# #MeToo: SEXUAL HARASSMENT AND EXECUTIVE COMPENSATION

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#### #MeToo: SEXUAL HARASSMENT AND EXECUTIVE COMPENSATION

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It would not surprise me to learn that workplace sexual harassment has a history as long as that of working relationships themselves. The incidence of misbehavior may have varied with geography, work setting, or the times, but bad behavior seems obdurate. Power is intoxicating and, when combined with carnal impulses (and perhaps an executive's inflated self-image and underdeveloped empathy for co-workers), makes possible mischief that is personally hurtful and institutionally corrosive.

The intractability of workplace sexual harassment has been noted with woe by a taskforce formed by the Equal Employment Opportunity Commission (the "EEOC"). That taskforce – the two co-chairs of which were EEOC commissioners – reported that studies of sexual harassment suggest 25 percent of women, at the low end, report having experienced sexual harassment in the workplace. Select Taskforce on the Study of Harassment in the Workplace, U.S. Equal Opportunity Commission, June 2016, p. 8. And this is the result 30 years after the Supreme Court held that workplace harassment is an actionable form of discrimination prohibited by Title VII of the Civil Rights Act of 1964. *Meritor Sav. Bank, FSB v. Vinson*, 477 U.S. 57 (1986).

Perhaps 2017 will prove to have been a watershed year, both in the effort to reduce the incidence of sexual harassment, and the effort to identify and punish wrongdoers. The reaction of the eponymous The Weinstein Company LLC and Wynn Resorts Ltd. to allegations of sexual harassment (or worse) against Harvey Weinstein and Steve Wynn has been startling given the close identification of those executives with "their" companies. And we have seen in the cases of Matt Lauer, Roger Ailes (in 2016), and key business producers in the financial services and entertainment industries a willingness of employers to terminate (or accept resignations from) employees who have been of great financial importance to their companies. This seems new; 2017 does seem to have been different. Whether, however, 2017 was a harbinger of an enduring change in employers' attitudes towards, and approaches in addressing, allegations of sexual harassment relating to key executives remains to be seen. If it is true that #TimesUp, and in particular if customers (and members of the public more generally) favor harsher treatment of executives engaged in sexual harassment or assault, compensation committees may find value in reflecting this new attitude in the structure of their companies' executive compensation programs and agreements.

### What is an Employer's Interest?

Although it seems naïve to imagine that sexual harassment will be eliminated root and branch, employers have a pretty substantial interest in minimizing it. Among the business risks posed by executives' sexual harassment or assault of co-workers (or business partners, customers, contractors, or others having a business relationship with the company) are the following:

- 1. <u>Potential claims</u> against the company by victims of sexual harassment, for example, where victims argue that the company is vicariously liable under Title VII of the Civil Rights Act of 1964, under the precedent of *Meritor Sav. Bank, FSB v. Vinson*, 477 U.S. 57 (1986); *Burlington Indus., Inc. v. Ellerth*, 524 U.S. 742 (1998); and *Faragher v. City of Boca Raton*, 524 U.S. 775 (1998).
- 2. <u>Increased difficultly in hiring and keeping quality talent</u>, where unwelcome behavior by executives adversely affects the work environment.
- 3. <u>Reputational risk</u>, particularly given what appears to be customers', business partners', and the general public's newly heightened intolerance for sexual misconduct. The reputational risk to a company would seem greater the more senior the misbehaving executive, the higher his or her public profile, and the greater the degree to which members of the public or customers identify the company with the executive. This seems particularly true where the company does not adeptly address misconduct after it is discovered.

# What to do?

<u>Cause and Clawbacks</u>. The two obvious tools for (a) making sexual harassment dear to misbehaving executives, by imposing substantial financial disincentives to bad behavior, and (b) avoiding outrage from customers, business partners, and the public when a reviled executive is involuntarily terminated yet receives substantial compensation on his or her<sup>1</sup> way out the door, are to (i) add sexual harassment to the definition of "cause" under employment agreements and executive compensation programs and arrangements, and provide for the forfeiture of large components of compensation on termination for cause, and (ii) provide for the clawback of already paid compensation in the event sexual harassment is discovered.

**Examples of Cause Language**. As to a "cause" definition, executive employment agreements found in 8-K, 10-Q, and S-1 filings have included the following language in their "cause" definitions:

Executive's . . . deliberate violation of a Company Group policy, including but not limited to those relating to . . . sexual harassment. [nLIGHT, Inc's executive employment agreements with Ron Bareket, Robert Martinsen, and Scott Keeney]

Employee's breach and violation of the Company's written policies pertaining to sexual harassment. . . . [Silverbow Resources, Inc. employment agreement for Steven W. Adam]

Willful disobedience of lawful orders, policies, regulations, or directives issued to Employee by [the Company], including policies related to sexual harassment. . . . [Parsley Energy Operations, LLC employment agreement with Vice President, General Counsel]

<sup>&</sup>lt;sup>1</sup> I understand that most claims of sexual misconduct are made against men, but to be inclusive I will not assume all miscreants are men.

Executive's breach or violation of any material written policy or regulation of the Bank, including, but not limited to, any written policy or regulation dealing with sexual harassment . . . . [Community West Bancshares employment agreement with Kristine Price]

**ERISA Vesting and Protected Benefit Rules**. As always, it is important that any compensation subject to the vesting standards of Part 2 of Title I of ERISA not be forfeited (at least to the degree the forfeiture would violate ERISA's vesting rules). Consider, for example, a nonqualified deferred compensation arrangement that (a) provides for distribution only upon separation from service (with no in-service payments), and (b) includes enough complexity so the Supreme Court's decision in *Fort Halifax Packing Co. v. Coyne*, 107 S. Ct. 2211 (1987) would not cause it to fail to be a "plan." The arrangement might, then, be a pension plan under ERISA. If – presumably inadvertently – the plan were to cover employees who are not members of a top hat group, there could be no forfeiture of benefits under the plan that would be inconsistent with ERISA's vesting requirements. An employer would not, of course, expect its arrangement to fail to be a top hat plan, and, therefore, would not expect ERISA's vesting standards to apply. The battle, then, would come after termination for cause, when the former executive might assert in litigation that the plan was not a top hat plan, and that the forfeiture of benefits was therefore impermissible (particularly if the executive had been employed long enough to vest under the slowest of ERISA's permissible vesting schedules).

Another concern involves the forfeiture or clawback of compensation that is not itself subject to ERISA's vesting standards, but that has been counted in determining the executive's benefit under a pension plan that is subject to ERISA's vesting rules. In many cases, disregarding forfeited or clawed back compensation will have no bearing on an executive's qualified retirement plan benefits because his or her compensation will exceed the Tax Code Section 401(a)(17) limitation even absent the forfeited or clawed back compensation. But where an executive would not exceed the 401(a)(17) limit without counting forfeited or clawed back compensation, whether those forfeited or clawed back amounts are counted as compensation under a qualified retirement plan could affect the calculation of benefits under the plan. Even then, there may be little concern about <u>forfeited</u> compensation. That is because the types of amounts subject to forfeiture occurs. Those amounts usually will not have become taxable prior to forfeiture and many qualified plans only count amounts once they become taxable. And qualified plans may also exclude incentive compensation expressly. Where compensation is forfeited plan benefit to be paid.

With respect to <u>clawbacks</u>, though, the concern could be greater. Assume, for example, that compensation that served as a basis for a defined benefit plan accrual is clawed back. If that benefit is not adjusted downward as a consequence, one hopes the employer would not be considered to have failed to follow the terms of the plan by counting the returned compensation. This is important because failing to follow plan terms can be both disqualifying and an ERISA fiduciary breach. And one hopes the failure to adjust for the clawback would not be considered to impermissibly favor highly compensated employees, by counting compensation a highly compensated participant was ultimately required to return. Despite these concerns, not adjusting the benefit seems the right result. That is because if a plan were to "reduce" benefits by no longer counting the clawed back compensation this would probably violate the protected benefit rules

under both ERISA and the Tax Code. If the executive was entitled to the compensation when it was included in the accrual of benefits under a qualified defined benefit or 401(k) plan, that benefit accrual probably may not be reduced, even if the compensation on which the qualified plan benefit is based must later be returned.

This qualified retirement plan complication is not unique to sexual harassment. It arises whenever compensation is forfeited or clawed back. Again, usually it won't matter, because the executive's compensation will exceed the Tax Code Section 401(a)(17) limit with or without the forfeited or clawed back compensation. But where that is not true, one must guard against reducing an executive's qualified retirement plan benefit, since doing so could both disqualify the plan (by violating Tax Code Section 411(d)(6)) and violate ERISA.

<u>Sexual Harassment Definition</u>. The term "sexual harassment" could use some definition. You will see from the excerpted employment agreement language above that what constitutes "cause" for a termination for sexual harassment may turn to a large degree on the company's more comprehensive written policies, which one hopes include some detail as to what constitutes prohibited sexual harassment.

<u>Pre-Employment Misbehavior</u>. Normally an employer would terminate an executive only for misdeeds occurring while the executive is employed at the company. But if the #MeToo movement sustains itself, and if companies are concerned that those with a history of sexual harassment will become liabilities once that history is discovered, employers may wish to consider the possibility of including as "cause" prior sexual misconduct, for example at a prior employer. Again, we would not normally expect pre-employment behavior to constitute cause, and one might argue pre-employment history is too remote to a company's interests to serve as cause. That position may make most sense to those sympathetic to the argument that it is relevant that different behavioral standards may have applied during the executive's tenure at his or her prior employer. One can, of course, expect strongly different reactions to this question whether different historical standards matter.

Long-ago Behavior at the Current Employer. Whether it matters that different norms of acceptable behavior applied in the past (if, in fact, that was the case), may affect not only whether pre-employment misbehavior should constitute cause, but also whether a long-tenured executive should be treated differently with respect to behavior that occurred long ago at the same company (rather than at a prior employer) but that has been exposed only recently, perhaps because the #MeToo movement emboldened co-workers to speak about long ago events. It would seem hard to give executives a pass for old misbehavior at the same employer, but it seems less hard to imagine not including as "cause" sexual misconduct at a prior employer. Of course, to the degree a company's written policies on sexual harassment have evolved over time, there may, by reason of that evolution, be an inherently relaxed standard applicable to periods when the policy was less strict.

An advantage of including in a draft of an employment agreement for a new executive a cause definition that includes having engaged in "sexual harassment" (by some definition or standard) at a prior employer is that if the prospective executive pushes back particularly hard, this may signal to the company that it should inquire further about the executive's work history. If in

probing that history the prospective employer learns of a propensity that may spell future trouble for the company, the company may wish to rethink how well the prospective executive would fit the company's plans.

<u>Prepare for a Battle</u>. To the degree the consequences of a termination for sexual harassment are different than other "for cause" terminations – for example, because clawbacks do not apply to "run-of-the-mill" cause terminations, but are applied to sexual misconduct terminations – employers will, of course, need to adequately document the type of cause triggering a termination and the evidence for it, especially where that cause is sexual harassment.

Because allegations of sexual harassment or assault may affect not only an executive's pocketbook, but also his or her personal reputation, companies can expect a hard fight should they assert that an executive is being terminated for sexual harassment (or assault). This may create special difficulties where an executive sues the company in an attempt to fight the forfeiture or clawback of substantial compensation. At that point, the company will need to address in court (or arbitration) the executive's assertions that he or she did not misbehave. What may make this especially challenging is that if the victim has not her or himself made the matter public, such as by filing a lawsuit against the company or the executive, the victim may be quite unenthusiastic about being called to testify in a proceeding between the company and the executive. If the victim wants relative anonymity, the executive may make the victim uncomfortable, and perhaps uncooperative to the company, through the litigation or arbitration process.

But in spite of all those practical difficulties, including sexual harassment and other sexual misconduct in a "cause" definition at least gives a company leverage should it need to negotiate the termination of an offending executive. As always, when negotiating a termination of employment, companies need to be careful not to violate Section 409A, particularly when "substituting" compensation in a fashion that could change the time or form of compensation subject to the Section 409A rules.

<u>**Clawbacks**</u>. As noted earlier, the two obvious tools for exacting a heavy financial price for sexual misconduct are (a) including sexual harassment in the applicable "cause" definition, and (b) including in the company's clawback policies – as well as in employment agreements and executive compensation plans and agreements – a clawback of compensation in the event an executive is discovered to have engaged in sexual harassment or other sexual misconduct. This is largely unplowed ground with respect to clawbacks and raises some special practical concerns.

One of these special considerations is whether a clawback should apply where the sexual misconduct is discovered only after, and perhaps long after, the executive has terminated employment for some reason other than sexual harassment, possibly even in a voluntary termination. In the case of a clawback by reason of an accounting restatement, it is reasonably clear when the restatement trigger occurs, and an executive's clawback risk usually remains for only a few years. For example, in the case of an accounting restatement, the clawback might apply only to incentive-based compensation received by executive officers in the three fiscal years preceding the date the company is required to prepare a restatement.

But what about a clawback for sexual harassment? Should there be a time limit for such clawbacks? Should it matter whether the company knew of the sexual harassment when the

executive left the company? In the case of later discovered sexual misconduct, one might argue that a clawback is not appropriate where the reason for termination had nothing to do with sexual misbehavior. But if after an executive's departure a victim brings a claim against the company, one can imagine the company might want to claw back compensation both to cover all or a portion of the company's liability and as a salve for its less clearly pecuniary troubles relating to the claims.

Where recently discovered misconduct occurred long ago, and was not the reason for the executive's termination, one possibility might be to clawback compensation based on that stale misconduct, but to limit the clawback to fairly recently granted compensation. The clawback might, for example, relate only to compensation granted or paid within the three years preceding the company's formal assertion of misconduct by the executive. Often, one thinks of statutes of limitations as setting appropriate standards for determining the staleness of claims, but where a sexual harassment claim does not become known until years after an executive leaves, one may wonder whether the limitations period that would apply to the victim her or himself should have any relevance, and whether the statute begins to run for the employer only when it learned, or should have learned, of the claim.

Not that the employer will necessarily care, but the recent Tax Cuts and Jobs Act of  $2017^2$  may have a slight adverse effect on the ability of an executive to effectively recover taxes he or she paid on clawed back compensation. Although clawed back compensation typically will be large enough so an executive may be able to recover taxes under the IRC Section 1341 rules, for small clawbacks of less than \$3,000, the ability to claim a deduction under IRC Section 165(a) for miscellaneous itemized deductions subject to the two percent floor of IRC Section 67(a) seems to have been eliminated, at least for the next several years. That is because Section 11045 of the Tax Cuts and Jobs Act of 2017 eliminates miscellaneous itemized deductions for the years 2018 through 2025. It does so through the addition of new IRC Section 67(g).

## Indemnification.

In addition to making sexual harassment a "for cause" reason for terminating an executive (resulting in the forfeiture of compensation), and a basis for clawing back compensation, employers may wish to consider including an indemnification provision in employment or other executive agreements, to protect the company against victims' claims against the company. They may wish to do so because employers can have vicarious liability for sexual harassment by their employees. See, e.g., *Burlington Indus., Inc. v. Ellerth*, 524 U.S. 742 (1998); *Faragher v. City of Boca Raton*, 524 U.S. 775 (1998).

If an employer includes an indemnification provision, it may wish to make explicit that it has no obligation to mitigate losses, and that it is to be indemnified even for a loss that was a result of its own negligence. Making clear that the company has no obligation to mitigate losses may be unnecessary, since there may generally be no duty to mitigate liability when recovering on an indemnification obligation. But the value in making the mitigation point explicit is that it may short circuit claims by executives that the company could have reduced its losses by not insisting on a nondisclosure agreement when settling with a sexual harassment victim. This is of note

 $<sup>^{2}</sup>$  I realize it actually is not called The Tax Cuts and Jobs Act of 2017, due to a ruling by the Senate Parliamentarian relating to the Byrd Rule, but for the sake of my sanity and that of readers, I'm going to call it by this short title that many commentators use.

because Section 13307 of the Tax Cuts and Jobs Act of 2017 denies an ordinary and necessary business expense tax deduction under IRC Section 162 for any settlement or payment related to sexual harassment or sexual abuse, if that settlement or payment is subject to a nondisclosure agreement. So, an executive might argue, the company could have saved tax dollars by not requiring a non-disclosure agreement from the victim. This Tax Code change was made through the addition of the new Tax Code Section 162(q). And that section also denies a deduction for attorney's fees related to such a settlement or payment. Time will tell whether the effect of this loss of deduction is to make the use of nondisclosure agreements in the settlement of sexual harassment or sexual abuse claims less common, or merely more dear. The executive's tax mitigation argument makes sense, of course, only if the loss to be indemnified is the net after-tax cost to the company of settlement payments and related expenses.

As to including an indemnification provision protecting the company from losses due to its own negligence, that could prove important since an employer may be liable for work environment harassment by an employee who is not the supervisor of the victim if the employer was "negligent in failing to prevent harassment from taking place." *Vance v. Ball State Univ.*, 570 U.S. 421 (2015).

Although an indemnification provision may give a company a chance of recovering its outof-pocket costs related to sexual harassment settlements, proving the amount of any resulting reputational damage to the company could prove exceptionally difficult. One wonders whether it might be possible to include a liquidated damages clause relating to reputational losses. Although any such liquated amount could well understate the amount of the reputational damage, if it is a large number it might act as an additional means of discouraging bad behavior. On the other hand, like all the provisions discussed here, a company must consider whether a liquidated damages provision could prove so fearsome, and so far outside the current standard practice in executive arrangements, that it would scare off even talent that poses little sexual misconduct risk. And remember that although changing a compensation <u>plan's</u> definition of "cause," and including clawback provisions in such a plan, are steps that need not necessarily be negotiated with executives, any indemnification provision would presumably need to be included by agreement of the parties in, for example, an employment or compensation agreement. This makes the concern about overreaching more pointed in the indemnification context.

# Arbitration.

For companies that prefer that disputes be determined through arbitration, in part to avoid the publicity associated with litigation, the calculus may be somewhat different where a dispute concerns sexual harassment or sexual assault claims. If an executive's misconduct has already become known, the company may prefer that its actions to recover compensation from the offending executive be as public as possible. If so, this would eliminate one of the arguments for requiring the arbitration of disputes, at least as they relate to alleged sexual harassment by an executive.

### Risks in Not Acting.

If a company includes provisions allowing it to forfeit compensation, clawback compensation, or seek indemnification in the event of sexual misconduct, but chooses not to use

those tools, one wonders whether this might invite criticism from customers, business partners, or the public. One might even wonder whether the failure to act could attract a shareholder derivative action claiming the company's directors breached their fiduciary duties of loyalty and care and wasted corporate assets by paying compensation that was a least arguably forfeitable, and failing to clawback compensation or enforce an indemnification provision. Notably, we have seen the filing of a shareholder derivative action making similar claims in City of Tamarac Firefighters Pension Fund Trust v. Corvi (filed in Delaware), though it is not entirely clear from the complaint whether the company had a clawback policy that could even have applied. This case does not involve sexual harassment, but nevertheless may serve as a warning. The case involves a claim by a pension fund that United Continental Holdings, Inc.'s directors acted improperly in paying a \$37 million severance package to United's former chief executive officer. The former CEO was terminated after the Chairman of the Port Authority of New York and New Jersey pleaded guilty to bribery charges, following federal investigators finding that the Port Authority Chairman pressed United executives into setting up a flight from Newark to Columbia, South Carolina, near which the Chairman of the Port Authority maintained a vacation home. The practical lesson may be that the risk in failing to exercise clawback or "for cause" forfeiture rights, and possibly indemnification rights, may increase as the amounts paid to a departing executive upon his or her departure reach eye-popping levels, and where the executive is thought by shareholders to have made missteps that either induce moral outrage or have proven especially costly for the company.

### **Discretion in Identifying "Cause."**

Leaving aside any concern about the potential for a shareholder derivative suit for failing to forfeit or clawback compensation (or to exercise indemnification rights), a company has some natural discretion when applying the "cause" provisions of an employment agreement or executive compensation program. Since sexual harassment will normally not be the only type of offense specified in a definition of "cause," companies may on occasion find themselves negotiating with an executive an understanding that the executive will be terminated for a different reason, but one that still constitutes "cause." An executive may find this more palatable than a documented termination for sexual harassment or assault. And, of course, it is not unheard of for a company to believe it has grounds for terminating an executive for "cause," but choosing instead to reach agreement with the executive that he or she will be terminated without cause, perhaps to avoid what the parties expect will otherwise be contentious litigation. Doing so may enable a company to rid itself of an executive it finds detrimental to the organization, while avoiding the cost and publicity of litigation.

Where either of these occur – that is, where a company believes that an executive has engaged in sexual harassment or assault that constitutes "cause" but instead agrees to a for cause termination on other grounds, or agrees to a termination not for cause – the company must consider the degree to which this may interfere with a later clawback or indemnification claim. This could become important where, for example, some time after the executive has left, a sexual harassment lawsuit is brought against the company by an alleged victim. One wonders whether the company might be estopped from asserting that the executive was terminated for, or possibly even engaged in, sexual harassment or other sexual misconduct where the company previously agreed that the termination was not for cause (or was for a different cause). And even if the company is not estopped from asserting that the executive was terminated for sexual misconduct, having previously formally agreed to termination for a different reason may adversely affect the

company's credibility when arguing that sexual misconduct was the real reason for the termination. This risk may be greatest with respect to sexual harassment claims discovered only after the executive's termination, but where the company knew of other, perhaps less serious, allegations of sexual harassment leading to the executive's termination.