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Under Pressure to Diversify: Availability of D&O Coverage for Corporate Diversity Claims © [¶7.1]

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With the recent rise in novel diversity lawsuits, which have targeted some of the leading companies across the country, and are sure to be a hot topic of litigation this year and beyond, policyholders are highly encouraged to review their existing directors and officers ("D&O") insurance policies to ensure that they have adequate protection in place to cover diversity claims.

If you are one of the more than 100 million people who watched the Super Bowl, you noticed that companies are starting to be more vocal about the importance of diversity. With ads featuring all Black actors and more modern families, companies are celebrating inclusion and promising to join the fight to end systemic racism. The NFL itself is a prime example of this change in messaging. Years after Colin Kaepernick faced backlash for kneeling to protest inequality, the NFL ran its own ad this year that highlighted its pledge to spend $250 million to end racism.

Talk of diversity and inclusion has been growing—and growing more insistent—starting with the first Black Lives Matter protests in 2013 and building to last year's protests following the murder of George Floyd, who died while being forcibly detained by Minneapolis police. Despite their messages of support for diversity and inclusion, however, many companies have struggled to promote diversity in their own ranks, especially with respect to their boards of directors and C-suite executives. But consumers

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and investors alike are now pressuring companies to meaningfully respond to their demands for internal change. Of late, this includes shareholder derivative lawsuits that use federal securities law not only to target the company's lack of success in diversifying, but also to challenge the commitment of the company's directors and officers to enact change. These novel ''diversity lawsuits'' open a new realm of potential liability, in addition to forcing companies to consider how to promote diversity in their ranks and respond to internal and customer demands for change.

While there have only been a handful of diversity lawsuits filed as of today's date, the allegations against some of the best known names in business, like Facebook, Oracle, and Monster Beverages, could easily apply to other publicly-traded companies across the country. The individual details vary from case to case, but the common charge against the directors and officers of the sued companies is that they breached their fiduciary duties and violated Section 14(a) of the federal Securities Exchange Act by failing to include diverse directors on their boards and in their senior executive ranks, while at the same time touting their commitment to diversity, equality, and inclusion in the company's proxy statements and other corporate publications. Corporate counsel can forget about their old playbook for dealing with employee discrimination complaints or outside groups threatening a boycott. This is new legal terrain being staked out by stakeholders in companies (in some cases, institutional investors) and the class action lawyers representing them.

Focusing on appearances, often including photographs of C-suite executives and board members in the complaints, diversity lawsuits shine a spotlight on the widespread issue of executive boards of public companies being overwhelmingly white. For example, the diversity lawsuit against Cisco alleged that the board breached its duties by not having a single African American member in its ranks. Most recently, on February 9, 2021, Micron was targeted for having only one racially diverse executive, despite the fact that the diverse executive was the CEO. In a rather aggressive move, the Micron complaint included a claim for breach of fiduciary duty on the basis that executive compensation was excessive in light of Micron's purported static achievements with respect to diversity when compensation was, at least in part, tied to the achievement of diversity-related goals.

Some statehouses have given plaintiffs extra ammunition by passing laws requiring that public and private companies promote diversity. In 2018, California was the first state to pass legislation requiring public companies headquartered in the Golden State to include a certain number of women on their boards by 2019, and to increase the number again by 2021. The state also recently passed another law mandating that those same companies must elect at least one director from an underrepresented community by the end of 2021, or otherwise face fines upwards to $300,000. In New York, the Women on Corporate Boards Study Act requires all boards to report the number of women members they have, effective June 27, 2020. While the New York legislation does not enact penalties or establish a quota like its California counterpart, it is a sign of continued governmental interest in using the law to diversify corporate boards. The challenge to diversify boards of public companies has also been taken up by Nasdaq, which, in December 2020,

filed a proposal with the SEC to adopt two new rules that would require most companies listed on the exchange to elect at least one woman director and one director from an underrepresented minority or who identifies as LGBTQ+ within a certain time frame. Under the proposed new rules, any company that fails to meet the requirements for its listing tier would be required to disclose in the company's annual meeting proxy statement or on its website the reasons for its failure.

This barrage of diversity lawsuits is probably only the first salvo. Since more and more companies are making public vows to promote diversity, plaintiffs will see an opening for high-priced litigation, and may believe they are doing good in the world by forcing companies to confront this issue. Further, the damages being sought are the kinds that get trial lawyers salivating. These diversity lawsuits have sought disgorgement of compensation by directors and officers (including stock gains), as well as attorney fees. In addition, they have demanded resignation of board members and executives; termination of auditors; institution of training programs regarding diversity; and establishment of hiring committees focused on bringing in diverse candidates.

What can a company, public or private, do to prepare for this? In the first instance, for the good of the company—and to avoid being the target of these novel diversity lawsuits—companies should actively recruit, hire, and train diverse talent. All the while, companies should recognize that insurance companies, as with any novel litigation, will likely try to wriggle out of coverage, if they become the next target. Companies with existing D&O policies should review their policies now, looking at how these diversity lawsuits have been structured to date, to ensure that they have adequate protection against these diversity lawsuits. In certain instances, companies will find it makes sense to further beef up traditional Side A, B, and C coverage in their D&O policies, so as to narrow the disputes they may have in the future with their insurance company.

(As a quick reminder, Side A typically covers directors and officers when a company cannot pay either because it is prohibited from doing so or does not have the necessary financial resources. Side B is coverage that reimburses the company for its payment of defense costs and indemnity of the directors and officers. Side C coverage is there for the company but may be narrower or less accessible than the other coverages, applying only to certain types of claims, such as securities claims.)

Policyholders will also want to review whether their insuring agreements are broad enough to cover diversity claims, as opposed to traditional discrimination claims. While this may appear to be a distinction without a difference, carriers may argue that allegations relating to the lack of diversity in the C-suite are not covered as they involve issues of implicit bias rather than explicit discrimination. Although such arguments are not likely to succeed, they are as yet untested in this developing legal landscape. To try to avoid such a dispute with an insurer down the road, policyholders will want to review the kinds of losses covered by their D&O policies in light of the remedies that are demanded in the diversity lawsuits, including the costs of diversity training and hiring programs as well as disgorgement of salaries.

D&O policies often include exclusions for certain bad acts by the insured. Insurers may argue that diversity claims

implicate this exclusion because the executives knew or should have known that diversity statements in public filings or otherwise provided to investors were false or fraudulent. In order for the exclusion to apply, however, there typically must be a final adjudication adverse to the insured. Insureds should confirm that the policy terms include this exception, expressly 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. While there are other issues that that may prevent an insurer from successfully relying on this type of coverage defense, the best way to head off a dispute at the pass is to ensure the ''final adjudication'' requirement is clearly stated in the policy.

Side D coverage may be worth obtaining and, if you already have it, it is important to re-evaluate its limits. Side D protects costs associated with internal investigations as a response to a shareholder derivative claim. Generally, directors must exercise ''good faith'' in dealing with potential or actual violations of the law or corporate policy. A company facing a diversity lawsuit has to ensure that any limits are high enough to cover such investigations. The standard $250,000 ''dropdown'' found in many Side D policies may be woefully deficient if a company has to conduct months-long investigation to determine why there is, for example, a dearth of LGBTQ+ board members or Hispanic directors. Such an investigation may require significant review of prior employee records, including candidate information, spanning over an extended time-period. A recent diversity lawsuit against Monster Beverage, for instance, consists of more than mere allegations concerning the racial make-up of the board. It gets into the composition of the company's entire workforce, why it did not become more diverse during a period of growth, and even the South African ancestry of its CEO, Rodney Sacks, a white billionaire who grew up during the Apartheid. Policyholders should gauge whether an increase in limits may be appropriate, so as to be prepared for these lawsuits with the right kind of legal advice.

Companies are well advised to consider the benefits of having a diverse team of executives and board members. Studies continue to demonstrate a correlation between diverse management teams and higher financial returns. This process—however—is not something that can be completed overnight, and the current landscape has shown that shareholders are demanding change now. For those policyholders who are still in the process of adding diverse talent to their executive and management teams, review of existing D&O insurance policies is highly encouraged in light of these novel diversity lawsuits that appear to be on track to be a hot topic of litigation in 2021 and beyond.