CORPORATE BRIEFING

Due diligence and #MeToo: skeletons in the boardroom

With the momentum of the #MeToo movement from late 2017, the focus has spread not only to encompass individuals, but the companies to which these individuals belong or belonged and how those companies ignored, covered up or facilitated cases of harassment and misconduct by employees. Media reports soon broadened beyond the entertainment industry to include individuals and companies in a range of industries, from fashion and retail to technology and accounting.

Reports and complaints of harassment and misconduct are increasingly leading to the high-profile departures of senior management and founders of companies. Beyond the immediate financial impact this may have on a company in terms of costly severance packages paid to departing management, settlement payments to complainants and expensive litigation, these claims can also result in lost productivity, damage to reputation, an adverse effect on customer relations and steep declines in share prices (*see feature article "Sexual harassment in the workplace: a ticking time bomb", www.practicallaw.com/w-014-2736*). For example, when Ted Baker announced in December 2018 that it would investigate claims of inappropriate behaviour by its CEO and founder, the price of shares in Ted Baker fell by more than 13%. Reports of harassment and bullying, both internal (such as informal discussions among employees of incidents and experiences) and external (such as media reports), can also lead to issues in recruiting and maintaining talent. For example, there was a walkout at Google offices worldwide in November 2018 in response to the handling of senior departures following sexual misconduct allegations.

The market reaction to reports of harassment and misconduct has led to a re-evaluation of the materiality of these complaints from a due diligence perspective, both in the context of mergers and acquisitions (M&A) and securities offerings. Companies and lawyers therefore need to re-examine the due diligence process, its role in considering harassment and misconduct claims, and how the process in M&A and securities offerings should be tailored to ensure the complete disclosure of these claims. There are also potential consequences and liabilities for companies and individuals under laws such as the Equality Act 2010, which are outside the scope of this article.

Due diligence

The due diligence exercise involves a review of company documents, requests for information specific to the company's business and industry, and interviews with management, company personnel responsible for areas such as compliance, external parties such as the company's auditors and external counsel in relation to significant litigation, and also tailored requests specific to the company's business and industry. In the M&A context, a buyer will also use the representations and warranties in the purchase agreement as a tool to encourage disclosure. As any matters disclosed will limit the buyer's ability to claim for breach of warranties, this is a useful way to focus the seller's attention on issues that are material to the buyer. Representations and warranties in an underwriting agreement for a securities offering serve as a similar check for disclosure purposes.

Generally, the purpose of the due diligence exercise is to identify material issues in relation to a company. The nature of materiality will depend on the underlying transaction. In the M&A context, materiality refers to issues that could have a value or cost impact on the target business (and potentially affect the buyer's business) and therefore either need to be addressed upfront through an adjustment to the purchase price or through representations, warranties and indemnities that allocate risk between the buyer and seller, or alternatively, need to be remedied by the buyer after closing. Matters that would necessitate structuring the transaction in a particular way, for example, to carve out certain liabilities, would also be considered material in the M&A context.

In the context of a securities offering or in evaluating whether a company is required to disclose information under applicable EU and UK securities laws, the materiality analysis should focus on whether the information would have an impact on the price of, or an investment decision in relation to, the company's securities. For example, a company might be required to disclose "inside information" under the Market Abuse Regulation (*596/2014/EU*) (MAR) (*see box "Inside information"*). From the perspective of the US securities laws, information is "material" if there is a substantial likelihood that a reasonable person would consider the information important in making an investment decision.

Harassment and misconduct

In theory, claims of harassment and misconduct should be picked up by the due diligence process. This is on the assumption that these are material issues and good corporate governance would require material issues to be reported to management committees and the board, and discussed in board and committee minutes. The lawyers' review of board and committee materials, which is the starting point of any due diligence exercise in connection with a transaction, should therefore reveal these issues. For lawyers conducting due diligence in the #MeToo era, references to senior managers being subject to claims of harassment or reports of a culture promoting harassment should immediately raise red flags for further diligence checks.

In practice, however, the ability of lawyers conducting due diligence to identify potential issues relating to harassment and misconduct at a company will depend on how far these claims are escalated within the organisation, which in turn will depend on the subject of the claims, their importance to the organisation and whether there is a widespread cultural issue in the organisation. It is also dependent on the adequacy and effectiveness of the company's internal procedures and disclosure controls, and the importance the company puts on these claims from a corporate governance perspective.

Historically, claims and reports of harassment and misconduct have been buried internally and masked by confidentiality agreements in connection with departing employees, who have often been the complainants, not the alleged perpetrator of the misconduct.

However, the use of non-disclosure agreements (NDAs) in the settlement of harassment claims by companies has recently come under fire. In November 2018, the Women and Equalities Select Committee launched a public inquiry into the use of NDAs in the settlement of harassment and discrimination claims.

Requests for information

Requests for information as part of the due diligence process should be worded to require the disclosure of all issues and claims relating to harassment and misconduct, regardless of the quantum involved and whether the claim is pending or settled. This will help uncover historical issues that could be of concern. The disclosure of confidentiality agreements entered into with employees should also be requested because the number of agreements disclosed could indicate whether there is an endemic issue within the organisation.

The specific policies and framework adopted by the company to deal with harassment and misconduct should be requested, instead of simply relying on a generic request for the disclosure of internal employee complaints procedures or employment policies. In discussions with compliance personnel at the company, questions should include what procedures the company has in place for whistleblowing, complaints and any related internal investigations following these complaints, with a specific focus on the procedures for dealing with claims relating to harassment and misconduct.

Failure to disclose

From the perspective of the seller (in the M&A context), or offering participants (in the context of a securities offering), with the advent of the #MeToo era, claims against senior personnel or a corporate culture that promotes or ignores bad behaviour by employees are very likely to be material to a company. For example, in an M&A transaction, any failure to disclose these matters would likely result in a breach of various warranties, including potentially those relating to claims, litigation or employment matters.

If it can be established that the seller acted fraudulently in failing to disclose, the seller will not be able to rely on any limitations on liability. In addition, if the repetition of warranties is a condition to closing, breach of the warranties will give the buyer a right to walk away. Similarly, depending on when the issue comes to light and the impact it has on the target company, the buyer may be able to trigger a material adverse change (MAC) condition, if included in the purchase agreement, and potentially walk away from the transaction. While it is generally quite difficult to trigger a MAC clause successfully, the buyer's ability to rely on a MAC condition may, at the very least, force the seller to renegotiate the economics of the transaction to its disadvantage.

> ### Inside information
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> The definition of "inside information" under Article 7 of the Market Abuse Regulation (*596/2014/EU*) is "information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments."

In the context of a securities offering by a company, failure to disclose a material issue relating to harassment and misconduct in the prospectus may expose the company and offering participants to disclosure liability in connection with the offering, which in some jurisdictions can carry strict penalties. For example, in an offering of securities in the United States, including under the private placement exemption of Rule 144A under the US Securities Act of 1933, as amended (the Securities Act), offering participants are exposed to potential claims under the anti-fraud provisions of the US securities laws. In the case of an offering registered with the US Securities and Exchange Commission, a company has strict liability with respect to disclosure violations and investors may have a rescission right against the company for disclosure violations (*Sections 11 and 12(a)(2) of the Securities Act, Rule 10b-5 under the US Securities Exchange Act of 1934, as amended*). Given the litigious environment of the United States, offering participants tend to be more focused on potential liability exposure and, typically, the due diligence exercise is focused on supporting the offering participants' due diligence defence, with US lawyers on the transaction delivering 10b-5 disclosure letters to the underwriters.

For companies subject to requirements under MAR to disclose inside information, the failure to disclose an issue relating to harassment and misconduct that constitutes "inside information" may carry penalties ranging from censure, fines, suspension in trading or the listing of the company's securities (if necessary to ensure the smooth operation of the market or to protect investors). Accordingly, sellers and offering participants should consider carefully at the outset of a transaction whether there are any harassment and misconduct claims that should be disclosed.

Develop best practices

As the accounting scandals of the early 2000s led companies to focus on accounting controls and corporate governance, and to adopt internal processes to ensure that material issues were properly escalated within a company, so the #MeToo era has brought the spotlight of materiality onto corporate governance practices in the handling of claims of harassment and misconduct. Buyers and advisers should ensure that due diligence requests are specifically directed at unearthing harassment and misconduct issues. Boards and management should examine internal and disclosure control processes to ensure that issues in this area are properly reported. Private companies that are not subject to the same disclosure obligations as listed companies should nevertheless examine their own practices in this respect and benchmark against listed company requirements to develop best practices, particularly if a company has ambitions for a future listing or transformative M&A transaction.

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