D&O Coverage for Lawsuits Alleging Lack of Boardroom Diversity: Is Your Company Protected?

By Jesse K. Hidell-Carrijo

Amid the current movement for racial justice, a new trend has emerged in the world of Directors and Officers (D&O) insurance. A recent wave of lawsuits that are expected to trigger D&O policies has been brought against major corporations in the U.S., with a message reflective of the movement: that racial diversity belongs in the boardroom.

Traditionally, D&O policies were purchased to obtain increased protection for directors and officers for a relatively low premium. However, in recent years, D&O premiums have soared as a result of the increased risk due, in part, to rapidly changing social environments such as the #MeToo movement and heightened awareness of racial/gender discrimination in the workplace. #MeToo propelled the woman's rights movement and resulted in litigation against corporations, along with their directors and officers, for sexual abuse and harassment in the workplace, as well as claims of unequal treatment. In September 2018, California became the first state to legally compel corporate board diversity with a law mandating that every public company in the state shall have at least one female director by the end of 2019.

The Black Lives Matter movement, which began as a response to police brutality in 2013, has recently surged with international awareness and support following George Floyd's death in May of this year. This social push for racial justice has likewise seen productive results. In California, Governor Newson recently signed into law a bill that requires, by the close of 2021, every public company with its principal office located in California to have at least one board director from an "underrepresented community," which includes minority groups characterized by both race and sexual orientation/identity. Failure to comply will result in fines in the amount of $100,000 for a first violation and $300,000 for any subsequent violation.

Additionally, there has been a push for increased boardroom diversity from the Securities Exchange Commission ("SEC"). In 2009, the SEC adopted a requirement for companies to disclose if and how diversity is considered as a factor in the process for considering candidates for board positions,

including any policies related to the consideration of diversity. In 2018, the SEC issued guidance encouraging the disclosure of self-identified characteristics of board candidates. As recently pointed out by Commissioner Allison Lee at the Council of Institutional Investors Fall 2020 Conference, "disclosure drives corporate behavior . . . . When companies have to be transparent, it creates external pressure from investors and others who can draw comparisons between companies."[1]

The current racial justice movement has prompted companies to vocalize their support for diversity initiatives. Corporations have declared publicly, and within proxy statements, their commitment to strengthen diversity through various initiatives and policies designed to ensure diversity at management and boardroom levels. Encouraging as this may sound, the danger comes when these proclamations lack substantive implementation. Making false public disclosures to the shareholders and the public exposes corporations to derivative suits brought by shareholders who claim to have invested in a particular company primarily because of certain public disclosures regarding diversity initiatives. The lack of implementation of these initiatives may demonstrate that they were misled. The lawsuits that have emerged alleged a violation of the federal securities laws and a breach of the directors' and officers' fiduciary duty.

Shareholder Derivative Suits

In the past few months, there have already been nine shareholder derivative actions filed against major U.S. companies alleging that their directors breached their fiduciary duties to the company by failing to include an African American on the company's board, despite numerous statements declaring a commitment to diversity.

Almost all of these actions have been filed by the same law firm and share substantially the same allegations. The companies that have been served so far include Facebook, Oracle, Qualcomm, NortonLifeLock, The Gap, Monster Beverage, Cisco, and Danaher. The complaints allege that the boards have filed false and misleading proxy statements regarding the companies' commitment to diversity. There are also allegations that the boards have breached their duties by continually rehiring the same auditors, which resulted in consistently biased reviews of the companies' internal control systems regarding diversity initiatives.

Among other remedies, the plaintiffs demand the resignation of board members and executive officers to make room for diverse candidates; "disgorgement" of the current board's compensation (including stock gains); a commitment to promoting hiring, advancement, and pay equity to minorities; required annual diversity, affirmative action, anti discrimination, and anti-harassment training of board members and executive officers; termination of auditors; and attorney's fees.

What This Means for Your Company's D&O Coverage

This trend of diversity-related lawsuits is not slowing down. In fact, what began as a single law firm seemingly acting as an outlier on a quest for social change, has grown as more law firms file similar lawsuits on behalf of their clients. The pertinent question now for every U.S. company who has publicly disclosed diversity initiatives is: "Am I covered?"

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[1]Diversity Matters, Disclosure Works, and the SEC Can Do More: Remarks at the Council of Institutional Investors Fall 2020 Conference, presented by Commissioner Allison Herren Lee on September 22, 2020.

A typical D&O policy has three insuring agreements: "Side A," "Side B," and "Side C." "Side A" provides coverage for the indemnification of the officers and directors when a corporation is unable to do so due to insolvency or if prohibited by law. "Side B" provides coverage for a company in the form of reimbursement for its indemnification of directors and officers. "Side C" provides coverage directly for the company for certain types of claims. In policies issued to public companies, "Side C" is almost always limited insurance for "Securities Claims" — claims based on state or federal securities laws. In policies issued to private companies, the entity coverage often applies to a wide range of claims against the company arising from wrongful acts by the insured company or its officers or directors.

Shareholder Derivative suits are "Side A" territory because the company is generally unable to legally indemnify the directors and officers. In most states, while a corporation is permitted to indemnify directors and officers for their defense costs in a derivative suit, the corporation is not permitted to indemnify directors or officers for a settlement or judgment in an action brought against them derivatively.[2]

The relief sought in these diversity suits includes both monetary and non-monetary relief. The monetary relief includes the return of all 2020 compensation received by the directors. This is most likely considered by the courts to be disgorgement if it is restitutionary in nature. Under the standard language, a D&O policy will likely not cover this form of relief sought by the shareholders. However, the term "disgorgement" has been subject to varying recent interpretations, with one court holding that settlement payments only constitute disgorgement if the amounts *conclusively* represent ill-gotten gains.[3]

The non-monetary relief sought includes the various demands made by the plaintiffs, as referenced above, such as changes in the board selection procedures and diversity training initiatives. It is unlikely that a D&O policy will provide coverage for the cost associated with fulfilling these non-monetary demands. This is because "Loss" is commonly defined as not including costs incurred by an insured to comply with any order for non-monetary relief, any agreement to provide such relief, or any regulatory or administrative directive. While case law on this issue is limited, the plain language of the policy will likely control, and courts have held the exclusionary language to "unambiguously eliminate coverage for non-monetary relief" and "the cost of undertaking those acts."[4] Thus, as is the case with monetary relief, coverage for non-monetary relief is unlikely, although both are ultimately dependent on policy language, specific facts, and jurisdictionally-specific authority.

However, even in the event that neither monetary nor non-monetary relief is covered, all is not lost! Defense costs may be covered under "Side C." Regardless of the plaintiff's success on the merits of these lawsuits, there will undoubtedly be a significant amount of defense costs incurred. In fact, defense costs for these types of suits may be the largest (if not the only) cost to the company and its directors, potentially costing millions for defense counsel to file a motion to dismiss.

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[2]Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 540 (Del. 1996) (Delaware does not "'allow indemnification of judgments or amounts paid in settlement in derivative suits'" because such payments would be "'circular since the corporation would simply be paying itself.'")

[3]In re TIAA-CREF Ins. Appeals, 192 A.3d 554 (Del. 2018), reargument denied (Aug. 23, 2018)

[4]Am. Med. Sec., Inc. v. Exec. Risk Specialty Ins. Co., 393 F. Supp. 2d 693 (E.D. Wis. 2005).

Many insurance policies do not expressly address the issue of whether the defense costs for the "nominal defendant," i.e., the company, in a derivative action are covered. Insurers may argue that "Side C" does not provide coverage for a corporation because claims typically are not brought directly "against" the nominal defendant or because the nominal defendant is not alleged to have committed a "wrongful act." However, if the policy is silent, "Side C" is likely to provide coverage for a defense because it expressly covers loss to the corporation.[5] As it stands, we are still monitoring whether these cases will survive a motion to dismiss. If they do not, defense costs may be all the insured needs.

Policy Enhancements to Consider Negotiating

In assessing coverage, it is important to recognize that D&O policies are not issued on standard forms and typically contain manuscript language. Coverage for these derivative suits will hinge on your D&O policy's specific language, but many terms may be open to negotiation.

"Side D" coverage is worth obtaining, and if you already have it, it is important to re-evaluate its limits. "Side D" is a common extension, providing a company with separate coverage for costs incurred in connection with internal investigations as a response to a shareholder derivative claim. Under Delaware law, where many companies are incorporated, directors must exercise "good faith" in dealing with potential or actual violations of the law or corporate policy.[6] When directors are placed on notice of misconduct within the company, they must take reasonable steps to investigate and remedy the problem. Such coverage is typically subject to a "sub-limit" (typically $250,000 to $500,000) that is often insufficient to cover the costs of such investigations.

Policyholders should be aware of the standard coverage exclusion for certain bad acts by the insured, such as fraud, dishonesty, violations of law, and unlawful personal profit or remuneration. Insurers will argue that diversity claims implicate this exclusion because of the allegations that an executive knew or should have known that the information provided to investors was false or fraudulent. However, the exception to this exclusion, which requires there to be a final adjudication adverse to the insured, should apply. Insureds should confirm that the policy terms include this exception, stating that the exclusion applies only if the referenced bad acts are established by a final, non-appealable adjudication in the underlying action or underlying judicial proceeding. If the language states that there must be a final adjudication in an "underlying proceeding," it would be best to refer to it as an "underlying judicial proceeding" to eliminate triggering the exclusion based on an administrative proceeding.

Most D&O policies include an "Insured v. Insured" exclusion, excluding claims brought by one insured against another. While this language is standard in D&O policies, insureds must verify that the exclusion does not apply to derivative actions.

Other enhancements to consider obtaining are: (1) Side A Excess Difference in Conditions (DIC) coverage, which not only serves as excess Side A coverage, but will drop down when underlying insurance

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[5]Delaware law permits indemnification only for defense costs, not judgments or settlements, under Section 145(b) of Title 8 of the Delaware Code.
[6]Stone v. Ritter, 911 A.2d 362 (Del. 2006).

refuses to pay; and (2) removal of the exclusions for "restitution," "penalty," and "disgorgement" from the definition of "loss."

Protect Yourself and Your Company

After reevaluating your coverage and negotiating any enhancements, the next question becomes: "How can I avoid being the next target of a diversity-driven lawsuit?"

The best ways to protect yourself and your company are to take affirmative action to implement policies that encourage company diversity and hire diverse board members. In the meantime, however, it is important for the officers and directors to be mindful of discrepancies between what is disclosed publicly and what actions are actually taken within the company. Companies can reduce their exposure to liability by closely following and enforcing governance procedures and taking reasonable precautions regarding disclosures and policy implementation.

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