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Mission-Critical Risk and Catastrophic D&O Claims

A Governance Framework for
Underwriters

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Introduction

Companies often rely on comprehensive directors' and officers' liability insurance (D&O) to attract qualified individuals to serve in executive and board positions. D&O insurance plays an important role in the financial ecosystem and was designed to protect directors and officers from personal liability that arises from good-faith business decisions which are made every day in their respective roles.

D&O insurance typically protects directors and officers from personal liability and reimburses companies when they indemnify those individuals for covered claims. Included in these covered claims is derivative litigation which typically alleges breaches of fiduciary duty, oversight failures, and corporate misconduct. D&O insurers frequently fund mega-derivative settlements arising from large corporate governance failures.

Catastrophic D&O derivative claims often originate from failures in corporate governance and oversight. Many companies that later become the subject of major derivative litigation appear financially healthy and governance-compliant before the underlying events occur.

How do we as an underwriting community come together to identify culture and governance failures before they turn into claims, and more importantly, before corporate actions harm the public? This paper argues that traditional underwriting indicators have limited predictive value for governance failures and subsequent derivative litigation. This will be explored through current legal frameworks and three case studies including The Boeing Company, Wells Fargo & Company, and McKesson Corporation. In addition to the findings in this paper, the Mission Critical Governance Scoring tool was developed to evaluate if underwriters could determine red flags and warning signs before governance failures occur.

Derivative Litigation as a Mechanism for Corporate Oversight

"A shareholder derivative suit...is a lawsuit filed by a shareholder on behalf of the corporation against directors, officers, or third parties who have harmed the corporation by breaching their duties. The claim belongs to the corporation, not the shareholder, and any recovery goes to the corporation."¹ Derivative litigation serves as a key mechanism for enforcing directors' fiduciary duties and holding boards accountable for alleged oversight failures.

Derivative suits are interesting because technically, the owners of the company (shareholders) are suing themselves (the company). Oftentimes, if the derivative suit reaches settlement, not only are monetary damages awarded, but governance changes are enacted along with internal control improvements. These monetary damages are often funded in full by D&O insurance.

The Corporate Governance Framework: Fiduciary Duties and Oversight Obligations

Each company has their own set of rules that they govern themselves by, which are typically put in place by the company and approved by the board. These rules include bylaws about board composition (criteria, diversity policies, director independence, board sizes, terms, voting policies, board responsibilities, etc.), and many requirements are set forth by case law. Directors & officers have several fiduciary duties that they must adhere to, the most important of which, in the context of D&O insurance and derivative suits, includes the duty of care, duty of loyalty, and the duty of oversight.

The duty of care requires directors to make informed decisions with reasonable diligence and prudence, which is owed by directors and officers to the corporation, not the stakeholders or broader society.² The duty of loyalty demands directors to act in the best interests of both the company and their shareholders before their personal and financial interests.³ Any personal bias or conflict of interest should be set aside. Most relevant to this paper is the duty of oversight, often referred to as a *Caremark* duty, which requires directors to implement and monitor systems designed to identify and flag significant mission-critical risks.

The Delaware Court of Chancery established a foundational oversight standard in *In re Caremark International Inc. Derivative Litigation*. Chancellor Allen wrote “[g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation...only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”⁴ The standard is clear. Directors must attempt to establish oversight procedures for significant corporate risks. *Caremark* establishes an exceptionally high bar for imposing personal liability on directors and officers. It must be, in Allen’s words, an “utter failure” of oversight.

This standard was upheld by the Delaware Supreme Court in 2006, in *Stone v. Ritter*, which established the modern-day oversight framework for corporations. While *Caremark* established the standard that directors must attempt to monitor the corporation, *Stone* reaffirms the bar and further elevates the standard. The court held that directors may face oversight liability when they utterly fail to implement a reporting system or disregard an existing system. In either case, liability to the directors and officers requires evidence that they knowingly failed to fulfill their fiduciary duties and acted in conscious disregard of their oversight responsibilities.⁵ This addition makes it more difficult for directors to be held accountable for potential oversight failures.

In 2019, *Marchand v. Barnhill*, another derivative suit was brought by shareholders against Blue Bell Creameries, an ice cream manufacturer and distributor, due to a listeria outbreak which caused three deaths, massive product recalls, and substantial harm to the company. The case alleged that two executives and the board “breached their duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of

Bluebell's food-making operations, and that the directors breached their duty of loyalty under *Caremark*.”⁶ Through the suit the court further expanded on the ruling in *Caremark* and *Stone*. Under *Marchand*, the court reaffirmed that directors and officers have a duty of oversight obligation which requires a good faith effort to establish and monitor reasonable reporting and oversight systems. The court clarified that a board's failure to establish such systems, or fail to monitor them effectively once implemented, may constitute bad faith and a breach of the duty of loyalty.⁶ *Marchand* stressed that boards should maintain reporting systems which are monitored, and engage in regular discussions regarding their mission-critical risks.

Corporate Culture is the Underlying Driver of Catastrophic Derivative Claims

Case Study A: *In re The Boeing Company Derivative Litigation*

On October 29, 2018, Lion Air flight 610 leaving from Jakarta, Indonesia, crashed shortly after takeoff, killing 189 passengers and crew. The plane which crashed was a commercial jetliner, the Boeing 737 Max 8. Then, 132 days later on March 10, 2019, an Ethiopian Airlines Flight 302 departing from Ethiopia, crashed shortly after takeoff, killing 157 passengers and crew. Both crashes were determined to be triggered by a failure in the Maneuvering Characteristics Augmentation System (MCAS) which the pilots could not manually override. The MCAS failure continuously pushed the nose of the planes down, leading to both crashes. Shortly after the Ethiopian Airlines flight crash the Federal Aviation Agency (FAA) grounded all Boeing MAX 737 aircrafts in the United States. What were the warning signs underwriters may have missed leading up to the governance failure, which led to a mega-derivative suit that was fully funded by D&O insurance?

Between 2015 and 2018, which is the same period of the 737 MAX rollout, Boeing's financial position was incredibly strong. They had a highly experienced C-suite along with a well-qualified board of directors. They had a massive, diversified backlog which means there was good insight into future performance and revenue, strong liquidity and manageable debt levels, ending 2018 with \$15.3 billion in operating cash flow, and strong growth in their core earnings per share. Their earnings in the second quarter of 2015 included record deliveries of their products but also points to a continued focus on cost reductions and productivity improvements.⁷

The 737 MAX airplane was a response to Airbus's release of the A320neo. The A320neo was equipped with state-of-the-art technology and efficiencies that were desired by airlines. “Rather than develop a competitive model from scratch, the company decided to redesign its flagship 737 model with larger engines. A redesign offered the advantages of simplified regulatory approval, reduced time-to-market, and less pilot training.”⁸ Speed to market for Boeing was prioritized by retrofitting the engineering of the older 737 models into the 737 MAX to compete with Airbus, instead of engineering a new family from square one. This reduced development time and simplified certification for airlines and pilots alike. The 737

MAX had to compete with the lower maintenance costs and fuel efficiency the Airbus A320neo was already providing for the market. Airbus had a full year's head start over Boeing, delivering their first unit in January of 2016. In 2018, the 737 MAX build out ramped up aggressively, delivering 256 aircraft to airlines across the globe. The total commercial airplane deliveries for 2018 were 806, meaning the 737 MAX was 31% of their deliveries for the year.⁹ The competitive pressures from Airbus drove Boeing to bring a competing aircraft to market as quickly as possible.

What role did management and the board play in overseeing product safety risks created by the speed to market pressure? The role of management and the board overseeing product safety risks subsequently became the central issue in the derivative litigation.

In the derivative *In re The Boeing Company Derivative Litigation*, plaintiffs claimed "Boeing's directors and officers failed [Boeing as an enterprise and its stockholders] in overseeing mission-critical airplane safety to protect enterprise and stockholder value."¹⁰ The lawsuit alleged that although the audit committee met regularly and was responsible for "risk oversight," they were not specifically tasked with discussing or monitoring safety risks of the aircraft despite their central importance to Boeing's business. The function of the committee was to monitor financial risks. Further deficiencies of the board were found, like the fact that the board did not regularly meet or allocate time for quality control or airplane safety. There was not even a mandatory meeting of the board called in response to the Lion Air accident, the meeting was optional. It was found after the plaintiffs obtained meeting minutes that "[t]he crash did not appear on the Board's formal agenda until the Board's regularly scheduled December meeting; those board materials reflect discussion of restoration of profitability and efficiency, but not product safety, MCAS, or the AOA sensor. The Audit Committee devoted slices of five-minute blocks to the crash, through the lens of supply chain, factory disruption, and legal issues—not safety."¹⁰ In February 2019 there was another board meeting that "addressed factory production recovery and a rate increase, but not product safety or MCAS.²⁵⁹ At that meeting, the Board affirmatively decided to delay its investigation into the 737 MAX, notwithstanding publicly reported concerns about the airplane's safety. Weeks later, after the Ethiopian Airlines Crash, the Board still did not consider the 737 MAX's safety. It was not until April 2019—after the FAA grounded the 737 MAX fleet—that the Board built in time to address airplane safety."¹⁰ Board materials reflected substantial discussions of efficiency, profitability and production, but under allocated time to safety, the MCAS system, the Lion Air accident investigation, and oversight of their production of their commercial aircraft.

The board later established the Airplane Committee in April 2019 which was explicitly tasked with overseeing airplane safety, and it was the first committee of the board to formally request information about the cause of crashes.¹⁰ In addition to the lack of safety oversight by the board, it was also established that there was no internal reporting system by which whistleblowers and employees could bring their safety concerns to the attention of the board.¹⁰

The allegations suggest that Boeing's board adopted a passive approach toward safety oversight despite the mission-critical nature of aircraft safety. However without access to confidential meeting minutes, and only access to what is publicly available, how could the underwriting community have identified the governance deficiencies alleged in the litigation against the directors and officers? Public indicators may have suggested elevated governance risk from the competitive pressure from Airbus and repeated emphasis on cost reductions and production efficiencies, but that alone is not enough to foresee an event of this magnitude. The derivative claim later settled for \$237.5 million, which was fully funded by their D&O insurance.

Case Study B: In re Wells Fargo & Company Shareholder Derivative Litigation

In 2016, Wells Fargo Bank, N.A. was the second largest national chartered bank in the United States with \$1.7 trillion in consolidated assets and 6,200 domestic branches, right behind JPMorgan Chase.¹¹ They provided retail, commercial and corporate banking services through three operating segments: the Community Bank, Wholesale Banking, and Wealth and Investment Management.¹²

In 1998 the Community Bank introduced a new sales model, or their cross-sell strategy. Wells Fargo wanted to be able to provide customers with any financial products and solutions they may need, which included but are not limited to, checking accounts, savings accounts, credit cards, debit cards, certificates of deposits, bill pay, etc.

It came to light in 2016 that Wells Fargo employees were creating fake accounts in a cross-selling scandal that shocked the financial institutions community, with some unauthorized activity dating back to 2002. The employees were tasked with unrealistic growth and cross-sell goals that drove them to create fraudulent accounts for customers without authorization, successively charging them false fees for services they did not ask for. This had a direct impact from management's aggressive sales culture.

Investigations revealed widespread unauthorized account openings and other consumer-abuse practices linked to aggressive sales incentives. The findings called Wells Fargo's sales culture and tactics into question.¹³ "The [Sales Practices Investigation Report] suggests Wells Fargo's decentralized corporate structure might have obscured the scale and nature of the underlying problems. According to the SPIR, this structure allowed parts of the bank to operate without oversight, impeding corporate risk management functions."¹⁵

In Wells Fargo's 2015 annual report, the company stated "every team member is responsible for managing risk."¹⁴ Despite this commitment, the organization engaged themselves in a toxic sales culture that harmed its customers for over a decade. Senior Community Bank leadership was aware for years that employees were engaging in unethical and unlawful sales practices to meet unrealistic sales goals, yet failed to adequately address the underlying causes driving the misconduct. The governance structure was flawed in that Wells Fargo's fragmented reporting structure and weak escalation processes led to gross

governance failures that resulted in significant fines, penalties, reputational harm, consumer harm, and a \$240 million D&O insurance funded derivative settlement.

Case Study C: *In re McKesson Corp. Derivative Litigation*

McKesson Corporation is a wholesale distributor of prescription drugs in the United States, which means they are an intermediary between drug manufacturers and health providers. Included in such distribution, is the sale of controlled substances, defined as “a drug or other substance that is tightly controlled by the government because it may be abused or cause addiction...[c]ontrolled substances include opioids, stimulants, depressants, hallucinogens, and anabolic steroids.”¹⁵

In 2008, McKesson settled a case for \$13.25 million with the Drug Enforcement Administration (DEA), which is a federal law enforcement agency under the U.S. Department of Justice (DoJ). The DEA is tasked to enforce U.S. controlled substance laws, which includes the distribution of opioids. The settlement was a civil penalty for failing to report suspicious, high-volume orders of hydrocodone and other substances to rogue pharmacies. The settlement “required McKesson to establish a compliance program designed to detect and prevent the diversion of controlled substances as stipulated under the Controlled Substances Act and applicable DEA regulations.”¹⁶ As a result of the settlement, McKesson agreed to establish their very own Controlled Substance Monitoring Program (CSMP) whose intent was to track and flag any suspicious order volumes to the DEA. The CSMP included monthly customer thresholds per pharmacy.

In 2017, McKesson was ranked in the number 5 spot on the Fortune 500 list of the largest US corporations.¹⁷ McKesson was the largest of three wholesalers who accounted for nearly 85% of all controlled substance distributions in the United States. In *In re McKesson Corporation Derivative Litigation*, plaintiffs alleged that McKesson’s implementation of the CSMP which followed the company’s 2008 settlement with the DEA, was ineffective and inadequately monitored by the board. The intention of the CSMP was to identify and report suspicious orders of controlled substances. Although an oversight system existed, it was not properly monitored by the board.

Six out of nine members of the board who oversaw the 2008 settlement, including the CEO, served on the board all the way through to 2017. Despite their awareness of the previous regulatory action and implementation of the CSMP, plaintiffs alleged that substantially similar compliance failures persisted years later.¹⁶ In spite of repeated warnings and internal findings regarding weaknesses found in the CSMP, the board failed to ensure that the program was effectively implemented and monitored.¹⁶ As a result, numerous deficiencies allegedly persisted, reflecting a governance culture that prioritized profit before oversight and public safety. As a result, the allegations suggest that McKesson’s failure stemmed not from the absence of oversight mechanisms, but from the board’s failure to meaningfully oversee and respond to repeated warnings regarding a mission-critical component of their business.

The derivative case settled for \$175 million and was fully funded by D&O insurers.

Why Do Boards Fail?

Boeing, Wells Fargo, and McKesson all have three very different operations, but all failed for similar reasons. A lack of oversight of their mission-critical risk. Boeing faced increased production and speed-to-market pressure, Wells Fargo faced a unique sales culture with unrealistic quotas and cross-sell pressures, McKesson sought profit over compliance. All three were made up of independent boards, had the CEO of their company on the board as a chairman, and had comprehensive and diversified board experience. In each case, cultural and governance shortcomings ultimately produced significant reputational damage and harm to the public.

Boards are structured to be efficient and effective, and they are the heart of corporate governance. Boards fail when they treat their duty of care, oversight, and loyalty as minor issues in their overall risk management and governance structure. As proven by the three case studies, these deficiencies lead to harm to the companies themselves and their customers.

Traditional governance indicators have limited predictive value for catastrophic claims, but how can underwriters know when mission-critical risks are independently escalated and challenged before they become normalized within the organization?

Past events are not always a precursor to future claims. Even with clean loss runs for prior years, positive and consistent financial results, public filings of performance, underwriting meetings or one-on-ones, underwriters are not equipped to predict governance failures, which are a leading cause of D&O claims.

Looking at a smaller sample size of mega-derivative lawsuits from the D&O Diary¹⁸, of the top 33 largest of all time (whether fully funded by insurance or not), 17 can be classified as *Caremark*-type matters for purposes of this analysis with settlements ranging from \$72.5 million to \$310 million (Appendix A). For purposes of this paper, a matter was classified as *Caremark*-type claim when the alleged misconduct materially involved a board's failure to implement, monitor, their mission-critical risks. In these derivatives, the patterns are all similar. Formal governances do not equal substantive oversight. Relevant mission-critical risk information did not consistently reach the board. Commercial priorities competed with safety, compliance, and customer protection. Boards were highly experienced but may not have established expertise in mission-critical risk exposures.

These large claims are not just the result of bad business judgment, but the result of governance systems that allowed misconduct, safety risk, regulatory violations, or poor corporate culture to persist until they produce socio-economic harm. Boards fail when they prioritize profit over compliance.

The Mission Critical Governance Scoring Tool

To better understand governance risks based on limited time and information, underwriters should focus their time equally on financial analysis as they do on corporate governance and internal controls. Underwriters should consider incorporating a scoring system for governance indicators.

In addition to the analysis presented in this paper, a Mission-Critical Governance Scoring Tool (MCGS) was developed using Microsoft Copilot to evaluate whether publicly available information and governance indicators could have identified warning signs preceding major derivative litigation events (Appendix B). Inputs for the MCGS include:

- Identification of mission-critical risk
 - o Has the board identified their mission-critical risk?
- Committee Ownership
 - o What committee owns the company's mission-critical risk?
- Relevant Board Experience
 - o Do board members have direct experience in the company's mission critical risk?
- Independent Leadership
 - o Is the CEO/Chair separate? Is the board independent?
- Board Refreshment
 - o Are there term limits and active refreshment?
 - o The year prior to Boeing, Wells Fargo, and McKesson's derivative suits, well over half of the board had five or more years of tenure on the board (nine of thirteen for Boeing; nine of fourteen for Wells Fargo; six of nine for McKesson).
- Meeting Intensity
 - o How often does the board meet?
- Risk Disclosure Prominence
 - o Is the mission-critical risk discussed in public filings?
- Regulatory Bodies (not scored – just informational)
- Repeated Regulatory Violations or Fines
- Whistleblower Hotline/Reporting Channel

These variables were carefully selected based upon the findings of the three case studies and what is widely known about *Caremark* cases. The MCGS provides a standardized rubric for reviewing publicly available information. Each variable is scored on a scale of zero to

two based upon predefined criteria. Zero being lower risk and two being higher risk. The largest score a company can receive on this model is an 18, which would deem it a high governance risk.

The model was able to compare publicly available information from pre-derivative Boeing, Wells Fargo, and McKesson, and present day. Pre-derivative Boeing scored 11/18, current day Boeing scored 2/18; pre-derivative Wells Fargo scored 9/18, current day Wells Fargo scored 2/18; pre-derivative McKesson scored 11/18, current day McKesson scored 3/18 (APPENDIX C). The post-event score improvements may not independently validate the MCGS as the implementation of stricter compliance requirements were a top priority of boards post-derivative. However, using the same variables pre and post litigation, we can see improvements in real time, and where the improvements occurred.

Several governance reforms implemented after the derivative actions directly corresponded with the variables measured by the MCGS. Boeing established an aircraft safety committee; Wells Fargo enhanced risk oversight and modified its governance structure; and McKesson increased board-level attention to the CSMP. These remediations align closely with the governance indicators into the MCGS and provide guidance for underwriters evaluating mission-critical governance risks. The tool can aid an underwriter for potential questions to the insured, or find places to dig deeper.

Before Boeing's derivative, there was a very impressive board. All 13 directors had senior leadership experience, eight with highly regulated industry experience, five with complex manufacturing expertise, but the 2018 Proxy does not clearly identify any with experience with regards to aviation safety.¹⁹ The 2018 and 2019 proxies do not mention safety, with regards to their mission-critical risk, once. The 2020 proxy mentions safety over 150 times.²⁰ The MCGS directly identifies the lack of reporting on safety through more than one input (risk identification; committee ownership; relevant board experience, etc). These risks are clearly mitigated as of 2026, as Boeing has placed a larger emphasis on safety.

For Wells Fargo, their 2016 proxy statement²¹ has little information regarding internal sales practices or management reporting, but their 2017 proxy statement²² mentions an overhaul of board oversight of risk including their sales practices. This is shown in the scoring improvement on the MCGS in the risk disclosure prominence bucket, along with other improvements.

For McKesson, the 2017 proxy statement²³ mentions controlled substances with regards to past settlements, but no mention of their CSMP, which was created in 2008. By 2020, the CSMP has its own dedicated section on the proxy.²⁴ The MCGS identified repeated regulatory violations pre-derivative, and correctly keeps the score the same in 2026. Improvements are found elsewhere year-over-year.

The framework is designed to encourage deeper examination of how mission-critical risks are monitored and escalated to the board.

Underwriting remains subjective, which is one of the most interesting parts of our industry. While this model is heavily reliant upon publicly available information, it is also heavily reliant on a large amount of research, discretion, and underwriting judgment. Given that the model is just a tool, underwriters may consider it when selecting risks to insure as a guide, not as a pricing tool.

Conclusion

D&O insurance exists to protect corporate leaders from personal liability that arises from good faith business decisions. Many derivative suits that are paid by D&O insurance carriers arise from *Caremark* claims that alleged prolonged failures of oversight involving their mission-critical risks that are central to the company's operations. Boeing failed to oversee airplane safety, Wells Fargo failed to oversee sales practices and employee conduct, and McKesson failed to oversee the distribution of controlled substances. While D&O insurance is not designed to protect directors and officers from the consequences of conduct that harms the public, the structure of the product can nonetheless provide coverage for catastrophic derivative claims arising from such events.

Whereas *Caremark* derivatives once were more difficult to advance in Delaware courts due to precedent set in *Caremark*, since *Marchand* in 2019, there have been 11 derivatives that have settled for \$72.5 million or more.

The case studies do not establish that catastrophic oversight failures can be predicted with certainty. They do, however, demonstrate that conventional indicators of financial strength and professional experience may coexist with deficiencies in board-level monitoring of mission-critical risk. The MCGS is best understood as a tool rather than a predictive model. By placing attention on the relevant variables provided, the tool can help underwriters identify areas required deeper analysis.

Given precedents set in *Caremark* through *Marchand*, boards should, in their best efforts, identify their mission critical risks, ensure appropriate oversight and reporting mechanisms are in place, and consistently monitor and discuss those risks at the board level. While these efforts cannot prevent litigation, they may provide a strong basis for dismissal of a *Caremark*-type claim.

Insurers should take advantage of the availability of AI to place underwriting tools into underwriting systems to equip the underwriter and enhance proprietary risk models. By creating a framework or scorecard like the MCGS for underwriting to mission-critical risk, and with the use of AI, it's possible that D&O underwriters can dive deeper into governance controls more than ever and spot deficiencies before they lead to catastrophic D&O claims and allow underwriters to enhance risk selection, portfolio management, and potentially improve profitability.

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Appendix A

See Attached: Appendix A – 33 Derivative Claims + 17 Caremark Cases

- Developed with the assistance of Copilot

Appendix B

See Attached: Appendix B – MCGS – BLANK

- Developed with the assistance of Copilot

Appendix C

See Attached: Appendix C – MCGS – Boeing+McKesson+WellsFargo

- Developed with the assistance of Copilot