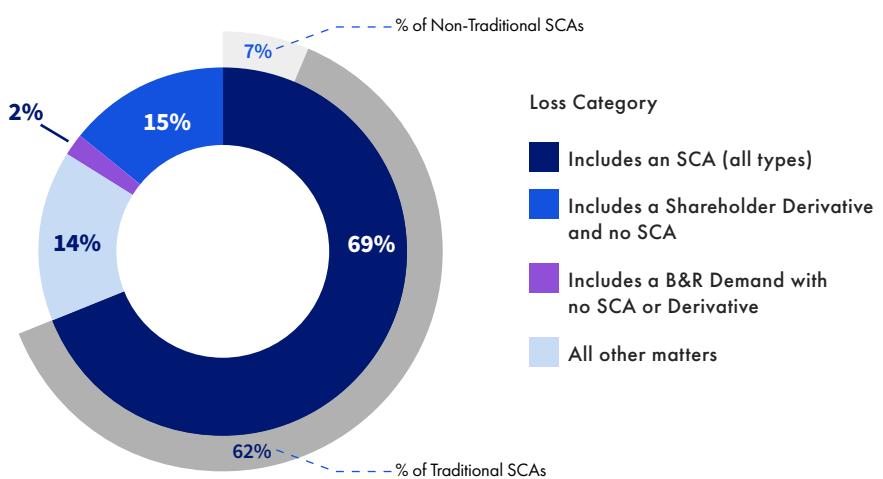
- Assessing true D&O exposure is essential to making sound insurance buying decisions and crafting sustainable D&O solutions, which requires looking beyond SCAs.
- The data tells a nuanced story. SCAs account for only 69% of all paid losses during the period studied.
- Of those SCAs with paid loss, 89% were "Traditional SCAs," which include actions based upon Sections 11, 12, and 15 of the Securities Act of 1933 and Section 10(b)(5) of the Exchange Act of 1934.
- Of all losses paid, 38% came from "Non-traditional SCAs," derivative actions, books and records (B&R) demands, or other types of claims.
- Non-SCA losses generally remain off the radar, yet represent a genuine risk to insurers and insureds alike.
- Standalone derivative actions are driving up D&O exposure, accounting for 15% of total losses during the period studied.
- B&R demands should be taken very seriously. Total loss associated with standalone derivative actions with at least one B&R demand is 81% higher than in those actions without B&R demands.

## A True View of Exposures

While seemingly ubiquitous, SCAs represented 69% of the overall D&O losses paid by AIG for public company insureds. **31% of D&O liability losses studied had no SCA-association at all.**

Among the losses for matters that did not include an SCA, standalone derivative actions led the pack, accounting for 15% of total losses paid during the period. The maximum loss paid on these standalone derivative actions was \$15 million. The average was \$1.6 million, a level that may keep them off the radar of the C-suite yet represents a material exposure.

A Comprehensive View of D&O Losses



## The Mega Derivative Myth

Much has been written about the rise of the “mega derivative” settlement, which for the purposes of this report we are defining as a derivative claim with a settlement in excess of \$90 million. Although large loss derivatives are not new, the frequency of these claims has increased markedly recently. Of the 19 largest derivatives settlements of all time, 12 were settled in 2016 or later and nine were settled in 2020 or later.<sup>1</sup> However, while there is much talk of “mega derivatives,” they are not a meaningful driver of either loss or claims for this category:

**Loss:** Only 28% of our loss in the “derivatives without an associated SCA” category comes from these “mega derivatives.” That means a substantial 72% of loss in this category is not associated with the top 19 derivative settlements of all time.

**Claims:** Only .03% of claims are standalone derivative actions (i.e., those without an associated SCA) and 4% of these are mega-derivative.

## Categorizing the SCAs

For the purposes of this study, AIG separated SCA losses into two groups:

“Traditional SCAs,” which include actions based upon Sections 11, 12, and 15 of the Securities Act of 1933 (those arising from IPOs or secondary offerings) and actions based upon Section 10(b)(5) of the Exchange Act of 1934 (those arising from false or misleading statements on which investors rely when buying or selling a security). These accounted for only 62% of the total losses paid during the period studied.

Seven percent of the SCAs with paid loss during the period arose from “Non-traditional SCAs.” These include actions based upon Section 14(a) of the Exchange Act of 1934, which allege material misrepresentations and omissions in proxy statements connected to a merger, actions based upon Section 14(e) of the Exchange Act of 1934, which allege fraudulent, deceptive, and manipulative acts connected to a tender offer (Section 14(e)), or Section 16(b) of the Exchange Act of 1934 alleging short swing profits.

**Standalone derivative actions accounted for 15% of total losses during the period studied and 11% when not including losses arising from mega-derivatives.**

<sup>1</sup> LaCroix, K. (2023, April 23). Largest Derivative Lawsuit Settlements. The D&O Diary. <https://www.dandodiary.com/2014/12/articles/shareholders-derivative-litigation/largest-derivative-lawsuit-settlements/>

## A Dangerous Entry Point

Standalone derivative actions in general are driving up D&O exposure. Our research shows the use of B&R demands is intensifying and the inclusion of at least one B&R demand associated with a shareholder derivative action is a significant multiplier of public company D&O losses.

The percentage of derivative claims accompanied by at least one B&R demand rose to 17% in 2021. Total loss associated with standalone derivative actions that include at least one B&R demand is 81% higher than the overall paid loss in those actions without B&R demands.

Additionally, derivative actions that do not include a related SCA but are accompanied by at least one B&R demand are associated with significantly higher loss. The average loss per claim for a derivative claim without an SCA but with a B&R demand is 73% higher than average loss for a derivative without either an SCA or B&R demand.

Instances of paid loss from B&R demands alone are also emerging. The average B&R loss without an SCA or derivative action was \$1.3 million, and the maximum reached \$10 million.

## Percentage of Derivative Claims Including a Books & Records Demand

Policy Year	Percentage of Derivative Claims Including a B&R Demand
2016	11%
2017	9%
2018	10%
2019	9%
2020	14%
2021	17%



**Total loss associated with standalone derivative actions with at least one related B&R demand is 81% higher than the overall paid loss in those actions without B&R demands.**

## Case Studies

The common denominator in many real-life, large-scale public company D&O claim scenarios are B&R demands.

On the heels of an initial B&R demand, the company faced an SCA alleging violation of Section 14(e) of the Exchange Act of 1934 – prohibiting fraudulent, deceptive, and manipulative acts in connection with a tender offer – which was quickly dismissed. Four months later, both class and derivative claims were filed. Armed with pre-litigation discovery obtained from the B&R demand, plaintiffs successfully proceeded past the motion to dismiss stage to the costly discovery stage. The matter ultimately settled for \$35 million, with defendants incurring at least \$13.7 million in defense costs, a total loss of \$48.7 million.

First notice was a B&R demand on behalf of a shareholder seeking to inspect records in connection with one company's acquisition of a majority interest in the insured company. Plaintiffs filed a complaint three months later. Following a motion to dismiss, the case proceeded, in part, as a direct and derivative shareholder action. The case settled on behalf of the non-insured defendants in the amount of \$45 million while the Court dismissed the insured defendant. Despite the dismissal, incurred loss, due to defense costs, still totaled over \$6.6 million.

An insured received notice of a B&R demand seeking information in connection with its proposed acquisition. The demand stemmed from a potential conflict of interest alleging that the terms unfairly favored a stockholder who controlled both companies. Three months later, plaintiffs filed a shareholder class and derivative complaint asserting that the controlling shareholder was unjustly enriched by the transaction. Plaintiffs were able to obtain pre-litigation discovery by way of B&R demands. The matter ultimately proceeded past a motion to dismiss, ultimately reaching a \$100 million settlement, which included \$35.5 million paid on behalf of individual defendants under a single D&O insurance tower issued to the acquiring company. Ultimately, loss on that tower totaled approximately \$69.7 million, inclusive of \$34.2 million in defense costs.

The insured first noticed a matter as a B&R demand arising from a transaction in which the company attempted to purchase allegedly overvalued assets from a company owned/controlled by the insured's CEO. Although the company abandoned the alleged conflicted party transaction, plaintiffs filed a derivative complaint three months later. The matter settled for corporate therapeutics only. However, the insured still fully exhausted its \$5 million primary D&O policy and the applicable \$1.5 million retention due to the plaintiff attorneys' fee award of \$4.5 million plus the defendants' own defense costs.

First notice was a B&R demand regarding certain transactions the insured company entered into with its controlling stockholder and Chairman. Nearly six months later, after obtaining pre-litigation discovery, plaintiffs filed a shareholder derivative complaint. Defendants declined to move to dismiss the action, believing it would be futile. The parties quickly reached a settlement for corporate therapeutics and plaintiff's attorneys' fees. Including defense costs, defendants incurred almost \$4.5 million in losses.

AIG has more than six decades of experience providing management liability solutions for companies, and their directors and officers. Our extensive knowledge, resources, and data enable us to tailor solutions to our client's individual needs. AIG's financial strength, integrated claims model, and proven claim expertise ensure that we are there, helping to drive the best possible outcome for our clients.

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The scenarios described herein are offered only as examples. Coverage depends on the actual facts of each case and the terms, conditions and exclusions of each individual policy. Anyone interested in the above products should request a copy of the standard form of policy for a description of the scope and limitations of coverage.

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