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Expanding Theories of Liability in the #MeToo Era

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Alleged workplace harassment is not a new phenomenon, but in the wake of allegations of sexual misconduct in the corporate context, plaintiffs increasingly are targeting an expanded group of defendants, including public companies, senior executive management and boards of directors. With the publicity that has attended the #MeToo movement in recent years, allegations relating to sexual harassment have spurred the filing of derivative actions (claiming harm to the corporation) and securities class actions (claiming a stock price reaction) purportedly due to executives' and the board's response (or lack thereof) to those allegations and related disclosures.

In early 2018, we noted that the plaintiffs' bar was seeking opportunities to assert these lawsuits, and, indeed, between January 2017 and December 2018, approximately 15 to 20 such cases were filed against public companies. In some instances, both derivative and securities complaints have been filed against the same company based on overlapping factual allegations. As publicity tends to follow the often salacious tales of sexual misconduct in the workplace, we believe that observable trends of follow-on harassment-related litigation will continue in 2019. An understanding of the nature and focus of shareholder suits in this context can assist public companies, their executives and board members in determining how best to avoid and manage this emerging litigation risk.

Shareholder Derivative Claims: Allegations and Pleading Challenges

Investors assert shareholder derivative actions purportedly on behalf of a corporation against corporate officers or directors (or other corporate insiders) for alleged harm to the corporation. Breach of fiduciary duty claims typically are governed by the law of the state of incorporation.

Derivative Allegations

In the workplace harassment context, derivative claims may allege a failure to address appropriately underlying allegations of sexual misconduct resulting in purported financial and reputational harm to the corporation. Specifically, derivative complaints may allege that directors or other executives breached their fiduciary duties (duties of care/loyalty/good faith), committed corporate waste or were unjustly enriched by:

- failing to establish and implement appropriate controls to prevent the misconduct;
- failing to appropriately monitor the business and properly investigate red flags;
- willfully ignoring misconduct and allowing a hostile culture to persist;
- failing to sanction misconduct;
- affirmatively condoning misconduct by settling lawsuits;
- approving severance or other payment to wrongdoers; or
- minimizing exposure or assuring the public that nothing was wrong.

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Pleading Challenges

Plaintiffs who bypass the procedural route of making a demand on the target company's board of directors to take action in the wake of a workplace harassment-type claim may face a defense challenge to the assertion that a pre-suit demand on the board would be futile. Specifically, plaintiffs are often required to plead demand futility with particularity. Despite any pleading challenges involved, however, the mere filing of a derivative claim against the corporation can magnify the issues on which the claim is based, namely by increasing public exposure, disrupting business and creating associated costs, including potential costly settlement of the suit.

Moreover, these pleading hurdles are not insurmountable, as demonstrated by a recent state court decision that denied a motion to dismiss a derivative action on demand futility grounds, finding the complaint sufficiently alleged, among other things, that the board knowingly failed to take action in the face of allegedly corroborated reports of sexual harassment at the company. Furthermore, derivative claims relating to sexual misconduct allegations have been settled for payments of tens of millions of dollars and the establishment of corporate governance measures.

It is therefore crucial that corporate executives and board members understand the developing legal landscape. By doing so, the company can position itself to address proactively both the underlying issues and the possibility of derivative liability.

Securities Class Actions: Allegations and Potential Hurdles

Securities fraud class actions under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder are predicated on alleged material misstatements or omissions that purportedly rendered a statement false or misleading, and often are asserted along with control person (culpable participation) claims under Section 20(a) of the Exchange Act.

Securities Fraud Allegations

In the context of underlying sexual misconduct allegations, investors' securities fraud claims typically concern public statements issued by a company with respect to corporate values, integrity, and adherence to ethical standards and internal policies, juxtaposed with executives' and boards' alleged knowledge of any actual misconduct within the company, that contradict those policies. Plaintiffs generally claim that the stock price declined as a result of allegations of misconduct becoming public.

Pleading Challenges

As with derivative cases, plaintiffs must clear a high pleading bar in order to pursue claims predicated on Rule 10b-5 liability. Specifically, Rule 10b-5 claims are subject to the heightened pleading requirements under the Private Securities Litigation Reform Act and Federal Rule of Civil Procedure 9(b). Often, these claims are met with challenges to the sufficiency of the pleading, particularly in instances where the claims target "soft" representations of corporate culture. Challenges to the legal sufficiency of the complaint may include arguments that:

- codes of conduct or public statements concerning corporate culture are merely immaterial aspirational statements or "puffery";
- a duty to disclose the alleged misconduct does not exist;
- the alleged facts fail to support a strong inference that the defendants acted with an intent to mislead investors;
- statements about ethical conduct did not alter the "total mix" of information available to stockholders in their decision-making; and
- the stock price declined due to factors other than a revelation that statements about ethical corporate conduct were false.

However, with increased litigation in this area based on disparate facts, courts have been tasked with reviewing harassment-related securities claims with more frequency, and the results have not been uniform.

A comparison of cases demonstrates the point. A 2016 decision, *Lopez v. CTPartners Executive Search Inc*., squarely found that certain statements — including statements that touted an inclusive and positive working environment, the promotion of honest and ethical conduct, and a transparent and objective compensation structure — were "immaterial puffery" because a reasonable investor would not rely on such general statements as a "guarantee" of particular facts. In 2017, in *Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co*., the Ninth Circuit similarly found statements in a code of conduct to be "inherently aspirational." In 2018, in *In re Signet Jewelers Ltd. Securities Litigation*, however, a court denied a motion to dismiss, finding that representations contained in a code of conduct, "which state, *inter alia*, that the company 'bases ... decisions solely on a person's [merit and]' ... has '[c]onfidential and anonymous mechanisms for reporting concerns' ... and that '[t]hose who violate the standards in this Code will be subject to disciplinary action' ... are directly contravened by allegations in the [complaint] ... ." As a result, the representations were actionable. Notably, the latter decision described the case as "a garden variety securities fraud suit." Accordingly, as with derivative cases, it is crucial to examine the evolving case law in this area, even within the same jurisdiction, to address effectively and defend against these types of allegations.

SEC Regulations and Investigations

Corporate public statements in the wake of sexual misconduct allegations also could result in a Securities and Exchange Commission (SEC) investigation or enforcement action based on the purported failure to disclose material information to investors. While we are unaware of any such actions to date, companies should be mindful of the risk that alleged public misstatements concerning corporate culture, and the existence and adherence to company policies concerning workplace behavior and inclusion, could give rise to such enforcement actions if and when allegations of sexual misconduct are revealed. Moreover, in some instances, private plaintiffs may support a securities fraud material omission claim on the basis of a failure to disclose SEC-required information.

For example, Item 303 of Regulation S-K requires a company to "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." In light of the current environment, and to the extent that public revelations of sexual misconduct in the corporate context continue to increase and companies continue to experience unfavorable consequences as a result, the bounds of this regulation may be tested in future cases.

Takeaways

To ensure that any underlying misconduct is addressed, and that the response to such misconduct is as effective as possible, companies should consider the following:

Strong Protocols, Policies and Training. These should be reviewed regularly and updated as necessary, provided at regular intervals and enforced at the organizational level. Corporate counsel also ought to ensure awareness of, and compliance with, rapidly changing local requirements in this area.

Nondisclosure Agreements. In some jurisdictions, such as New York and California, requiring nondisclosure agreements (NDAs) in settlements pertaining to sexual harassment and discrimination is limited or prohibited. Where they are permitted, carefully consider NDAs or confidentiality provisions, recognizing that such provisions may be perceived as silencing the alleged victim while shielding the alleged perpetrator.

Internal Investigations. Consider proactively conducting an internal investigation to identify issues and facilitate improvements before lawsuits and reputational harms occur. Companies can consider a comprehensive investigation in response to complaints or other red flags, or a more limited review in the absence of specific reported issues.

Board Considerations. Consider when to escalate allegations to the board, and the board's role in preventing and responding to sexual harassment allegations. Relatedly, companies ought to be mindful of the number of women in high-level positions and on the board so as to ensure a more inclusive environment at the top. For example, California requires that publicly held corporations whose "principal executive office" is located in California include at least one female board member by 2019 and either two or three by 2021, depending on the size of the board. In addition, several companies have announced various high-profile initiatives to support gender diversity in both internal leadership and external roles.

Outward-Facing Statements. Take into account potential legal implications of the substance and tone of outward-facing statements and any disclosures about corporate values, policies and culture.

Additional Considerations. Review severance packages for adequate consideration, consider the timing of termination and succession plans, and understand directors and officers liability insurance and coverage.

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