PLUS JOURNAL

Second Quarter 2018 - Vol. XXXI - Number 2

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Can Directors and Officers Be Liable If They Fail to Engage Shareholders' Social Causes?

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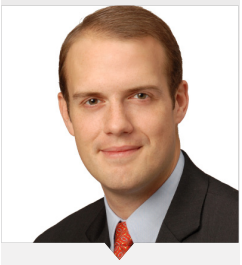

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In the 2017 Annual Corporate Directors Survey, recently released by PricewaterhouseCoopers, nearly 900 directors of U.S. public companies offered their perspectives on the most important issues facing corporate leadership. A common thread in the directors' responses was the mounting pressure from shareholders to ensure that social issues are reflected in how their companies do business, as well as in the composition and governance of their boards. Diversity, equal and proper treatment of women, maintaining privacy in the face of ubiquitous technology and environmental issues, are among the pressing social concerns that shareholders are expressing to directors and officers. As directors and officers consider how they will take action to address these important social issues they must also consider the changing landscape of potential legal liability for their failure to do so. As shareholder pressure regarding these issues increases and theories of liability and corporate injury continue to evolve rapidly, the stakes for corporations and their directors and officers have never been higher.

Areas of shareholder concern fall into four categories: (i) well-established challenges in board governance, such as ensuring the quality and diversity of directors and officers, which are receiving new attention as "social issues"; (ii) heightened liability surrounding directors' and officers' failures to address sexual harassment in the workplace; (iii) threats to digital privacy; and (iv) emerging bases for liability, including the failure to consider environmental changes and their impact on long-term corporate growth or the company's own practices for complying with regulatory requirements.

Well-Established Challenges in Recruiting Diverse and Active Directors and Officers

The swell in concern for these "social issues" has prompted many shareholder groups to demand diversity in race, gender, age and geographic location of officers and directors. The goals of attracting and retaining motivated directors and officers with diverse perspectives is not a new challenge and is one that directors and officers should already be prepared to address. Not only does the diversity of viewpoints provide for depth and strength of decision making; but, as noted in at least one report referenced in the PricewaterhouseCooper's survey, diversity among the board also creates transparency to review issues which may result in identifying fraud, improper conduct, bribery or other criminal activities. In addition, if concerns arise about a director or officer based on his or her failure to add value, offer creative contributions to the growth of the company, or to simply fail to attend board meetings, best practices are designed to bring about change.

One widely used mechanism to promote transparency and encourage refreshment of officers and directors are formal evaluations. Such evaluations, which can be administered in person or through a digital platform, help determine the skill sets and performance of individuals and the board as a whole. A significant benefit of evaluations is that they create comparable data on which directors and officers can rely to identify, discipline and/or remove underperforming board members. Having performance data in hand can be particularly valuable where prevailing board culture may have permitted underperforming directors and officers to remain. Using this tool is a mechanism to avoid liability later on.

Removing underperforming directors and officers, however, is only part of responsible board refreshment. Recruitment must be undertaken not merely to fill vacant positions or to address shortcomings in diversity. Instead, directors and officers must critically assess the strengths and weaknesses of the collective board and determine the skills and attributes that should be prioritized among new directors and officers. Inviting shareholder input into a transparent process of determining these priorities may aid shareholder relations and provide the directors and officers with a clearer understanding of shareholders' most pressing social concerns.

Ultimately, a diverse set of qualifications and perspectives will enhance any board. With ongoing refreshment, the board will continue to reflect changing demographics and shareholders' increasing demand for socially responsible corporate governance.

Theories of Director and Officer Liability for Social Issues

Officers and directors must also be prepared to address liability for issues that are now in the spotlight. In the past year alone, claims against companies and their officers and directors for failures to prevent sexual harassment (and/or sexual assault) have generated headlines and forced companies and their boards to reevaluate their internal structures for determining risks, reporting incidents, and taking prompt corrective action. Other issues, such as data privacy breaches and environmental regulatory matters, have also surfaced and raised new questions about corporate preparedness to deal with such constantly evolving issues.

Board Liability for Sexual Harassment

Sexual harassment in the workplace is, unfortunately, not a new phenomenon. However, the recent cascade of high-profile allegations of misconduct and the appropriate momentum of social movements for gender equality and fairness have made the eradication of sexual harassment a key concern for shareholders. While companies have historically faced liability for the failure to properly address allegations of sexual harassment or sexual misconduct, recent cases, in which the allegations depict toxic work environments and "under the rug" settlement payments rather than identifying the source of the problem and taking corrective action, should give directors and officers pause to reevaluate the integrity of their anti-harassment policies and the potential liability, if the policies are not meaningfully enforced at all levels.

For instance, a recent $90 million settlement of a shareholder derivative action based on allegations that the directors and officers had permitted a culture of sexual, as well as racial, harassment and retaliation reflects the new and long overdue zero tolerance approach to this issue. The basis for the claimed liability was the alleged longstanding history of harassment and discrimination, alleged breaches of fiduciary duties to install and enforce controls at the company and the alleged failure to take corrective action. By way of example, to demonstrate that the board's improper handling of allegations of sexual harassment had damaged the company, the plaintiffs pointed to, among other things, tens of millions of dollars allocated for "under the rug" settlements to resolve the most egregious allegations.

A recent lawsuit filed by Olympic gold medalist, McKayla Maroney, similarly narrowly focuses on the existence of previously settled claims as evidence that directors and officers, among others, had clear knowledge of misconduct, but did not take appropriate steps to stop it. Filed as part of the fallout from the revelations that former-USA Gymnastics team doctor Larry Nasser had sexually assaulted more than 100 girls and young women while purportedly providing medical treatment, Maroney's complaint focuses on the liability of USA Gymnastics, the U.S. Olympic Committee, and Michigan State University, who was Nasser's full-time employer. Maroney alleges that, as part of the settlement agreement that she signed with USA Gymnastics regarding her alleged abuse by Nasser, she was forced to sign a confidentiality agreement. Maroney asserts that USA Gymnastics' decision to keep her allegations against Nasser – and those of other victims – confidential shielded Nasser from outside investigation and permitted him to continue abusing girls and young women. In addition, Maroney alleges that the U.S. Olympic Committee and Michigan State University were aware of similar "red flags" surrounding Nasser but worked to conceal his abuse rather than take corrective steps. These allegations will undoubtedly point to liability and multiple terminations of officers and directors. Maroney, and other potential plaintiffs, will seek significant multimillion-dollar monetary damages from those entities and their directors and officers.

These cases signal a fundamental shift in what constitutes an appropriate response to sexual harassment and abuse in the workplace. Authorizing payments to settle individual claims can no longer be considered a sufficient response. Indeed, "under the rug" settlements themselves are now serving as both evidence that the board had knowledge of prior incidents and as part of the calculation of damage to the company or organization. Directors and officers cannot rely on merely reacting to individual claims, but must reflect on whether their anti-harassment and reporting systems truly address and repair the corporate cultures that allow harassment, discrimination and abuse to continue.

A successful anti-harassment policy must be clear and understandable both with respect to what constitutes appropriate conduct and how reports are to be made and investigated. Regular trainings to employees, management and the board, should include specific examples of proper and improper conduct and should be tailored for the type of work environment and the nature of the interactions that occur between employees. Trainings should also include clear instructions for making a report of harassment or discrimination. Moreover, employees should be provided with a list of various individuals within the company who have been identified to receive and investigate complaints. Employees should be assured that all reports are confidential and that retaliation against a reporting employee will not occur.

Management training regarding complaint investigation and escalation processes is also essential. Promptly addressing complaints and reporting them to upper management and the board for corrective action is critical. Indeed, if improper conduct is widely understood and employee reports are received – but management fails to act – the system has failed. Moreover, if complaints, particularly those regarding high-level personnel, such as c-suite officers and business generators, are

susceptible to being downplayed or disregarded, liability and substantial monetary damages will result and criminal charges are also possible. Accordingly, reporting structures which remove managerial discretion from escalating complaints and which generate reports to the board, no matter how egregious, may be necessary to ensure that anti-harassment programs remain effective.

Boards must take steps to ensure that robust anti-harassment policies are in place and – most significantly – that they are seriously considered, addressed and enforced at all levels of the company.

Board Liability for Data Privacy

With the ever-changing flow of technology, individual privacy and the security of digital data have become social issues of their own. The technological safeguards and procedures for responding to cyber-attacks are complex and often involve sophisticated technologies. Nevertheless, officers and directors must understand the steps that their company is taking to protect its digital assets.

Although some early attempts by consumers and shareholders to hold directors and officers liable for their failures to address cyber threats were unsuccessful, recent litigation involving the catastrophic Equifax data breach may have created a new focus of liability for directors and officers when a data breach occurs.

In September 2017, credit monitoring and reporting firm Equifax announced a cyber "incident," which may have impacted as many as 143 million U.S. customers. The information that was misappropriated included names, Social Security numbers, birth dates, addresses, and, in some cases, driver's license and/or credit card numbers. Significantly, and although Equifax asserts that it is mere coincidence, SEC filings showed that Equifax's Chief Financial Officer and other executives, collectively, sold more than $1.5 million in Equifax stock in the days following the discovery of the data breach, but before the breach was publicly announced.

Following the announcement of the data breach, numerous consumer groups filed class action lawsuits alleging, among other things, negligence and failure to disclose by the company. A recent securities class action, however, has presented new damage theory for the data breach, which may become a model for future cases against directors and officers. The securities class action complaint, filed in the Northern District of Georgia, contains allegations that the company failed to maintain adequate measures to protect its data systems, including failures to maintain proper security, controls and monitoring systems.

While these allegations are not novel, the securities class action complaint connects these failures to the precipitous decline in Equifax's stock price following the announcement of the data breach. This clear connection between a data breach and a decline in stock price creates a tangible injury, which prior actions against directors and officers lacked. Equifax may have experienced a particularly conspicuous decrease in its stock price because its business is largely dependent on its ability to protect confidential consumer information. However, the theory that a decrease in stock price may create sufficient damage to support claims that a company or its directors and officers failed to adequately safeguard digital information may lead to increased litigation.

Likewise, the allegations of insider trading have triggered additional questions regarding the timeline of when the company and its directors and officers knew of the breach, the nature of the investigation conducted, and the internal and external announcement of the incident. Equifax has maintained that the CFO and executives who sold shares shortly after the breach was discovered were not aware of the breach at the time of their respective transactions. Equifax has also asserted that the delay between its discovery of the breach and its press release announcing the breach (of almost a month) was due to a forensic examination to determine the scope of the breach. If this case proceeds through discovery and to trial, more will be learned about whether Equifax's internal reporting structures, which apparently failed to notify the CFO, and the timeliness of its investigation and disclosure of the breach are considered reasonable by shareholders or the court.

A data breach effecting nearly 150 million Americans, particularly at a company whose business model requires that it be entrusted with confidential information, should cause all directors and officers to re-examine their company's ability to identify and resist cyber threats.

The best practices for addressing cyber threats require a combination of assessing the company's digital assets, implementing appropriate security measures based on the nature of the company's assets and known threats, and, importantly, continuing to monitor the evolution of threats and available safeguards.

In order for directors and officers to discharge their duties in evaluating threats and assessing whether their protections are adequate, directors and officers must personally understand how their company's technologies work and how the selected safeguards are designed to react to potential threats. With the stakes of cyber threats now larger than ever, directors and officers cannot merely rely on technology officers and employees and must be in a position to genuinely engage in the decisions made to protect the company's technological assets.

In addition, companies should respond to every digital security incident. Seemingly innocuous irregularities and anomalies may be preliminary attempts by cyber criminals to probe for weaknesses in a company's security. Moreover, because the reasonableness of cyber protections are measured, in part, by the known and potential threats to specific industry or company, the failure to evaluate, learn and upgrade security in response to smaller incidents could create liability if a catastrophic breach occurs.

Finally, digital security policies must extend beyond computer systems and

must include training for management and employees. Both groups should understand data breach protocols, but should also be aware of email phishing and other scams that cyber criminals use to gain access to corporate networks. Human beings are often the weakest point in digital security, and all effective policies must take this vulnerability into account.

Ultimately, the best practices for maintaining data security and limiting liability if a breach occurs share the same goal: fostering a genuine understanding and compliance with security procedures. This includes the directors and officers who are ultimately responsible for overseeing appropriate safeguards.

Emerging Issues

Finally, directors and officers must continually evaluate and prepare to address social issues, such as environmental concerns, for which damages have long been difficult to demonstrate, but for which liability may be on the horizon.

For instance, it is difficult for a shareholder-plaintiff to demonstrate how directors' and officers' failures to adopt environmentally friendly policies adversely affects the company's earnings. In fact, in many cases, "green" policies decrease profits because they internalize environmental costs for which a company may not otherwise be financially responsible.

However, recent reports regarding the financial ramifications of environmental changes may be forming the basis for future shareholder claims. For instance, in statements by BlackRock and Vanguard, which are referenced in the PricewaterhouseCooper's report, investors are beginning to examine how environmental concerns and sustainability should be factored into long-term corporate growth plans. Such reports and analyses are significant because they connect social issues to a company's bottom line. As discussed above, demonstrating damages to the company has historically been a substantial hurdle to shareholder-plaintiffs seeking to hold officers and directors liable for failures to take action with respect to environmental issues and concerns. Therefore, as these analyses continue to gain mainstream acceptance, they may eventually be used by shareholders to demonstrate that a board's failure to plan for environmental costs has stifled long-term growth.

In addition to the impact of environmental conditions on long-term corporate growth, liability is also emerging for managers, directors and officers who make poor decisions in response to regulatory and social pressures to produce environmentally conscious products. Volkswagen, for example, faced consumer and shareholder class actions in 2015 based on the declines in vehicle values and the company's stock after it was revealed that Volkswagen had programmed its diesel vehicles to produce acceptable emissions only during laboratory testing.

Further, in January 2018, Volkswagen announced that its Director of Government Relations was stepping down amidst reports and investigations of testing conducted in 2014, in which monkeys were forced to inhale vehicle emissions. Initial reports indicate that the Volkswagen official was in charge of the testing, but did not inform the then-CEO (who presumably did not inquire into the area of testing and methods of testing). As this matter unfolds, there will be significant ramifications for the company and its officers and directors regarding whether any mechanisms were in place to report this type of abuse to animals as well as the company's efforts to evade governmental regulatory standards.

Directors and officers must stay informed of emerging reports regarding the environment as well as the practices their company uses to comply with regulatory and market pressures to create environmentally conscious products.

Conclusion

Directors and officers have and continue to be obligated as fiduciaries to act in the best interest of their companies. The PricewaterhouseCooper's report confirmed that social issues ranging from diversity and gender equality to privacy and the environment are increasingly important to shareholders. Effective directors and officers from varied backgrounds will always benefit a company and pose both an ongoing challenge as well as an immediate opportunity for directors and officers to embrace calls for diversity and transparency. Directors and officers, however, must also prepare for other theories of liability, including claims related to sexual harassment and data privacy, where damages are discernable and larger than ever. Finally, directors and officers must also continue to monitor and review environmental issues ranging from immediate regulatory compliance to long-term sustainability.

As shareholders demand that corporate concern for social issues evolves from an aspiration to a core business tenant, shareholder claims that directors and officers have failed to properly address these concerns is a near certainty. The steps boards take today to stay genuinely informed about these issues and bring their corporate culture in line with new social norms may be the only way to avoid substantial liability in the years to come.