D&O Insurance to Fund Entire "Largest Ever" $139 Million News Corp. Derivative Suit Settlement

In what the plaintiffs' lawyers claim to be the largest derivative lawsuit settlement ever, the parties to the News Corp. shareholder derivative litigation have agreed to settle the consolidated cases for $139 million. The cash portion of the settlement is to be funded entirely by D&O insurance. The company also agreed to other corporate therapeutics, including establishing a whistleblower hotline. The settlement is subject to court approval.

The first of the lawsuits against the News Corp. board was filed in Delaware Chancery Court in March 2011, asserting claims in connection with the company's $675 million acquisition of Shine Group, Ltd., a U.K.-based television production company owned by Elizabeth Murdoch, daughter of News Corp. Chairman Rupert Murdoch. Later complaints added extensive additional claims seeking to hold the company's directors accountable for the scandal surrounding the company's use and attempted cover-up of illegal reporting tactics (phone-hacking scandal). The various cases were later consolidated in the Delaware Chancery Court.

In their Third Amended Consolidated Complaint, the plaintiffs alleged that the board's oversight of the company's affairs represented a "textbook example of failed corporate governance and domination by a controlling shareholder." The complaint alleges that for years "the Board has condoned Murdoch's habitual use of News Corp. to pursue his quest for power, control and political gain and to enrich himself and his family members, at the Company's and its public shareholders' expense." Elizabeth Murdoch allegedly made $250 million in the acquisition. The complaint alleges that the ongoing scandals have not only harmed the company's reputation and cost it millions in defense costs

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and other expenses, but that the company's share price is artificially depressed because of the negative association of the company with Murdoch.

The defendants filed a motion to dismiss the consolidated amended complaint. The parties argued the motion to dismiss on September 19, 2012. While the dismissal motion was pending, the parties engaged in mediation that ultimately resulted in a settlement.

The plaintiffs' lawyers claim that this is the largest cash shareholders' derivative settlement ever. We have been tracking derivative suit settlements and there have been several that were nearly as large as the News Corp. settlement:

The El Paso/Kinder Morgan merger-related derivative suit settled in September 2012 for $110 million.

In 2005, the Oracle derivative suit settled based on the payment by Oracle CEO Larry Ellison of a total of $122 million.

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In September 2008, the parties to the 2002 AIG shareholders' derivative lawsuit agreed to settle the case for a payment of $115 million (of which $85.5 million was to be paid by D&O insurance) in what was touted at the time as the largest Delaware Chancery Court derivative lawsuit settlement.

These settlements are all dwarfed by the $2.876 billion judgment entered into on June 2009 against Richard Scrushy in the HealthSouth shareholders' derivative lawsuit in Jefferson County (Alabama) Circuit Court. That astronomical judgment represents its own peculiar point of reference. As highlighted, it was a judgment following trial, rather than a settlement.

Another outlying point of reference is the $1.262 billion judgment that Chancellor Leo Strine entered in the October 2011 Southern Peru Copper Corporation Shareholder Derivative Litigation. That case too represents a derivative suit judgment following trial, rather than a settlement.

An additional derivative lawsuit resolution that is worth considering in the context of the "largest ever" is the December 2007 settlement of the UnitedHealth Group options backdating-related derivative lawsuit. The lawsuit settled for a total nominal value of approximately $900 million. However, while the press reported the settlement as the largest derivative settlement ever, the value contributed to the settlement consisted of the surrender by the individual defendants of certain rights, interests and stock option awards – and not cash value in that amount.

Aside from the question of the News Corp. derivative suit settlement's sheer size, there is also the fact that the settlement was funded entirely by D&O insurance. Given the amount of the settlement, the settlement costs undoubtedly were covered by several carriers that participated in News Corp.'s D&O insurance program. This large settlement not only represents a serious and unwelcome development for the specific carriers involved, but it also represents a potentially unwelcome event for the D&O insurance industry as a whole due to the severity of the loss.

In the past ten years or so, shareholders' derivative suits typically did not present the likelihood of significant cash payouts for D&O insurers, at least in terms of settlements or judgments. The cases did present the possibility of significant defense expense and also of the possibility of having to pay the plaintiffs' attorneys' fees – but by and large, there was usually not a cash settlement component. As the above examples illustrate, that has clearly changed in more recent years.

This trend initially gained momentum with the options backdating scandal. Many of the options backdating cases were filed as derivative suits rather than as securities class action lawsuits (largely because the options backdating disclosures did not always result in the kinds of significant share price declines required to support a securities class action lawsuit). Many of the options backdating case settlements included a cash component, and as illustrated by the Broadcom case mentioned above, some of the options backdating derivative suit settlements included very substantial cash components.

As highlighted by the El Paso settlement, the inclusion of a significant cash component has also been a feature of the settlements of some of the merger objection suits that have recently been filed as part of the current upsurge in M&A-related lawsuits.

This upsurge in the number of derivative suit settlements that include a significant cash component can only be viewed with alarm by the D&O insurance industry. For many years, D&O insurers have considered that their significant severity exposure stemmed from securities class action lawsuits. The undeniable reality is that in some circumstances, derivative suits increasingly represent a severity risk as well. And the settlement amounts themselves represent only part of the D&O insurers' loss costs. The D&O insurers also incur millions, and possibly tens of millions, of defense cost expense in these derivative suits.

An even more concerning aspect of the rise of significant cash settlements in derivative cases for D&O insurers is that these settlement amounts represent so-called "A Side" losses. That is, the losses are paid out under the portion of the D&O insurance policy that provides insurance for nonindemnifiable loss. A derivative suit settlement is obviously not indemnifiable, because if it were to be indemnified, the company would make the indemnity payment to itself. For the "traditional" D&O insurance carriers, there is perhaps no particular pain associated with the fact that the loss is paid under the "Side A" portion of the policy, as opposed to the other policy coverages (that is, the "Side B" or "Side C" coverage that are more typically called into play). But these days many companies carry – in addition to their traditional D&O insurance that includes all three coverages (Sides A, B and C coverage) – additional layers of excess Side A insurance.

As long as the corporate defendant is solvent, this dedicated excess Side A insurance would not be responsive to a securities class action lawsuit, because the settlement of a securities class action lawsuit is an indemnifiable loss to which coverages B and C should apply. However, the Side A coverage does apply to a shareholders' derivative lawsuit settlement because the settlement amount represents a nonindemnifiable loss. So while a jumbo securities class action settlement typically would not trigger coverage under an Excess Side A policy, a jumbo derivative settlement may trigger the Excess Side A policies.

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The question for the carriers providing this type of excess Side A insurance is whether or not the premiums they are charging are adequate to compensate them for the risks of the kinds of losses associated with large cash shareholder derivative settlements. By and large, the carriers providing this insurance consider that their most significant exposure is related to claims in the insolvency context. But as this settlement and the Broadcom settlement demonstrate, it is also possible that the Side A insurance could be implicated in a jumbo derivative settlement as well.

The increasing risk of this type of settlement represents a significant challenge for all D&O insurers, but particularly for those D&O insurers concentrating on providing Excess Side A insurance. Those insurers will have to ask how they are to underwrite the risks associated with these kinds of exposures, and how they are to make certain that their premiums adequately compensate them for the assumed risk.

ABOUT THE AUTHOR

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