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The Securities Law Questions Raised By #MeToo

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There is a dearth of guidance as to whether and when a public company should disclose details concerning a sexual harassment investigation of one of its executives. Although companies often do not disclose internal or government investigations generally, and there are no cases obligating disclosure of sexual harassment investigations specifically, companies are not impervious to litigation for (1) failing to disclose such information, or (2) breach of fiduciary duty in connection with tolerating sexual harassment. As outlined herein, there are several theories involving federal securities laws and state law governing fiduciary duties through which plaintiffs may attempt to bring suits. Companies conducting sexual harassment investigations should consult outside counsel and continue to reevaluate the investigation's status in order to determine if and when disclosure is either required or legally prudent.

Due in significant part to the recent #MeToo movement, a wave of workplace sexual harassment allegations, some involving high-level executives, has flooded the corporate arena. And with this flood of allegations has come increased publicity, which has forced companies to contemplate their public responses.

Allegations have occurred in nearly every industry — from Hollywood to corporations to the judicial system. No employer should tolerate unlawful harassment or assault, and those who have engaged in such wrongful behavior often face significant legal and professional repercussions. Employers are also often vicariously liable for unlawful workplace harassment, particularly if the harasser holds a senior management position. In these instances, companies may face significant monetary awards, including for emotional distress, lost wages, attorneys' fees and even punitive damages. In addition, there may be legal implications for those who oversee the investigation, especially in the realm of a public company's disclosure requirements and for executives and boards of directors with fiduciary duties to stockholders. This article seeks to evaluate sexual harassment investigations through the lens of federal securities laws and state fiduciary duty law.

Allegations of unlawful workplace harassment trigger a response obligation under the law. Almost always, an internal investigation is the first step of a prompt and appropriate response. Less frequently, a government entity, such as the U.S. Equal Employment Opportunity Commission, may also conduct an investigation. Although the scope of the investigation will be highly dependent on the particular circumstances of the allegations, it generally will involve a variety of witnesses, some of whom may have competing interests. Through anti-harassment policies, companies often commit to keeping a harassment investigation "as confidential as practicable" or use other words to that effect. This approach is consistent with EEOC guidance that directs employers "to make clear to employees that it will protect the confidentiality of harassment allegations to the extent possible, recognizing that an employer cannot guarantee complete confidentiality."

Indeed, in its "Enforcement Guidance: Vicarious Employer Liability for Unlawful Harassment by Supervisors," the EEOC further cautions that "information about the allegation of harassment should be shared only with those who need to know about it. Records relating to harassment complaints should be kept confidential on the same basis." Disclosing information beyond the extent necessary to conduct an appropriate investigation risks impairing the interests of the reporting employee and witnesses, and could deter others from raising concerns.

While the law varies by state, individuals generally are protected against invasion of privacy by private parties, including employers. An employee who makes an internal report under a typical anti-harassment policy will have a reasonable expectation of privacy with respect to his or her claims. As applied in the employment context, privacy laws may require balancing an employee's privacy interests against an employer's business interests, the result of which is not always obvious.

Despite the EEOC's position and privacy interests of individuals involved, investors may nevertheless expect a company to disclose facts and details of an investigation that could have a material impact on the business. When accusations — even if ultimately unfounded — become public, the reputation of the company or a senior executive may suffer. In turn, this reputational damage can negatively impact the company's stock price, customer and supplier relationships, goodwill, retention of talent, and strategic transactions. In light of these potential consequences, it is not surprising that boards who know about possible harassment by senior executives may elect not to disclose information until necessary, if ever, especially given the apparent shield of employment laws. This tension — between disclosure and negative financial impact versus nondisclosure and potential civil liability — could be particularly vexing for public companies that highlight a CEO's expertise and reputation as being crucial to the company's success in their U.S. Securities and Exchange Commission filings. Does this type of statement trigger disclosure obligations if, at the time of the SEC filings, the company was aware of internal sexual harassment allegations against the CEO?

There are no specific securities law requirements to disclose internal sexual harassment investigations, but, under some circumstances, the decision whether to disclose, and if so, how much to disclose, is not an easy one. Under the securities laws, there is an absence of cases and SEC interpretive guidance providing meaningful direction on this topic. Consequently, disclosure practices vary. For public companies, it is important to understand that disclosure at the investigation stage is not automatic. With the assistance of counsel, companies should carefully consider their own unique facts and circumstances to reach a judgment as to their disclosure obligations.

Practical Reasons for Disclosing or Not Disclosing a Sexual Harassment Investigation

Despite the above-referenced employment law considerations, practical considerations may cause companies to disclose sexual harassment investigations even without a particular rule or regulation requiring immediate disclosure.

First, a company may feel pressure to disclose due to certain business relationships or obligations. For example, the company's auditors may encourage the company to disclose the investigation if the company may make a significant payment to resolve it in the future; to avoid tense conversations with its auditors or potential delays in SEC filings, some companies may elect immediate disclosure in this scenario. In other cases, a company may have a merger and acquisition deal or other transaction pending and, in order to provide shareholders a better understanding of the transaction's terms, may choose to disclose in connection with management changes or other adjustments. A company may also decide to disclose information in an effort to ensure that it may trade its own stock without concern that the investigation may constitute material nonpublic information that would prevent the company from trading.

Additionally, a company may decide to disclose in order to preemptively shape the narrative. Companies may fear poor reactions from customers, stockholders, analysts, rating agencies, institutional investors and others (including shareholder plaintiffs lawyers) if they learn of the investigation later. Most companies prefer to provide information that will inevitably become public at some point, rather than have the information disclosed by a third-party source, so that the company maintains a level of control over messaging and content.

Stockholders may, however, overreact to the mere disclosure of an investigation because they are generally not in a position to analyze the facts. This reaction to the mere existence of an investigation itself could negatively impact the company's stock. Similarly, the mere fact that the company discloses an internal investigation or circumstances surrounding one may be perceived by some investors as indicative of guilt or severity of the allegations. This type of disclosure has the potential to generate baseless lawsuits and/or books and records demands by shareholders.

Accordingly, practical considerations often point in conflicting directions, and it is therefore important to evaluate the specific facts of each scenario and understand the applicable legal disclosure obligations.

Consider the Type of Allegations and the History Behind Them

Before disclosing an internal investigation pertaining to allegations of sexual harassment, the company should consider the type of allegations, the history of the alleged harasser and other similar situations at the company, the potential impact of the investigation on the company, and other relevant factors. It is imperative to determine whether there is a history or pattern of inappropriate behavior. If so, a company should investigate whether any settlements have been paid in the past, and whether company money was used to pay for those settlements (discussed more below in the recent cases section).

Considerations such as the type of allegations, the parties involved, the relevance of repeat offenses and potential settlements can all help a company determine whether the investigation is "material" to a degree that necessitates some disclosure. For example, if certain members of the board were aware of a CEO's previous history of wrongdoings or pattern of paying settlements to former employees, a new investigation may be more significant than a first-time offense. In addition, if the company determines that its culture or internal reporting and compliance procedures governing such allegations are insufficient or were not followed, the company must consider those factors in crafting a disclosure strategy.

Under harassment law, employers are required to launch fact investigations immediately. The amount of time it will take to complete the investigation will depend on the particular circumstances and these fact-finding exercises can in some situations take several months to complete. Early disclosure may create a situation in which the company has an ongoing legal or practical duty to provide updates about the investigation in its SEC filings. In addition, public companies must satisfy other potential disclosure requirements as described below, and they must also comply with Regulation FD, which prohibits selective disclosure of material nonpublic information to certain parties. Such duties to update only serve to affix the public eye's gaze on an already negative situation.

Rules and Regulations Governing Disclosure Obligations

Generally, the securities laws require disclosure: (1) when an affirmative duty to disclose arises under applicable rules or regulations; or (2) when failing to disclose the information would render other disclosures materially misleading. The disclosure rules that likely apply to sexual harassment investigations include SEC Regulation S-K, Items 103 and 303. In the absence of other triggers (such as filing a registration statement or purchases or sales of company securities by the company or an affiliate of the company), both of these disclosure items are required for domestic public companies in quarterly reports on Form 10-Q and annual reports on Form 10-K. Companies must also consider additional disclosure obligations set forth by the national stock exchanges. Additionally, if a company cites its CEO's reputation as reason for its success while simultaneously conducting an internal sexual harassment investigation regarding the CEO's behavior, the company should carefully analyze the circumstances to avoid rendering any statement materially misleading.

Item 103, titled "Legal Proceedings," sets forth the types of legal proceedings that a public company is required to disclose. In short, once a matter becomes an active claim or proceeding against the company, the potential application of Item 103 must be analyzed. Item 103 generally requires companies to disclose "material" pending legal proceedings, which in turn requires review of the relevant facts and circumstances. Item 103 also provides a disclosure threshold for pending proceedings for which the amount involved, exclusive of interest and costs, exceeds 10 percent of the company's consolidated current assets. Companies must aggregate similar legal proceedings, both pending and known to be contemplated, in calculating whether legal proceedings exceed this threshold. For purposes of Item 103 (but not Item 303, discussed below), companies should weigh the probability that a loss will be incurred as well as the anticipated magnitude of any such loss. Many proceedings, such as lawsuits, are already publicly filed, which can simplify the disclosure decision.

Because internal investigations typically, if not always, precede any of the disclosure requirements of Item 103, companies often do not disclose the existence of an investigation under Item 103.

Item 303, titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A), may also require companies to disclose information related to threatened or pending litigation. Item 303 requires public companies to disclose in MD&A "any known trends or uncertainties that have had or that the company reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." More pointedly, Item 303 requires that the "discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition," including "descriptions and amounts of ... matters that would have an impact on future operations and have not had an impact in the past ..." Although internal investigations do not often trigger MD&A disclosures, plaintiffs lawyers frequently contend that Item 303 requires a company to disclose an investigation if it "reasonably expects" the investigation will have a material adverse effect on the company. Allegations of sexual harassment filed against a company's CEO, for example, may carry a material adverse effect on the company.

Companies should engage with their advisers in making these determinations and should also consider the interpretive guidance in SEC Staff Accounting Bulletin No. 99, which states that materiality cannot be determined solely on the basis of quantitative measures (such as the potential dollar amount involved), but requires analysis of a variety of other qualitative factors.

Accounting Considerations: It is also important to consider internally, and in discussions with auditors, the potential application of Accounting Standards Codification (ASC) 450 when considering disclosure obligations. ASC 450 addresses, among other things, disclosure requirements for "loss contingencies," including disclosure of both asserted and unasserted claims against the company (as opposed to claims against only individuals). With respect to unasserted claims, ASC 450 states that disclosure is required if there has been a "manifestation by a potential claimant of an awareness of a possible claim" and the claim is at least "reasonably possible." ASC 450 does not state whether the commencement of an internal investigation is a manifestation of awareness of a possible claim.

ASC 450 also states that in the absence of a manifestation by a potential claimant of awareness of a possible claim, disclosure of an unasserted claim is nonetheless required if (1) it is "probable" that the claim will be asserted, and (2) there is a reasonable possibility that the outcome will be unfavorable. The mere fact that a company has commenced an investigation does not mean that it is probable that a claim will be asserted or that, even if one is, there is a reasonable possibility that the outcome will be unfavorable. Nevertheless, if the company and its auditors conclude that the company must disclose the investigation per ASC 450 as a footnote regarding loss contingency and/or establish a reserve for it, that decision will usually support disclosure elsewhere in a filing, such as in the legal proceedings sections of an SEC Form 10-Q or 10-K.

Differences Among Item 103, Item 303 and Accounting Disclosures: Although the disclosures required by Item 103, Item 303 and ASC 450 may overlap to some extent, they are not identical. If a company chooses to address these requirements with a single set of disclosures, it should ensure that its disclosures satisfy all applicable requirements. For example, Item 103 requires principally descriptive disclosure. Item 303 requires some analysis of the likelihood of an adverse outcome and its potential amount, as well as the potential effect on the company's income statement and balance sheet items. ASC 450 requires a different and more technical assessment of potential probabilities and outcomes than Item 303.

Recent Case Law and Sexual Harassment Investigations

Three recent cases provide some insight on how plaintiffs attorneys may allege securities violations in the wake of sexual harassment investigations.

On Jan. 19, 2017, the Ninth Circuit affirmed the dismissal of Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co., a putative shareholder class action against Hewlett-Packard and its former CEO. Investors brought a securities fraud claim under Section 10b and Rule 10b-5 of the Securities Exchange Act of 1934 based on the CEO's violation of the corporate code of conduct after he publicly promoted the corporation's high standards for ethics and compliance. The CEO, Mark Hurd, resigned after a former HP independent contractor alleged that Hurd sexually harassed her during her tenure with HP. This allegation prompted an internal investigation within HP in which the company confirmed that Hurd had misrepresented his relationship with the contractor — both lying to investigators and doctoring expense reports. Following news of Hurd's resignation and allegations, HP's stock price dropped, resulting in an alleged loss of $10 billion.

Investors pursued federal securities law claims under two theories — one premised on misrepresentations and one premised on omissions. First, the plaintiffs alleged that HP and Hurd promulgated material misrepresentations to the company's shareholders when Hurd made public statements promoting HP's business ethics during the course of HP's internal investigation. Second, investors alleged that the defendants misled investors by failing to disclose Hurd's unethical behavior. The Ninth Circuit affirmed the district court's dismissal of the complaint, concluding that neither the statements nor the omissions were misleading. Specifically, the Ninth Circuit concluded that statements regarding a company's ethical code did not give rise to securities fraud claims because they are not material to stockholder decision-making. Furthermore, the court noted, "although the facts reflect misbehavior by the corporation's highest executive in violation of its ethical code, the fact that HP and Hurd enhanced and touted [HP's ethical code] does not, without more, transform the misbehavior into an actionable material omission under the securities laws."

This case also provides some guidance on SEC items 103 and 303. Notably, the investors did not allege HP's failure to disclose the internal investigation, but rather Hurd's failure to comply with the company's ethical code. As noted above, this is likely because Item 103 requires disclosure of legal proceedings against the company, but not preproceedings, and Item 303 requires a trend or uncertainty reasonably likely to have a material impact on the company's financial condition. This case illustrates that the existence of internal investigations alone most likely does not trigger public disclosure obligations under such circumstances.

Second, in City of Monroe Employees' Retirement System v. Rupert Murdoch, et al, allegations about recent sexual harassment investigations at 21st Century Fox also shed light on how those investigations may lead to potential litigation claims against boards of directors. It has been reported that before the public learned in great detail of the allegations, 21st Century Fox underwent two investigations based on sexual harassment allegations against Roger Ailes, the late Fox News CEO, and former celebrity Fox News personality Bill O'Reilly. Both investigations involved 21st Century Fox paying large settlements to several women to settle sexual harassment allegations. These investigations and subsequent payouts could create legal questions in the area of federal securities law — specifically, whether the payouts were substantial enough to be considered material to investor decision-making. For example, although the payouts for O'Reilly were alleged to be roughly $13 million, 21st Century Fox reported revenues of more than $27 billion in 2016, and therefore the settlements may not have been quantitatively material.

On Feb. 9, 2018, 21st Century Fox and its board of directors obtained approval from the Delaware Court of Chancery of a $90 million settlement of this shareholder derivative suit against the board, certain executives, members of the Murdoch family and the estate of Roger Ailes. Rather than securities law disclosure claims, the suit alleged that the 21st Century Fox board of directors and its officers breached their fiduciary duties to the company's stockholders. Following the sexual harassment allegations and investigations, stockholders brought this lawsuit derivatively, meaning that it was an action in the name of the corporation with damages claimed to be paid into the company for the harm suffered.

The complaint alleged a "systematic, decades-long culture of sexual harassment" that "led to a hostile work environment at Fox News Channel." The plaintiffs alleged that the board breached its fiduciary duties to its shareholders by failing to fully investigate and implement sufficient controls to correct the hostile work environment. To substantiate damages to the company, the plaintiffs argued that "the public revelations of the toxic culture since July 2016 have led not only to numerous sexual harassment settlements and racial discrimination lawsuits, but to departures of talent and damage to good will. This, in turn, has caused damage to the Company's reputation and good will, as well as significant financial harm." This recent settlement included both monetary and nonmonetary relief. Specifically, the defendants' insurers agreed to pay $90 million to the company, less attorneys' fees for plaintiffs, and also agreed that the company "shall put in place governance and compliance enhancements," which will consist of a designated team to monitor and investigate workplace harassment. Fox has also disclosed that it has received other regulatory investigations, and the plaintiffs in the derivative case allege that the United States Attorney's Office is investigating securities law claims based on the company's disclosures.

The third case, Norfolk County Retirement System v. Stephen A. Wynn, et al., concerns a more recent sexual harassment investigation involving Steve Wynn, the former CEO and Chairman of Wynn Resorts, and also raises federal securities laws issues. In the wake of the allegations against Wynn and his subsequent resignation, the company's stock price has dropped roughly 12 percent. Similar to the situation with 21st Century Fox, the news of Wynn's alleged sexual harassment and subsequent investigation prompted a Wynn Resorts shareholder to file a derivative lawsuit against the company and its board of directors for breaching their fiduciary duties by "knowingly turn[ing] a blind eye to allegations of patently egregious misconduct by Mr. Wynn involving the company, taking no action to protect the company and its sustainability for regulatory compliance." In addition, the complaint alleges that the board knowingly concealed Wynn's wrongdoings in its 2017 proxy statement by stating that it was "committed to sound and effective corporate governance," while failing to disclose the alleged misconduct, settlements, and investigation. The complaint also alleges that the board failed to disclose a 2005 settlement based on Wynn's alleged sexual misconduct in its 2011 Massachusetts gambling license application where Massachusetts must consider the "integrity, honesty, good character and reputation of the applicant." The case seeks damages on behalf of the company for the amount of any and all damages caused by the defendants' breach of fiduciary duties. In addition, similar to the shareholders in 21st Century Fox, the plaintiff asks the court to direct "the company to take all necessary actions to reform and improve its internal control and board oversight concerning sexual harassment."

Key Take-Aways

- An assessment of whether to disclose an internal investigation related to alleged workplace harassment must be formed only after careful consideration of various legal principles, including employment and securities law issues.

- Every situation is different. Even if there is no specific law or case requiring disclosure of an internal investigation, lawsuits may still arise under a variety of theories.

- Seek employment counsel's advice on all aspects of a workplace harassment investigation, including any confidentiality implications.

- Nondisclosure of internal investigations is common while in the investigation stage, and disclosure is never automatic. Rather, upon receipt of an allegation and when conducting an investigation, companies should work with outside securities counsel, in addition to employment counsel, to help them carefully consider the unique facts and circumstances and should continue to assess disclosure obligations on an ongoing basis.

- Companies should review risk factors every quarter. Companies should also review SEC filings to determine what types of specific disclosures have been made regarding their CEO and other senior management members, their behavior, reputations, and their importance to the business.

- Internal disclosures should be made on an as-needed basis, limiting the possibility of leaks.

- Even if a company decides not to disclose an investigation in its early stages, the company should continue to reevaluate the status of the investigation from time to time as it progresses in order to determine if an obligation to disclose the investigation has arisen.

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