Pinterest Discrimination Case Highlights Risk Of ESG Pledges

By **Denise Williamee and Nir Kossovsky** (December 10, 2020)

Denise Williamee

Nir Kossovsky

A shareholder derivative lawsuit filed Nov. 30 naming the board of directors and top executives of Pinterest Inc., is part of a trend that is unique to this era of social justice pledges — where the actions and statements of companies themselves is placing individual corporate leaders at risk.

This litigation, filed by the Employees' Retirement System of Rhode Island in the U.S. District Court for the Northern District of California, claims the board and top executives of Pinterest failed to protect women and people of color from discrimination.

It alleges that: "As a result of Defendants' illegal misconduct, the Company's financial position and its goodwill and reputation among its largely female user base (upon which Pinterest's success depends upon) were harmed and continue to be harmed."

It follows public allegations by two employees who said they were at least partly motivated to come forward by a desire to expose the company's practices in the wake of its statements in support of the Black Lives Matter movement — statements these employees considered hypocritical.

Pinterest has responded that it has initiated an "ongoing independent review regarding our culture, policies, and practices," with a goal of "building a diverse, equitable and inclusive environment for everyone." But is that enough?

Companies making aspirational pledges around diversity and other societal priorities could be putting themselves and their leadership at risk.

The Business Roundtable pledge to elevate stakeholders like employees, communities and the environment to equal stature with shareholders, and expansive environmental, social and governance commitments in pursuit of higher ratings and inclusion in ESG investment funds, are all raising expectations of social consciousness.

If enterprisewide systems and governance are not adequately aligned, at some point there is bound to be a reputational crisis in which expectations and reality clash. And when corporate finances or operations are affected, the board and executives are going to get sued — just as they have been at Pinterest.

So what should counsel's role be? In today's world, a pandemic, social media activism, ethnic and racial justice movements, diversity demands, a bitterly divided body politic, and pledges to foster environmental sustainability, social justice and woke governance are extra-legal matters that increasingly fall under general counsel's purview, because they complicate the legal management of traditional legal and regulatory matters. These extra-legal matters fall under the umbrella of reputation risk.

Reputational damage occurs when companies fail to meet the expectations of their stakeholders, whose disappointment and anger manifests in material ways: impaired cash flows, increased cost of capital and diminished stock price. Also damaging is the dogpiling of

litigators paired with the hammering of regulators, who are not even waiting for a headline-making crisis.

Any company that makes aspirational public statements without the operational, cultural and governance structure in place to back them up is raising expectations in much the same way as Pinterest raised them with its public comments on Black Lives Matter — and it is setting itself up to disappoint stakeholders and put its leadership in legal jeopardy.

U.S. Securities and Exchange Commission Regulation S-K calls for more human capital disclosures. The Delaware Chancery Court's 1996 decision in In re: Caremark International Derivative Litigation post-Marchand has made oversight of mission-critical corporate operations a test of the duty of loyalty, and In Re: Signet has made ESG-like pronouncements — historically immaterial puffery — potentially material in the securities arena.

Marchand is the battering ram plaintiffs are using to breach Caremark pleading defenses. For example, directors' duty of loyalty were successfully questioned in alleged failures of:

- Innovation in In re: Clovis Oncology Inc., a Delaware Chancery Court case over the board's failure to protect the firm's reputation for pharmacologic innovation;
- Safety in Marchand v. Barnhill, a Delaware Supreme Court case over the board's failure to protect the company's reputation for food safety; and
- Environmental sustainability in the Delaware Chancery Court's decision in Inter-Marketing Group USA Inc. v. Armstrong, over the board's failure to protect the firm's reputation for oil pipeline-related environmental protection.

That means that with respect to diversity, the environment or any other social issue that comes along, boards can no longer automatically consider themselves protected by the puffery defense. These are not being taken as mere marketing statements; investors are relying on them.

And now, shareholder plaintiffs are seeking to hold directors accountable for reputational damage. The Pinterest litigation is merely the most recent on a long list, with 39 federal securities lawsuits filed in the year ending June 2020 citing reputational damage. This is nearly a 60% increase from the previous year, according to a published analysis, and is the third consecutive year of this growing trend.

Of all the promises a company can make, ESG pledges are especially precarious. Investors treat them as material, with a recent Bank of America Corp. survey showing that four of five younger investors take ESG into account when making investment decisions. And yet, there is no universally accepted set of metrics for ESG performance, so when lofty promises are not met, there is no clear standard of defense.

General counsel, along with their outside legal advisers, need to become integrally involved in the reputational risk management process, conducting, under the umbrella of privilege, a meticulous and honest assessment of every aspect of companies' operations and filings to identify potential risks and/or exposures — the gaps between the expectations of stakeholders and what the company can deliver. This assessment differs from a compliance review which begins with the question: What does the law expect?

Counsel understands the potential consequences of missing legal expectations, but they also need to ensure the company is properly gauging and delivering upon the expectations of its stakeholders: customers, employees, vendors, creditors, investors, ESG raters, bond-raters, proxy advisers and the social license holders of society at large.

The role of counsel will likely resemble that of central intelligence, cutting across silos and gathering information on the capabilities of every department to deliver on the expectations they have set with their constituencies.

The action plan emerging from the assessment has two strategic aims. The first, operational, directly mitigates reputation risk by targeting the gaps between expectations and the reality of capabilities. The options are to raise capabilities to meet expectations, manage expectations to meet capabilities, or accept the reality of a gap and finance the potential losses from a reputational crisis with insurances, including insurance captives. Authentic, preemptive reputation risk management is far superior to relying on crisis communication efforts alone when heads begin to roll.

The second is preemptive communications. Authentic reputation risk management gives marketers and investment relations professionals the best possible authentic story to tell about strong corporate governance. It provides confidence to ESG and bond raters, equity investors, regulators and other stakeholders. It also protects the personal reputations of individual board members and provides leverage in negotiating director's and officer's liability coverage in this ever-hardening insurance market.

A new era of enterprise risk management is on the horizon, and unless companies want the same result as Pinterest and many other companies are seeing, they need help navigating the treacherous waters of aspirational promises and pledges now more than ever.

Denise Williamee is vice president of corporate services at Steel City Re LLC.

Nir Kossovsky is CEO of Steel City Re.