

Bringing The #MeToo Movement Into The Board Room

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Maintaining a workplace environment free of discrimination, sexual harassment and other misconduct is critical to both the short-term productivity and long-term health of a business. Reports of sexual harassment allegations at public corporations can have material negative effects on stock price, with some corporations seeing double digit single day drops after accusations are made public. As we have written elsewhere, the primary obligation to manage these risks on a day-to-day basis falls to executive leadership.¹ But the #MeToo movement also has raised questions about the role of boards of directors to provide oversight of management and, to the extent that senior management may be a source of the problem, the board's obligation to take more direct action.

This note discusses some key issues for General Counsel to consider as they advise corporate boards about how to navigate their responsibilities in this environment.

Sexual Harassment Issues Can Create Significant Risks For Boards

1) *Shareholder Derivative Lawsuits*

As most directors know, a *Caremark* claim is a claim that a board of directors breached its fiduciary duties because it was on notice of risky corporate conduct and consciously disregarded its duty to exercise oversight, exposing the company to financial risk. *See In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996) (directors allegedly breached duty of care by inadequately supervising employee conduct, leading company to pay substantial fines). *Caremark* claims are notoriously difficult to plead successfully.² “[O]nly 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.” *Caremark*, 698 A.2d at 971; *see also White v. Panic*, 793 A.2d 356 (Del. Ch. 2000) (finding complaint failed to state derivative claim that directors breached their fiduciary duties by failing to implement mechanisms to control corporate officer's sexual harassment). Nonetheless, some scholars have argued that multiple allegations of sexual harassment may build a pattern of “red flags” that expose boards to liability for failing to respond to misconduct or consciously allowing that type of behavior to continue.³ Furthermore, even without a finding of liability, these lawsuits can be embarrassing, distracting, and costly to resolve.

¹ Confronting Sexual Harassment in Today's Workplace: 8 Questions Companies Should Be Asking Themselves, Cleary M&A and Corporate Governance Watch (Feb. 6, 2018), www.clearymawatch.com/2018/02/confronting-sexual-harassment-todays-workplace-8-questions-companies-asking/

² Delaware courts describe *Caremark* as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” *Stone v. Ritter*, 911 A. 2d 362, 372 (Del. 2006).

³ Daniel Hemel & Dorothy Shapiro Lund, “It May Not Matter What the Weinstein Company Knew,” *The Atlantic* (Oct. 14, 2017), www.theatlantic.com/business/archive/2017/10/harvey-weinstein-company-legal-consequences/542838/.

2) Disclosure Claims

In certain cases, a public company may have an obligation to publicly disclose harassment claims, lawsuits or settlements, to the extent that the matter is likely to have a quantitatively or qualitatively material impact on the company. Such disclosures can negatively affect stock price and leave the company vulnerable to shareholder lawsuits alleging disclosure violations. Companies may also face investigations or civil charges from the SEC for failing to disclose information regarding harassment allegations or settlements that it determines are material to investors in the aggregate.

3) Reputational Harm, Additional Regulatory Scrutiny, Increased Vulnerability to Activists and Other Potentially Negative Effects

Beyond risks directly tied to litigation, sexual harassment allegations against a senior executive generally result in harmful media coverage and long-standing reputational damage for the corporation and, potentially, members of its board of directors. Coverage of the allegations may affect recruitment or retention of employees. Sexual harassment allegations may also cause additional regulatory scrutiny of pending M&A transactions or other material projects. Although it is unlikely that even widespread misconduct would be enough to alter the eventual outcome and result in a denial of regulatory approval for a transaction or project, such allegations can make an already burdensome process even more expensive and time-consuming. In addition, failure to appropriately manage issues of workplace harassment may expose a board to increased pressure from opportunistic activists looking to exert influence while a company may be more vulnerable following negative press or a drop in stock price. Activists could use such a period of turmoil as leverage to push for their own agenda.

Proactive Steps Boards Should Consider In Light Of The #MeToo Movement

1) Sexual Harassment Policies And Training Procedures

As much as with any other area of compliance, it is important that the board set a tone at the top that sexual harassment is not acceptable and that inappropriate behavior will be promptly investigated and result in appropriate consequences. To do that effectively, a board must be sufficiently informed as to the soundness of company-wide sexual harassment policies and training procedures, as well as to the vigilance of their enforcement. Therefore, boards that have not recently reviewed these policies should do so promptly, and all boards should have a practice of periodically reviewing them to ensure that they continue to reflect best practices as they evolve, particularly regarding reporting channels, victim anonymity, and prohibitions on retaliation, among other key features.

Among the issues for a board to consider carefully is the question of what types of allegations should be escalated to the board's attention. We recommend that any allegations involving a member of senior management should be brought to the board's attention, as well as any widespread allegations about a group or an area within the company. A board should demand sufficient information from management to understand and assess potential problems.

In a recent letter to the former lead independent director of Wells Fargo, the Federal Reserve Board emphasized the director's alleged lack of initiative in pressing for information about

compliance issues at the bank, and stated that taking initiative in ferreting out information, including “an alternative view [to that of] management” was a core part of the director’s “oversight” responsibility.⁴ Similarly, independent directors can play an important role in seeking information about discrimination, sexual harassment and other misconduct.

2) Clawback and Related Policies

Boards should consider what contractual and compensation incentives exist to motivate compliance with the company’s behavioral expectations. Some companies have revised clawback policies and definitions of “cause” to encompass reputational and economic harm that might arise from violations of company policies concerning workplace conduct. Boards are exploring these options because reputational harm is real harm, even if it is sometimes hard to quantify, and because they are seeking to counter any public perception that the corporation is being “soft” on executives whose behavior violated its policies, because of shortsightedness, a conflict of interest or other factors.

3) Difficult Board Independence Situations

At least annually, a board should complete questionnaires that elicit information about, and should deliberate concerning, director independence. Typical director and officer questionnaires are too long and technical to be the sole vehicle for making independence determinations, which should be intensely fact-specific and nuanced.

To illustrate the difficulty of these determinations, conflicts issues have arisen from situations where a director is an employee of a non-profit organization to which the company is a major donor (*see In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003)); where a director is an executive at another company where the senior executive serves as a director (*see Del. City. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015)); or where a director and the senior executive have interlocking business relationships such as shared investments or co-ownership of property (*see Sandys v. Pincus*, 152 A.3d 124 (Del. 2016)). Although personal friendships are not usually considered to compromise independence (*see Beam v. Stewart*, 845 A.2d 1040 (Del. 2004)), even friendships may raise concerns if the relationship between the director and the senior executive is particularly lengthy or robust. CalPERS and ISS have suggested that director independence may be compromised after tenures of 12-15 years.

A board must be particularly cognizant of director independence issues when it has received specific allegations of harassment by a member of senior management and is considering creating a special committee to investigate those claims. Any director selected to serve on such a committee should be above any suspicion of a conflict that could compromise her independence. A truly independent committee will also be an important factor in demonstrating that the board is in a position to exercise business judgment, such that shareholders will not be able to bring derivative claims without first making a demand to the board.

⁴ Letter from Federal Reserve Board to Stephen Sanger Re: Accountability as Lead Independent Director of Wells Fargo & Company Board of Directors (Feb. 2, 2018), www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a3.pdf.

4) Refreshing Board Membership

Over the last few years, investors have been increasingly focused on board composition – including diversity, skill set and tenure on the board. For example, State Street Global Advisors, The Vanguard Group, Inc., and BlackRock, Inc. have each announced a commitment to board gender diversity (although this focus has not yet trickled down to management). In another example, CalPERS and ISS have amended their policies to scrutinize director independence after certain tenure periods. Lack of refreshment is also a key criticism used by activist investors, often as leverage for other issues on their agenda. As we have written elsewhere, activist investors are increasingly using perceptions of weaknesses by companies on “social good” matters to build support within the institutional shareholder community for their campaigns.⁵

Within this existing context, the #MeToo movement may provide yet another reason for boards to consider reviewing their membership and recruiting new board members. New members are more likely to bring fresh perspectives to a discussion of the challenges facing the business, may be perceived as more independent, and may be better positioned to exercise oversight and provide direction for senior management. Boards should continue to take steps to evaluate the composition of their board and may want to take steps to preempt any criticism.

5) Reflecting on the New Environment

Political and cultural developments have arguably created a new environment for public corporations and their boards, in which sensitivities to social issues that are related, but not central, to typical business issues have to be adjusted. Institutional shareholders, executives and corporations have reacted to these developments in high-profile ways,⁶ and other constituencies – such as regulators, customers and employees – may add their voices in particular circumstances. Because by assumption social issues are generally not related to routine business decisions, boards may find that they are not able to effectively apply the same decisionmaking

⁵ Ethan Klingsberg, “The Schizophrenic Investor Landscape: The Significance for Boards and Managements of the JANA/CalSTRs Letter to Apple,” Cleary M&A and Corporate Governance Watch (Jan. 8, 2018), www.clearymawatch.com/2018/01/schizophrenic-investor-landscape-significance-boards-managements-jana-calsters-letter-apple/.

⁶ See, e.g., Laurence D. Fink, Chairman and CEO, Blackrock, Inc. (2018 Annual Letter to CEOs) (“Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that that will help them achieve their goals?”); The C.E.O. Who Stood Up to President Trump: Ken Frazier Speaks Out, David Gelles, New York Times (Feb. 19, 2018) (“Before announcing his decision to resign from the president’s manufacturing council, Mr. Frazier consulted with the Merck board. ‘I wanted to say that this was a statement I was making in terms of my own values, and the company’s values, and there was unanimous support for that,’ he said. ‘My board supported that 100 percent.’”); How Banks Could Control Gun Sales if Washington Won’t, Andrew Ross Sorkin, New York Times (Feb. 19, 2018) (“Jamie Dimon, chief executive of JPMorgan Chase, which issues credit cards and owns a payment processor, has talked about how he and his bank have “a moral obligation but also a deeply vested interest” in helping “solve pressing societal challenges.”); and Amazon, Berkshire Hathaway and JPMorgan Team Up to Try to Disrupt Health Care, Nick Wingfield, Katie Thomas and Reed Abelson, New York Times (January 31, 2018) (“The companies said the initiative, which is in its early stages, would be ‘free from profit-making incentives and constraints.’ . . . [Mr. Buffett] believes the condition of the country’s health care system is a root cause of economic inequality.”).

framework that has served them well when considering business issues to social issues. That is, the normal weighting of considerations impacting a decision, including how to react to the #MeToo movement, may need refinement.

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As allegations of workplace sexual harassment continue to make headlines, the board and its oversight will play a critical role in guiding companies through challenging situations. If you have any questions about these issues, please call any of your regular contacts at the firm.