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MASSIVE SETTLEMENT IN WELLS FARGO DERIVATIVE SUIT

The parties to the consolidated Wells Fargo derivative suit arising out of the bank's phony customer account scandal have agreed to settle the case for a variety of cash and non-cash benefits with a stated value to the company of $320 million, inclusive of a cash payment of $240 million. Not only is this one of the largest-ever derivative lawsuit settlements, but, according to the plaintiffs' counsel, the $240 million cash portion of the settlement to be paid by the bank's D&O insurers, is "the largest insurer-funded cash component of any shareholder derivative settlement in history." This settlement represents the latest in a series of derivative suit settlements with a significant cash component - a case resolution pattern in high-profile derivative suits that arguably represents the new normal in the world of D&O liability exposures.

BACKGROUND

The bank's sales practices scandal arose out of a high-pressure sales strategy that led to as many as 2.1 million deposit and credit card accounts being created using fictitious or unauthorized customer information. In September 2016, fines and penalties totaling $185 million were imposed on the bank, including a $100 million fine by the Consumer Financing Protection Bureau, $35 million penalty to the Office of the Comptroller of the Currency, and another $50 million by the City and County of Los Angeles. In addition, in late March 2017, the bank agreed to a $110 million settlement of the consolidated class action that had been filed on behalf of bank customers who were affected by the improper sales practices.

In April 2017, following an independent board investigation, the bank imposed compensation clawbacks totaling over $180 million on certain former bank executives for their involvement in the fraudulent account scandal.

These various developments led to a host of lawsuits, including not only the derivative lawsuits, but also a related securities class action lawsuit that was settled in 2018 for $480 million.

THE DERIVATIVE LAWSUITS

Beginning in September 2016, a number of Wells Fargo shareholders filed a series of shareholder derivative lawsuits in the Northern District of California. These various derivative suits were later consolidated and the court appointed co-lead plaintiffs and co-lead counsel, after which the plaintiffs' filed a consolidated amended complaint. In addition, a number of other Wells Fargo shareholders filed separate state court derivative actions relating to the bank's alleged improper sales practices. These state court actions have either been stayed or dismissed.

The consolidated amended complaint alleged that the bank's board and senior executives "perpetuated" a business-model based on aggressively cross-selling additional products to existing customers. Employees allegedly could face termination if they failed to meet allegedly "unreasonably high sales quotas." These practices "effectively forced" its employees to open over two million unauthorized accounts. The company senior officials allegedly "knew

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180 North Stetson Avenue
Suite 4600
Chicago, IL 60601
(312) 784-6001

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or consciously disregarded that Wells Fargo employees were illicitly creating millions of deposit and credit card accounts for their customers, without these customers' knowledge or consent." The amended complaint contends that the defendants knew about and permitted these activities notwithstanding complaints to the company's ethics line, several wrongful termination lawsuits, a whistleblower lawsuit, and a Los Angeles Times article that reported the fraudulent account creation activity.

The amended complaint asserted claims for breach of fiduciary duty; unjust enrichment; violations of the federal securities laws and the California Corporations Code; corporate waste; and contribution and indemnity. Plaintiffs sought declaratory relief, damages, injunctive relief, restitution, and attorneys' fees.

The defendants filed a motion to dismiss the amended complaint. In an October 4, 2017 order, Northern District of California Judge Jon S. Tigar substantially denied the defendants' motion to dismiss. The parties subsequently entered into mediation during 2017 and 2018. The mediation resulted in a mediators' settlement proposal, which, in December 2018, the parties accepted. On February 28, 2019, the plaintiffs' filed a motion for preliminary approval of the settlement with the court.

THE DERIVATIVE LAWSUIT SETTLEMENT

The settlement agreement consists of several parts: (1) a monetary payment of $240 million to be paid by Wells Fargo's insurers; (2) acknowledgement by Wells Fargo that the derivative suit was a significant factor in the company's adoption during the suit's pendency of a number of corporate governance reforms; and (3) acknowledgement by Wells Fargo that the derivative suits were a significant factor in instituting the remedial steps undertaken by Wells Fargo during the pendency of the actions, including compensation reductions and forfeitures involving certain bank executives. The parties agreed and offered to the court that the governance reforms and clawbacks have a combined value to Wells Fargo of $80 million, for a stated total settlement value of $320 million. The defendants have denied and continue to deny any allegations of wrongdoing or liability.

The settlement includes an agreement and understanding that as part of the settlement hearing before the court, the co-lead plaintiffs' counsel will apply to the court for an award of fees and expenses not to exceed $68 million, to be paid by Wells Fargo out of the insurance proceeds.

By any measure, this settlement is one of the largest shareholder derivative settlements ever. Just exactly where it fits on the derivative settlement league tables depends on how you look at it, but that is for another discussion. Irrespective, the Wells Fargo derivative suit settlement represents a very significant development. Among other things, it is the latest example of the way in which shareholder derivative settlements now increasingly involve a significant cash component, which was very uncommon in the past. Typically, derivative settlements in the past involved an agreement to adopt corporate therapeutics and the payment of plaintiffs' attorneys' fees. In the last ten years, it has become increasingly common for high-profile derivative suit settlements to involve a significant cash component, increasing the financial risk of these settlements for both the defendant companies and their D&O insurers.

As the massive amount of insurance money that is going toward this settlement demonstrates, the advent of a significant cash contribution component in derivative settlements represents a very serious problem for D&O insurers. The increase in the cash component of derivative settlements is one more change in the D&O litigation arena that significantly increases the D&O insurers' potential exposure. This arguably is a particular concern for excess D&O insurers, as these large losses now push into the high attaching excess layers in a way they would not have in the past. Moreover, the advent of this change in derivative suit settlements over the last few years has coincided with the period in which D&O insurance premiums have significantly decreased (particularly the

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Suite 4600
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premiums for high attaching excess layers). Recently, the carriers have tried to start pushing back on premiums, arguing that they are not being adequately compensated for the risks they are underwriting.

The one thing that seems certain is that given the plaintiffs' lawyers' hoped-for payday of $68 million, the plaintiffs' bar will certainly have incentives to pursue more claims of this type. To be sure, the Wells Fargo case was unusual and involved allegations of significant wrongdoing. There are however, a host of current corporate scandals out there (e.g., Tesla, PG&E, Kraft Heinz) that arguably also raise serious allegations.

Given that it involves the settlement of a derivative suit, the settlement presumably is non-indemnifiable, meaning that the settlement will be covered by the Side A coverage of the policies of the settling insurers. This in turn means that the Excess Side A coverage of any Side A DIC policies in Wells Fargo's insurance tower were likely triggered as well. Without knowing more about the Wells Fargo's insurance tower, it is hard to know whether or to what extent the group of contributing insurers included Side A DIC carriers.

The size of the Wells Fargo derivative suit settlement is the latest drumbeat in an increasing cadence of changes to the securities litigation landscape and, by extension, to the D&O insurance industry. Given the significant excess capacity in the industry, whether these changes have a meaningful long-term impact to the industry remains to be seen, but in the short term, D&O underwriters will certainly be taking this into consideration as they chart their course for the balance of 2019.

ABOUT THE AUTHOR

This article was prepared by Kevin M. LaCroix, Esq. of RT ProExec. Kevin has been advising clients concerning directors' and officers' liability issues for nearly 30 years. Prior to joining RT ProExec, Kevin was President of Genesis Professional Liability Managers, a D&O liability insurance underwriter. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell.

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Agents and brokers, for more information contact your local RT Specialty broker:

RT Specialty
180 North Stetson Avenue
Suite 4600
Chicago, IL 60601
(312) 784-6001

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