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Tax, Financial and Social and Governance (ESG) Reporting Concerns of Sexual Harassment Non-disclosure Clauses

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Abstract

This research focuses on the tax, financial reporting, and sustainability consequences that companies face as a part of settling agreement non-disclosure clauses for workplace sexual harassment claims and cases. Given recent events such as the sexual harassment cases of former Governor Andrew Cuomo and those in the entertainment industry like Harvey Weinstein, managers, and decision-makers must be able to justify decisions to include such clauses in a settlement agreement, and then require an external review of the facts, circumstances, practices, and institutional policies which helped lead to such claim(s). The recent change in legislation and regulation has impacted how companies can work to eliminate and combat sexual harassment cases in the workplace. Using contextual analysis, we first examine the tax considerations of non-disclosure clauses, post-adoption of I.R.C. §162(q), and subsequently review emerging financial reporting consequences of sexual harassment, and finally, we review sexual harassment in relation to the growing SRI movement and its focus on the two specific ESG factors related to governance and social issues. Our research proposes practical guidelines, considerations, and reforms for companies to manage tax, financial, public relations, and environmental, social and governance (ESG) elements associated with efforts to "weed out" sexual harassment behaviors within organizations.

Keywords

ESG reporting, financial reporting, public relations, sexual harassment, non-disclosure clauses

Introduction

Sexual harassment claims are difficult to defend and expensive to settle with potential exposure running into the hundreds of millions of dollars (Antilla, 2016). Such claims also expose companies to considerable public relations consequences and can damage a company's reputation and brand for years to come

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(Does et al., 2018). Corporate America has long sought to keep sexual harassment claims out of the public eye through “hush money” payments subsidized by American taxpayers (Henning, 2017), which attempt to keep plaintiffs quiet and minimize disruptions. The use of mandatory and binding non-disclosure agreements (“NDA”) in case settlements has become a common practice.

Those defending against these claims are faced with a very difficult task. Management and counsel must minimize financial and public relations damages simultaneously. In damage control operations, corporations have traditionally sought to settle such claims at the lowest financial cost possible, while minimizing public relations damages with binding non-disclosure clauses. This “settle and conceal” strategy has yielded many harmful unintended consequences, harming both employees and investors alike.

Previously, the Internal Revenue Code permitted companies to deduct the costs of defending against and settling sexual harassment claims containing NDAs (Wegmann, 2017). In late 2017, Congress passed and adopted I.R.C. §162(q), also known as the “Weinstein Tax” (Wood, 2018b), eliminating the deductibility of defense-related expenses associated with non-disclosure clauses (Paul, 2017).

If used properly, NDAs can effectively serve the interests of companies, employees, and others. As confidentiality and discretion can be very important to an organization’s success, NDAs can serve important organizational purposes such as protecting business and trade secrets, intellectual property, client lists, and other proprietary information. NDAs can also contain potentially devastating public relations damages while protecting individual privacy interests.

NDA-derived confidentiality can have tremendous negative consequences as well. NDAs have been used to conceal criminal or otherwise wrongful behaviors, including ongoing and long-standing sexual harassment practices. Thus, the use of NDAs in sexual harassment cases can allow wrongful behaviors to persist long after they should have ceased. Burdge (2018) argues that confidentiality in this manner has negative repercussions for clients and attorneys alike, as well as the justice system in general.

In a post-Weinstein Tax world, it is imperative that corporations reassess internal policy approaches, risk-management strategies, corporate culture, and tax considerations associated with sexual harassment.

Tax law is not the only consideration for companies relative to sexual harassment. Due to the rise in prominence of socially responsible investing (SRI), companies must be aware that investors are increasingly concerned about more than just bottom-line results in financial statements, but also with a company’s performance in environmental, social and governance (ESG) matters. ESG is a category of non-financial factors that have been used in the literature to indicate non-required reporting (in addition to financial reporting) that many companies have begun preparing. The phrase (and acronym) Environmental, Social, and Governance (ESG) was first coined by the United Nations in a 2004 report entitled “Who Cares Wins” (United Nations [UN], 2004). In less than two decades, the ESG movement has grown into a global movement that has represented more than US$30 trillion in assets (Holder, 2019). ESG has never been more critical to companies as the “emphasis on ESG is increasingly growing as major institutional investors are making it clear they expect the companies they hold to commit strongly to ESG criteria” (Atkins, 2020, para. 3). These disclosures and reports are frequently in standalone sustainability reports or annual reports (CFA Institute, 2022). The present research is applied directly to social and governance issues related to NDAs.

Companies that perform poorly in these areas will see access to investor funds decline, and costs of capital increase. Finally, the regular and institutional practice of relying upon NDAs to contain public relations damages could also trigger an obligation to report such use as a material risk or legal proceedings under applicable sections of Regulation S–K. The present research focuses on social and governance issues as opposed to traditional environmental issues.

Literature Review

For many years, socially responsible investors and the public have urged policymakers and corporate executives to eradicate sexual harassment from the American workplace. In 2017, these calls inspired the implementation of I.R.C. §162(q) by the Tax Cuts and Jobs Act. Through I.R.C. §162(q), Congress eliminated certain deductions associated with defending sexual harassment claims including defense and settlement expenses in sexual harassment claims containing a mandatory and binding non-disclosure clause.

In December 2019, Harvey Weinstein reached an agreement with dozens of accusers for US$25 million (Twohey & Kantor, 2019). Stories of other high-profile alleged offenders such as Bill O'Reilly, Matt Lauer, Governor Andrew Cuomo, Kevin Spacey, Al Franken, Charlie Rose, John Conyers, Bill Cosby, C. K. Louis, and Glenn Thrush have peppered the news with frightening regularity, bringing the problem of sexual harassment to the forefront as a major problem in corporate America (Carlsen et al., 2018).

For years, many American corporations took a standard approach to resolving sexual harassment claims, settling claims as quickly and quietly as possible while containing long-term reputational damage through non-disclosure clauses. The "settle and contain" strategy may not only seem sensible, but it may be a fiduciary obligation to settle such claims with the intent of minimizing financial exposure and containing reputational harm.

Indeed, from a defendant's perspective, settlements may appear to be the only reasonable option under a given set of facts and circumstances, especially for frivolous claims. In the prequel to the Firth Circuit Cavanaugh case, the Tax Court posited:

> it is an unfortunate fact of business life that corporations and prominent individuals get sued, sometimes on dubious facts and theories of liability. Settling such suits may be distasteful, but even a small chance of an enormous payout may justify a deal that protects assets from the uncertainty of litigation and protects a business reputation from scandal (Cavanaugh v Comm'r., T.C. Memo. 2012-324 [U.S.T.C. November 26, 2012]).

While such approaches may operate to contain financial and reputational harm in the short term, over the long term they serve to do the opposite. The "settle and contain" approach has permitted toxic workplace cultures to linger and protected habitual offenders from being exposed to public view. Lawsuits, criminal proceedings, costly settlements, and legal fees may prove to be only the tip of the iceberg. Settling sexual harassment claims by concealing the facts from the public view may disincentivize companies from taking badly needed corrective action. Moreover, this strategy can allow such practices to persist. Kantor and Twohey (2017) note that at the Weinstein Company, a code of silence was enforced, with employee contracts containing language that leaders could not be criticized in a manner that would negatively impact the company's reputation, while payouts with associated confidentiality clauses prohibited speaking about terms of separation.

Persistent toxic environments can turn an isolated incident of sexual harassment into a systemic pattern of abuse to employees, stockholders, and a company's brand. Some believe that non-disclosure agreements serve to keep claims of harassment and abuse out of the public arena (McCullough, 2019; Office of Senate Floor Analyses, 2018).

Investors are also impacted by organizationally systemic sexual harassment practices and toxic workplace cultures. Organizations and their investors may never recover from claims of systemic sexual harassment and abuse. Damage mitigation, human resources implications, public relations costs, and lost revenue streams may persist indefinitely. Such patterns of systemic abuse can threaten a company's survival and deeply damage a company's stock price and market capitalization (Prasad, 2018). Prasad asserts that promising to suppress one's speech implicates public policy and undermines the public's interest in being made aware of repeat offenders.

Accountants and their clients need to understand the role that NDAs play in perpetuating sexual harassment and protecting habitual offenders. By concealing such items from public view, non-disclosure clauses help entrench toxic workplace cultures and extend abusive practices. It is imperative that companies conduct a thorough review of corporate policies and approaches to defending and resolving sexual harassment claims, and make changes designed to ensure a safe workplace for all.

Analysis

Sexual harassment NDAs impact organizations on multiple levels. Our findings first examine the tax considerations of non-disclosure clauses, post-adoption of I.R.C. §162(q). The next section reviews emerging financial reporting consequences of sexual harassment, and the final element of findings focuses on sexual harassment in relation to the growing SRI movement and its focus on ESG factors.

Tax Considerations of Sexual Harassment Non-disclosure Clauses

When companies or professionals endure reputational harm, the direct and indirect costs can be staggering. The tax consequences of preventing reputational harm, enduring reputational harm, and remediating such harm, are deserving of examination.

The Weinstein Tax

Recent changes in the Internal Revenue Code have altered the landscape for the deductibility of monies expended settling and defending against sexual harassment claims if settlements include non-disclosure agreements. The Weinstein Tax represents Congress' attempt to increase corporate transparency in sexual harassment matters by curtailing the use of binding non-disclosure agreements. In 2017, Congress adopted Code Section 162(q) which prohibits deductions for settlements or payments related to sexual harassment or sexual abuse if the settlement is subject to an NDA, as well as associated attorney's fees (I.R.C. §162 (q)).

Following the passage of the Weinstein tax, deducting the costs of litigation and settlement of sexual harassment/abuse claims will no longer be deductible. However, the requirements of I.R.C. §162(q) are only the first test a taxpayer must pass in obtaining deductibility of expenses related to sexual harassment claims. Even if no NDA is utilized, settlement costs or attorney's fees may not necessarily be deductible.

"Origin of the Claim Rule" and the "Furtherance Rule"

While I.R.C. §162 generally "permits an individual or corporate taxpayer to deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business," the deductibility of reputational and character defense-related expenses to sexual harassment or abuse requires a closer examination. Assuming a sexual harassment claim does not include an NDA (barred by the Weinstein Tax deductibility disqualification) taxpayers must demonstrate that the activities from which sexual harassment claims derive were engaged in and were directed for profit-seeking reasons (Estate of Meade v Commissioner of Internal Revenue, 1974).

Reputational harm of any nature can initiate major reputational harm and the expenses which go along with it. However, many of the behaviors which may impair an organization's reputation derives from activities outside of the normal scope of an organization's business or profit-seeking activities. In such situations, a question arises as to whether defense or settlement costs are deductible.

For example, a key executive could engage in professionally harmful or embarrassing behavior on personal time resulting in liability. Such behavior may cause expenses and losses to the business, even if the behavior was unrelated to the business. In similar situations, courts have held that the question of deductibility of defense or settlement-related expenses turns on whether the origin and character of the claim arising from the taxpayer's profit-seeking behavior and *not* on whether the reputational harm inflicts expenses/business losses (United States v Gilmore, 1963).

Several cases after Gilmore confronted the question of deductibility in countless factual scenarios, with courts deciding cases on both sides of the deductibility question (McMillan v. Commissioner, 2019). In the McMillan case, the IRS had challenged several deductions that were claimed for a business. Specific to the present research, one of the deductions that were challenged by the IRS was related to the deductibility of lawsuits. Recently, the Fifth Circuit confronted a case where a corporation charged with being civilly responsible for the death of another sought to deduct associated litigation and settlement expenses. The CEO and sole shareholder were alleged to have been partly responsible for the death of his girlfriend, an employee, from a drug overdose. The corporation and chief executive, in his individual capacity, reached a settlement agreement of the underlying wrongful death claim for US$2.3 million. The company reimbursed the chief executive for his contribution towards the settlement and sought to deduct these costs as business expenses on its tax return. The Fifth Circuit reasserted the longstanding rule that an examination of all relevant facts be conducted to decide the "kind of transaction" in which litigation was initiated (Cavanaugh v Commissioner, 2019).

In determining the deductibility of expenses, it is critically important to closely examine "each activity to ascertain whether its objective was to make a profit" (Synanon Church v Commissioner of Internal Revenue, 1989). Additionally, "even when the underlying suit includes allegations of employees acting within the course and scope of their employment, the court must determine whether their activities arose from or were connected to the corporation's profit-seeking activity" (Cavanaugh v Commissioner, 2019). Accordingly, in sexual harassment cases, courts will determine whether the activities were connected to a profit-seeking activity. Even criminal defense expenses could qualify for deductibility if the crime charged is directly connected to a taxpayer's business activities (Commissioner v Tellier, 1966).

When examining a claim for deductibility, employees acting within the scope of their duties may not be sufficient. The precise nature of the activities of behavior engaged must be "in furtherance" of the corporation's profit-seeking endeavors (Cavanaugh v Commissioner, 2019). In *Synanon*, the Tax Court disallowed litigation expense deductions on the grounds that the activities in question were not "profit-seeking" and failed to derive "from, or [be] proximately related to, any specific business activity" (Synanon Church v Commissioner of Internal Revenue, 1989). This is particularly important in that the expenses were disallowed for tortious acts committed within the scope of employment. The key to making the inquiry of deductibility "does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts" (Boagni v Commissioner of Internal Revenue, 1973).

Accordingly, claims like asserted sexual harassment-based behavior must be examined according to the Gilmore tree of precedent and the "origins of the claims rule." This analysis requires (a) a factually intense examination of the precise behavior or set of behaviors or activities that led to the claim, and (b) whether this claim was proximately related to the legitimate profit-seeking activities of the business. This is particularly important in sexual harassment or sexual abuse cases that may have questions as to whether activities engaged in are in furtherance of a business's profit-seeking motives, especially for activities outside of the workplace (Dolese v United States, 1979).

Personal/Individual Deductibility

Though the issue of harm is generally viewed from a business perspective, individual taxpayers also confront deductibility questions concerning costs associated with reputational harm. In such situations, if a taxpayer first meets the deductibility bottlenecks of the Weinstein Tax and the "origins of the claim" rule, he or she may seek to deduct reputation-related expenses.

Where claims arise from business or employment activities, the deductibility of expenses may turn on a taxpayer's business role. I.R.C. §162, "permits an individual or corporate taxpayer to deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business" (Estate of Meade v Commissioner of Internal Revenue, 1974). Courts have allowed deductions based on the individual's business in the employment relationship. Other courts have refused to restrict the types of individual conduct for which legal expenses are deductible to civil or criminal actions, focusing only on whether the conduct causing the claim had a business origin.

While such expenses of corporate officers and other employees may be allowable only as unreimbursed employee business expenses, those of proprietors and partners could potentially be fully deductible under §162. Employees may only rely upon the miscellaneous itemized deduction provisions of 26 U.S.C. §67(a), and 26 CFR § 1.67-1T.26 CFR 1.67-1T. Prior to the 2018 tax year, these provisions allowed miscellaneous itemized deductions which exceeded 2% of adjusted gross income for unreimbursed employee expenses.

Following the changes imposed by the terms of The Tax Cuts and Jobs Act of 2017, such deductions are no longer allowed, and shall not be permissible until the law sunsets in 2026 (26 U.S.C. §67(g)). The implication for employee-taxpayers seeking to deduct expenses associated with reputational harm is that they are currently afforded no tax relief until 2026, and then would be subject to the 2% floor on itemized deductions under 26 U.S.C. §67. In such instances, companies may seek to reimburse employees for such costs, but the deductibility of such reimbursement will turn on meeting the requirements of the "origins rule" and the Weinstein tax.

Deductibility of Punitive Expenditures

Corporations may also be prohibited from deducting any portion of a punitive organizational payment to the government. In a sexual harassment context, this could arise in a situation where the EEOC levies a fine against a company for wrongful acts or practices (Dickey, 2019). Under I.R.C. §162(f)(1), payments made related to government fines are not deductible. Accordingly, companies which run afoul of government agencies, like the Equal Employment Opportunity Commission ("EEOC"), and incur a punitive fine, will not generally be able to deduct such costs.

I.R.C. §162(f)(2) contains an exception that permits a deduction for amounts paid for either restitution or to come into compliance with the law. Because income tax deductions "are matters of legislative grace [,] the taxpayer bears the burden of proving entitlement to any deduction or credit claimed" (MedChem, Inc v Commissioner, 1992). To meet the exception and obtain deductibility for either restitution or compliance expenditures, a taxpayer must first meet (a) the establishment test (§162(f)(2)(i)) and (b) the identification test (§162(f)(2)(ii)).

Taxpayers engaged in government settlement negotiations must be sure to document itemized fines and/or fees. I.R.C. §6050X requires an appropriate government official to provide an itemized settlement agreement, which is reported to the IRS and other relevant parties. Ensuring government compliance with §6050X is important as under §162(f) and proposed regulations a settlement agreement or court order that fails to meet the identification requirement will preclude a taxpayer from taking applicable deductions.

Problems and Potential Unintended Consequences of the "Weinstein Tax"

The Weinstein Tax represents an attempt to combat sexual harassment and penalize companies that utilize non-disclosure agreements to conceal inappropriate behavior. However, §162(q) carries potential unintended consequences that may infringe upon the rights of sexual harassment victims.

Lack of Working Definitions of Operable Terms and Other Ambiguities

The Weinstein Tax provides no working definition of applicable and relevant terms such as "sexual harassment," "sexual abuse," or "non-disclosure agreement." This could result in confusion for those drafting settlement agreements (Rader, 2019), resulting in insufficient settlement agreements and eventual liability. The Weinstein Tax also does not provide guidance on how general releases might be handled. These and other issues may need clarification via litigation and practitioner interaction with the IRS.

Fear of Plaintiff's Loss of Deduction for Attorney's Fees

The language of §162(q) suggests that the legal expenses of both defendants and plaintiffs will be non-deductible. The text of the statute does not restrict the deductibility limitation to defendants, but forces plaintiffs to refrain from deducting legal expenses would run counter to the spirit and intent of the law and has caused significant uncertainty in the tax community (Bair, 2018; Wood, 2018a).

At the time of the adoption of §162(q) it was unclear whether the deduction limitation also applied to the plaintiff's payments or attorney's fees related to a non-disclosure bound settlement agreement (Wood, 2018b). To resolve this open question, the IRS provided that: *recipients of settlements or payments related to sexual harassment or sexual abuse, whose settlement or payment is subject to a nondisclosure agreement, are not precluded by section 162(q) from deducting attorney's fees related to the settlement or payment, if otherwise deductible* (Internal Revenue Service, 2019). Without this clarification, §162(q) appears to require the counterintuitive result that plaintiffs include the full amount of their recovery as taxable income.

Some Victims Truly Desire Confidentiality and Desire NDAs

An unintended consequence of §162(q) is that plaintiffs truly desiring non-disclosure clauses may be impeded by post-Weinstein Tax organizational policies barring NDAs in sexual harassment claims. Plaintiffs might be discouraged from bringing forth claims for fear of having sensitive facts exposed. As §162(q) bars deductibility for settlements or payments "subject to a nondisclosure agreement," this appears to apply to plaintiffs and defendants. Additionally, plaintiffs desiring a non-disclosure clause could be negatively compromised in settlement bargaining leverage, as the cost of settlement for NDA-bound agreements will be higher for defendants.

Corporate Transparency Benefits Remain to be Determined

The financial costs associated with the inability to deduct expenses from settlement agreements containing non-disclosure clauses must be weighed for each circumstance against potential reputation harm imposed by both long-term and short-term claims. Although §162(q) makes it more expensive to settle NDA-bound sexual harassment cases, companies may decide that the additional cost is worthwhile in certain situations.

Financial Reporting Considerations: Reportable Legal Proceedings and Business Risks Under Regulation S–K, Items 103 & 105

When it comes to the reporting of sexual harassment matters, confidentiality comes at the expense of transparency. Confidentiality can obscure material business risks (Item 105) from the public view as well as ongoing litigation (Item 103), either of which may influence an investor's actions.

Companies which fail to disclose items of material risk are not immune to litigation concerning failure to disclose material information. Management could be held responsible for a breach of fiduciary duty obligations owed to shareholders. Item 105 of regulation S–K requires companies registered with the SEC to include a risk factor disclosure setting forth circumstances or situations that could make an investment speculative (17 CFR § 229.105). Employers may be held liable for workplace sexual harassment, particularly if the alleged violator is considered senior management. In such situations, corporations may face substantial monetary judgments or settlements; damages may include emotional distress, lost wages, attorneys' fees, and/or punitive awards.

Materiality must be considered, but recent settlement amounts reveal that institutional practices protecting habitual offenders come at a cost that would be material to even the biggest of American companies. For executives, there could be additional concerns, including the fiduciary duty to stockholders, and the duty to report material business risks and legal proceedings.

For many years, companies have suffered through major judgments and settlements in resolving sexual harassment cases. For example, in 1996, Smith Barney was sued by 23 women for sexual harassment and pay discrimination in a ground-breaking class-action lawsuit. In what came to be known as the "boom-boom room" suit (named after a basement party room at Smith Barney in Garden City, NJ), over 2,000 women joined in a class action lawsuit. The case was settled for US$150 million in settlements and arbitration (Iacurci, 2019). Subsequently, in 2008, Smith Barney again settled similar claims totaling US$33 million (Reuters, 2008).

Sexual harassment and other ESG matters can cost companies significantly (McGrath, 2019). Sexual harassment claims can also deeply impair equity values (LaMagna, 2018). In the wake of sexual harassment allegations against Steve Wynn, shares of Wynn Resorts fell by 20%. Investors have a major stake in a company's policies and practices regarding sexual harassment. From a financial reporting and disclosure standpoint, companies with knowledge of outstanding potential exposure (especially if it is not yet public), that is material to a company in an accounting context, may be legally *required* to report such legal matters or business risks.

Regulation S–K requires that companies report material legal proceedings (C.F.R. 229.103). Instructions for Item 103, however, provide further guidance on reporting obligations that limit the required disclosures. Disclosures must be made only for proceedings that involve claims for damages greater than 10% of the total consolidated current assets of a registrant and its subsidiaries, subject to aggregation of the number of claims for all related proceedings if they are based on the same legal and factual issues. American reporting law generally requires companies to make disclosures when either (a) an affirmative direct duty to disclose exists by rules or regulation, or (b) if the failure to so disclose would render, by the omission of material facts, other corporate disclosures materially misleading (17 C.F.R.240.10b-5(b)).

Mandatory reporting of legal proceedings is triggered once a claim for damages could reasonably be expected to reach 10% of consolidated current assets. While a duty to report arises once the 10% threshold is reached, some have concluded this is an uncommon occurrence (Hemel & Lund, 2018).

An independent review of each company's exposure should consider the nature of the claims, the identity and position of the alleged offender(s), the presence or absence of a historic pattern of behavior, and/or whether similar claims have been litigated or settled in the past. A corporation could then decide whether an affirmative obligation to report exists under Item 103, or whether it should make a voluntary disclosure. In today's environment, it may make sense to err on the side of disclosure and organizational transparency (Vanderzeil & Currier, 2018).

Although mandatory reporting is triggered at 10% of consolidated current assets, no disclosure is required to be made of legal proceedings that do not reach this threshold. Hemel and Lund (2016) conclude that most sexual harassment claims will not meet the threshold of mandatory reporting under Item 103. Companies required to prepare annual reports may wish to report such claims in certain defined circumstances (17 C.F.R. §229.303). However, there are two opposing views about the extent and timing of similar legal disclosures on Form 8-K (material events): some argue that early reporting can create an unnecessary precedent for disclosing at low thresholds (Maurer, 2019). Consequently, interested investors must often resort to other sources of information that are available, likely to more sophisticated investors, creating an uneven playing among financial market participants concerned with these matters.

ESG (Environmental, Social and Governance) Implications of Non-disclosure Clauses

Increasingly, corporate executives must be aware of socially responsible investor concerns and seek to align corporate initiatives with investor expectations. The growing interest in corporate ESG performance is expanding as research demonstrates that financial metrics alone simply no longer suffice (Reinicke, 2019). Items such as intangible assets, brand value, and corporate culture cannot be evaluated through traditional measures. When it comes to evaluating a business beyond the financial statements, ESG analysis may be particularly useful.

A company's workplace culture can have a tremendous impact on firm value; corporate cultures which permit ongoing sexual harassment present a tremendous downside risk to investors (Flood, 2019). Kim et al. (2017) assert that companies that tolerate or cover up sexual harassment could face issues in attracting, retaining, and motivating talented workers, as well as customer defections, ruined business deals, and lost revenues/profits. The existence of workplace harassment and its tolerance as evidenced by textual analysis of online job reviews is associated with a 7.5%–13.8% reduction in firm value (Au et al., 2020).

Consequently, SRI has been growing at an exponential rate for several decades, as SRI is seen by many to be a "green mega trend," not likely to soon subside (Smith, 2020). Collins and Sullivan (2020) noted that the percentage of retail and institutional investors that apply ESG principles to at least a quarter of their portfolios increased from 48% in 2017 to 75% in 2019. Moreover, sustainable funds, which invest based on environmental, social or governance themes, attracted US$20.6 billion in new money in 2019 (Iacurci, 2020). By 2025, some believe that ESG assets under management will equal 50% of the total (Deloitte Center for Financial Services, 2018).

Approximately 85% of investors recently declared an interest in sustainable investing, increasing from 71% in 2015 (Morgan Stanley Institute for Sustainable Investing, 2019). Consumer demand for such investments is outpacing supply, with investors prepared to pay a premium to companies strong in charitable and ESG metrics while valuing companies with a negative social impact lower than similarly situated socially neutral companies.

Due to the sheer size and scope of ESG assets under management, companies and stocks that run afoul of ESG fund managers and socially responsible investors do so at very heavy risk. As socially responsible investors desire non-financial information, companies that do not meet ESG fund manager expectations run the risk of being disregarded from consideration for new ESG fund purchases and possible divestment from existing funds. Exclusion from ESG funds and portfolios could very well drive down both demand for a stock and the price at which it sells and trades.

Sexual Harassment and The "S" in ESG-The Social Factor

SRIs are increasingly interested in directing and influencing corporate behavior in social and governance matters. ESG and reporting are becoming more prevalent at a time when investors have become aware of the importance such information plays in guiding investment decisions. Strong governance, and effective management of environmental, human capital factors, and social matters do not merely depict a company's ESG performance, but they also directly increase the likelihood that companies will perform well financially over the long term while managing risk effectively (Friede et al., 2015). Historically, SRI has focused on the three traditional perspectives: "ESG." In the SRI world, environmental concerns have played a dominant role in the ESG trilogy (Beerens, 2018).

While there have been few social matters more pressing for corporate America than sexual harassment in recent memory, this has not yet manifested in the large-scale development of "S"-based SRI funds. As wave after wave of publicly disturbing corporate sexual harassment cases has come forward, however, things have begun to change. The white-hot spotlight on the #MeToo movement (with more than 77 million Facebook posts or comments and 2.3 million tweets in the first few weeks) took corporate America and the investing public by storm (Prasad, 2018). This, in turn, helped stir a burgeoning interest in sexual harassment as an important focus of corporate behavior.

Non-disclosure Clauses Help Shore-up and Reinforce Toxic Workplace Cultures

Companies which have a history of tolerating sexual harassment may be more likely to have poor records on other important measures of workplace culture. In fact, it has been argued that "Secrecy is an ally of sexual violence" (Prasad, 2018). For example, Harvey Weinstein was known to heavily rely upon secrecy in the workplace, buttressed by heavy use of non-disclosure clauses in settlement agreements. Mr. Weinstein was able to maintain his pattern of abuse for almost 30 years. During his years of abuse, he reached settlements containing non-disclosure clauses with at least eight different women (Kantor & Twohey, 2017). One can speculate if the spotlight of public attention and accountability had been focused on his behavior earlier, the abuse may have stopped.

Companies that heavily rely upon non-disclosure clauses to conceal sexual harassment claims may pose a higher risk than similarly situated companies that do not rely upon them. Research finds that other types of personal managerial indiscretions which become public, even those unrelated to business activities, are associated with their firms showing overall poorer operating results and a higher likelihood of litigation in unrelated areas (Cline et al., 2018). In turn, such companies may lag industry leaders on issues such as gender balance in corporate leadership, fair/equal pay metrics, flexible work and family leave options, and others. Workplace cultures that accept, tolerate, or conceal sexual harassment and serial offenders could end up being harmed in a myriad of ways, from losing access to the best and brightest employees to suffering catastrophic financial losses in litigation (Kim et al., 2017).

These issues could create staggering future liabilities but may also provide a lens through which investors can determine that a company is poorly run relative to competitors. Non-disclosure clauses run the risk of maintaining and reinforcing toxic and harmful workplace cultures (Akins, 2020). Market forces, investor movements, and the public policy momentum are driving forward a sea change in corporate reporting practices and behaviors relating to sexual harassment.

Discussion

In sexual harassment cases, the decision to utilize a non-disclosure agreement should now be considered extraordinary and should require approval of multiple levels of the organization, including the General Counsel, the CEO, and perhaps the Audit Committee of the Board of Directors. Further, decision-makers must be able to justify every decision to include such a clause in a settlement agreement, and then require an external review of the facts, circumstances, practices, and institutional policies which helped lead to such claim(s) initially. Each time a decision to incorporate a non-disclosure agreement is made, it should trigger an internal review to identify and eliminate harmful institutional practices.

There very well may be cases whereupon non-disclosure clauses in settlement agreements may be necessary and appropriate. In all such cases, the tax considerations of including a non-disclosure clause should be examined closely by decision-makers.

Sexual Harassment NDAs Warrant Heightened Scrutiny

Due to the heightened danger related to sexual harassment cases, and the unfortunate ability of properly drafted NDAs to conceal wrongdoing and potentially permit such behaviors to continue, each proposed NDA in a sexual harassment case should receive heightened scrutiny. Organizations should consider drafting special by-law provisions which require each sexual harassment NDA to be deeply examined, both for the facts of the instant case, and for what the allegations could mean for the branch, division, segment, other subdivision, or an entire organization.

Independent Review of Sexual Harassment Settlements Containing NDAs

To protect themselves, offenders frequently hide their offensive and/or criminal behavior from public view. This makes an investigation into the situation very important to uncover any violations. In order to ensure the situation is handled objectively, an independent review process should be enacted with each level of the company hierarchy understanding their role and involvement.

Executive

Corporate executives, seeking to minimize reputational damage and/or revelations regarding management's failure to provide proper oversight of offenders, may have a vested survival interest in seeking to conceal or screen instances or patterns of sexual harassment. Thus, executive-level management should be removed from the final and exclusive authority to resolve sexual harassment claims.

Prior to approval from any NDA in a sexual harassment case, the executive general counsel should be required to receive an independent opinion that the NDA in question is not concealing a systematic pattern of abuse, or a habitual offender from public disclosure. If an independent review decides that the harassment is part of a larger systemic pattern of abuse, the general counsel should be required to not only refrain from including an NDA but should be required to notify the Audit Committee of the Board of Directors and the CEO.

Middle Management

Middle management should play an active role in an independent review. Operational controls over these requirements should be part of an effective internal control system within the human resources administration function. Internal controls over financial reporting should be connected to (a) ensure proper financial reporting of book/tax differences that arise due to non-deductibility of costs associated with agreements containing non-disclosure clauses and (b) ensure liability and disclosure issues are given due consideration.

Review Committee

An independent committee should be created to review cases of sexual harassment. The review committee will be within the human resources purview and report results to the Audit Committee of the Board of Directors and the CEO. The committee should maintain objectivity and independence by maintaining confidentiality to prevent retaliatory action against employees.

Taking such steps may at first appear to expose a corporation to heightened liability, and negative public relations consequences. However, such actions will, over the long run, help establish a culture of transparency that is critical to minimizing organizational risk and exposure.

Mandatory Sexual Harassment Review/Audit

Following any allegation and/or any settlement of sexual harassment allegations, each department, operating unit, segment, or other subdivision of an organization involved in a sexual harassment claim should undergo an independent third-party sexual harassment audit. This audit should examine not only the specific incident/claim but also the workplace culture as well.

Bar Individuals Implicated in Sexual Harassment Charges/Allegations from Settlement Negotiations

Those implicated in sexual harassment charges or allegations should be removed from any authority to engage in or contribute to settlement discussions. In closely held companies, or in charges involving a primary shareholder, this may be difficult to accomplish. Nonetheless, the heavy influence of an offender over settlement discussions could fail to properly separate the personal interests of the offender from the corporate interests of uncovering the truth, and if necessary, making appropriate institutional and human resources changes. In these situations, corporations should appoint outside counsel.

Abandon NDAs in Sexual Harassment and Abuse Cases

Another bold step forward towards transparency that corporations can take is to release previous signatories to settlement agreements in sexual harassment claims from their NDAs. Corporate transparency is of paramount value. Transparency improves investor confidence by reducing downside investment risk. Several companies have taken a leadership role in no longer requiring NDAs in sexual harassment cases. For example, in late 2017, Microsoft took the step of waiving mandatory arbitration agreements in employee contracts for sexual harassment claims (Smith, 2017). NBC has also released its former employees from existing NDAs (Campbell, 2019).

Releasing previous NDA signatories will send a message to the market that a company does not tolerate sexual harassment and values transparency. Permitting past victims to speak out provides perceived corporate transparency, which improves investor confidence.

Bar Mandatory Arbitration of Sexual Harassment Claims

Claimants frequently use litigation to bring forth allegations and to seek justice. Many companies restrict the rights of employees to air claims in the courts by requiring mandatory arbitration clauses as a term of employment. Currently, Federal law provides strong protections for corporate mandatory arbitration clauses. The United States Supreme Court has held that the Federal Arbitration Act requires the enforcement of corporate mandatory arbitration clauses (Gilmer v Interstate/Johnson Lane Corp. [1991] 500 U.S. 20; Circuit City Stores, Inc. v. Adams [2001] 532 U.S. 105; AT&T Mobility LLC v. Concepcion [2011] 563 U.S. 333; Kindred Nursing Centers Ltd. Partnership v. Clark [2017] 137 S. Ct. 1421; Epic Systems Corp. v. Lewis [2018] 138 S. Ct. 1612). This applies to employee-related claims, including sexual harassment and sexual abuse claims (McCullough, 2019).

Accordingly, corporations have the full authority under Federal law to require mandatory arbitration of sexual harassment and sexual abuse cases. Unfortunately, mandatory arbitration of sexual harassment and abuse claims can impair organizational transparency and perpetuate sexual harassment and other wrongdoing (McCullough, 2019).

While organizations are free to waive organizational mandatory arbitration clauses, to do so could greatly increase the costs of litigation and risk exposure. Organizations should conduct an analysis of mandatory organizational arbitration clauses and strongly consider exempting sexual harassment and sexual abuse cases therefrom. Such actions could produce a solid return in improved organizational transparency, greater management accountability, and could potentially reduce organizational downside risk.

Assess and Make Any Necessary Changes to the System of Internal Control

Finally, organizations undergoing a sexual harassment review should engage in an independent review of the system of controls in managing organizational sexual harassment and abuse. This should include a review of all training programs as well as processes for reporting and evaluating complaints regarding workplace culture (including sexual harassment). It should also include a strong review of protections for whistleblowers and complainants.

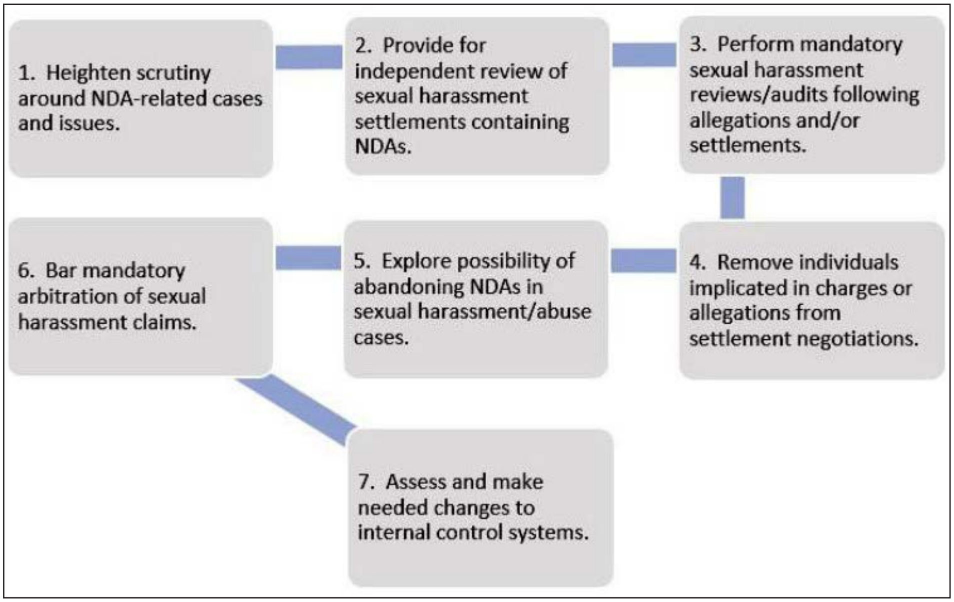

Figure 1. NDA Guidance Related to Sexual Harassment and Abuse Cases.

Conclusion

While in the past companies would settle and conceal sexual harassment claims, in today's world, such claims should be viewed as an alarm to conduct further investigation into an organization's culture, climate, and workplace practices. The use of an NDA in sexual harassment cases should be considered an extraordinary measure and should require the approval of multiple levels of the organization, including the General Counsel, the CEO, and the Audit Committee of the Board of Directors.

Companies confronting sexual harassment claim not only to face financial and public relations concerns, but tax, financial reporting, and ESG considerations as well. In sexual harassment-related claims, costs of non-disclosure bound settlement agreements are no longer deductible because of the "Weinstein Tax" (Internal Revenue Code (IRC §162).

As a result, the cost of settling sexual harassment settlements containing non-disclosure clauses has increased. Even without a non-disclosure clause, companies must also pass the origins of the claim/in furtherance test to secure the deductibility of sexual harassment-related expenses. Corporations must also take note of the rise in SRI. SRIs are increasingly relying upon non-financial statement performance measures to evaluate companies. As a result, companies that obscure and conceal harmful workplace culture will face increasing challenges attracting investors than do similarly situated competitors. We propose a seven-step model to help guide corporations and firms in dealing with sexual harassment and NDA-related issues, as provided in Figure 1, above.

Decision makers must not only be able to justify the decision to utilize an NDA but must also see such a decision as a mandate to initialize an independent and external review of the facts, practices, and institutional policies which helped lead to such a claim. Each time a decision to incorporate a non-disclosure agreement is made, it should initiate internal reviews geared toward the identification and elimination of harmful practices.

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