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Boardroom Lessons From Shareholders' Diversity Lawsuits

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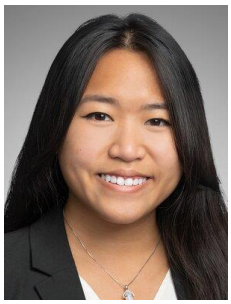

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In recent months, the corporate diversity movement was dealt a series of uncharacteristic setbacks. On May 13, Los Angeles Superior Court Judge Maureen Duffy-Lewis struck down S.B. 826 — a law requiring California corporations to reserve board seats for women directors — as contrary to the California Constitution's equal protection clause.[1]

That ruling followed a separate decision in April enjoining enforcement of A.B. 979, a statute mandating that public California corporations diversify their boards with members of underrepresented communities.[2]

Recent shareholder derivative litigation premised on corporate efforts to promote workforce diversity have encountered similar obstacles. Since 2020, shareholders have brought at least a dozen derivative suits that fault directors and officers for failing to uphold diversity and inclusion policies.[3]

With the March 2022 dismissal of a complaint against directors and officers of Cisco Systems Inc.,[4] however, most of these derivative suits have failed to survive the pleading stage.

But an obituary for derivative suits pressing diversity reforms may still be premature. As the nation marks the second anniversary of George Floyd's murder, the momentum behind corporate efforts to promote diversity, equity and inclusion in the workplace is only growing.

And recent developments in Delaware law and U.S. Securities and Exchange Commission disclosure requirements may present new avenues for shareholders to pursue their aims.

With investors demanding more transparent disclosure and increased board oversight of diversity and inclusion initiatives, the shareholder derivative lawsuits offer important lessons on how boards may protect themselves while fostering diverse workforces and safeguarding company goodwill.

Shareholders Seek to Hold Directors Liable for Lack of Diversity

Derivative lawsuits targeting a board's failure to detect or address instances of sexual harassment and misconduct are not new.[5] But, in recent years, the scope of such derivative lawsuits has broadened to include allegations about the board's lack of diversity or, more generally, failures to enact and enforce policies designed to promote diversity, equity and inclusion throughout the company.

Since mid-2020, shareholders have filed at least 12 such derivative lawsuits against public company officers and directors. The timing coincided with the decision by many companies — in the wake of Floyd's murder — to make public pledges to improve the racial diversity of their workforces.[6]

Seizing upon those public statements, the shareholder lawsuits typically allege that company directors authorized statements that falsely represented the company's commitments to diversity and anti-discrimination policies. Put differently, shareholders claimed that the directors and officers had failed to practice what they had preached, causing injury to the companies they serve.

Though the facts vary, the core claims in the complaints are similar. They allege that the company's directors and officers:

- Breached their Caremark duty of oversight by failing to monitor the company's compliance with anti-discrimination laws;[7]

- Authorized false statements in proxy materials and in codes of conduct,[8] such as claiming to have a policy of being committed to diversity and inclusion;[9]

- Breached their fiduciary duties by failing to ensure diverse candidates were selected to the board;[10] and

- Overcompensated themselves at the expense of minority and women employees.[11]

The complaints assert claims for breach of fiduciary duty, abuse of control, unjust enrichment and violations of Section 14(a) of the Securities Exchange Act.

The lawsuits demand remedies rarely, if ever, pursued in shareholder derivative suits.

Requested reforms include removing board directors;[12] donating director compensation to charities that promote the advancement of minorities; [13] reporting information about the hiring, advancement, promotion and pay of minority employees;[14] and tying executive compensation to meeting diversity goals.[15]

Shareholder Derivative Diversity Lawsuits Thus Far Have Failed to Overcome Legal Obstacles

So far, these lawsuits have faced substantial headwinds. Of the roughly 12 shareholder diversity lawsuits filed since mid-2020, nine have now been dismissed.

Some common themes emerge. Demand futility has been a frequent stumbling block, with most courts holding that shareholders had failed to show that the presuit demand requirement was excused on the ground of futility.

Demonstrating demand futility, according to the 1993 Delaware Supreme Court decision in Rales v.

Blasband, requires shareholders to allege "particularized facts creating a reasonable doubt that a majority of the Board would be disinterested or independent in making a decision on a demand."[16]

In this context, alleging demand futility obligated shareholders to plead particularized facts showing that a majority of directors faced a substantial likelihood of liability based on the shareholders' claims.[17]

Most courts found the derivative complaints to be lacking in this regard. As to the fiduciary duty claims, courts held that the shareholders had failed to plead particularized facts showing that the defendants knew that challenged assertions were false,[18] or even that the assertions were false in the first place.[19]

For example, in Klein v. Elison, a 2020 case in the U.S. District Court for the Northern District of California, the court found a derivative complaint challenging Oracle Corp.'s proxy representation that Oracle "actively seeks women and minority candidates from the pool from which director candidates [are] chosen" lacked any particularized facts showing the representation to be false.[20]

The complaint's allegation that no Black individuals currently serve on the board failed to support an inference that Oracle's statement about seeking out minority candidates was untrue.[21]

Exculpatory provisions in company charters only heightened the plaintiffs' burden. Under Delaware law, an exculpatory provision may shield directors from personal liability absent bad faith, intentional misconduct or a knowing violation of the law.[22]

Ocegueda v. Zuckerberg, in the U.S. District Court for the Northern District of California, held that establishing liability for otherwise exculpated claims requires shareholders to "plead particularized facts that the directors had actual or constructive knowledge that their conduct was legally improper,"[23] a high bar that the shareholders have thus far failed to clear.

Courts also struggled to find any red flags showing that board members knowingly disregarded illegal behavior, as required under Caremark.[24]

For example, in Falat v. Sacks, a U.S. District Court for the Central District of California lawsuit brought by female employees alleging sexual harassment, but in which the company was not found liable, was not a red flag sufficient to establish a breach of the directors' duty of care.[25] At least two courts also dismissed state law claims based on forum-selection clauses.[26]

As for the Section 14(a) claims, multiple courts found the challenged statements about diversity goals to be, in the words of the Ocegueda court, "inactionable puffery" or merely aspirational and therefore immaterial.[27]

A 2021 U.S. District Court for the District of Delaware order dismissing Kiger v. Mollenkopf said that to be misleading a statement must be "capable of objective verification" — aspirational statements that "emphasize a desire to commit to certain 'shared values' ... and [that] provide a 'vague [statement] of optimism'" are incapable of such verification.[28]

Relatedly, courts, including Ocegueda, found lack of an essential link between the challenged statements and a "loss-generating corporate action."[29]

In the recent cases In re: Danaher Corp. Shareholder Derivative Litigation in the U.S. District Court for

the District of Columbia, and Lee v. Frost, in the U.S. District Court for the Southern District of Florida, involving Danaher Corp and OPKO Health Inc., for example, the shareholders claimed that proxy representations about diversity goals caused shareholders to reelect directors, who then failed to promote diverse candidates, which in turn injured the company.[30]

In both cases, courts found the alleged causal chain too attenuated to establish a resulting loss.[31]

Recent Legal Developments May Portend a Second Wave of Shareholder Diversity Suits

Although these suits have failed to gain traction, recent developments may portend a second wave.

Derivative plaintiffs typically bolster their demand-futility allegations by exercising their right to inspect corporate books and records under Title 8 of the Delaware Code, Section 220. Books-and-records demands have been on the rise, fueled by recent decisions broadening shareholder inspection rights.

Generally, shareholders seeking corporate records need not present evidence that the suspected wrongdoing could support claims raised in a later action capable of surviving a motion to dismiss.[32]

Instead, according to the 2020 Delaware Court decision in AmerisourceBergen Corp. v. Lebanon County Employees' Retirement Fund, shareholders need only supply a "credible basis from which the Court of Chancery can infer … possible mismanagement or wrongdoing warranting further investigation," a standard that has been described as the lowest possible burden of proof under Delaware law.[33]

In another Section 220 case, Employees' Retirement System of Rhode Island v. Facebook Inc., a 2021 decision of the Delaware Chancery Court authorized access to a company's emails because traditional board materials were "bereft of relevant information" and "reveal[ed] little or nothing of the Board's thinking."[34]

Although the shareholders behind the dismissed derivative suits do not appear to have sought access to company books and records, that pattern may be changing: At least one derivative plaintiff, the plaintiff in Kiger v. Qualcomm Inc., filed in Delaware Chancery Court this year, has demanded to inspect to Qualcomm's records purportedly to "investigate the lack of diversity at Qualcomm."[35]

More derivative plaintiffs pushing for diversity and inclusion reforms can be expected to follow this path.

Other recent decisions may embolden would-be derivative plaintiffs. Caremark claims — recognized in the 1996 Delaware case In re: Caremark, as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment"[36] — have shown signs of viability in recent Delaware decisions.

These cases show an increased willingness to entertain oversight claims involving so-called essential and mission critical issues pertaining to compliance risks.[37] Odds of success for Caremark claims remain low, however, and the courts may well conclude that diversity issues do not rise to the level of mission-critical compliance risks.

Nevertheless, the Caremark standard may not prove as insurmountable in the future as it has in decades past.

New rule changes obligating public companies to make environmental, social and governance disclosures may provide further fuel for shareholder derivative suits. In March, the SEC proposed rule changes requiring registrants to include climate-related disclosures in their registration statements and periodic reports.[38]

The commission appears poised to add additional ESG disclosure requirements, especially relating to workforce diversity statistics and goals. Those requirements may spur new shareholder diversity lawsuits that exploit mandated disclosures in SEC filings.

Practical Steps to Mitigate Risk and Foster Diversity

Companies will continue to face scrutiny from stakeholders related to promoting diversity, and gender and racial equity. Boards can minimize the risk of shareholder derivative suits, however, and prepare to defend any that are filed by adopting preventive measures where appropriate. Among other options, boards may consider the following steps.

Establish a board-level reporting and monitoring system for diversity issues.

To help stave off Caremark claims, boards should consider implementing a reporting system providing for regular updates from senior management responsible for diversity, inclusion and anti-discrimination matters. Boards should also consider establishing crisis-response protocols and teams to address incidents that, if mishandled, could inflict serious reputational harm and spur new lawsuits.

Document board discussions concerning diversity, equity and inclusion.

Boards should memorialize their oversight of diversity, equity and inclusion issues, with a view toward making the relevant board minutes available in response to books-and-records demands. Responses to such demands should be carefully considered in light of evolving law.

Understand the factual basis for management's public statements on diversity and inclusion matters.

Companies are rightfully disclosing their commitments to addressing diversity and inclusion, but those commitments can provide fodder for shareholder lawsuits unless backed by tangible action. Defending corporate commitments to diversity as inactionable puffery may be a successful short-term legal strategy, but it is unlikely to placate stakeholders in the long term.

Companies should be mindful that the safe harbor for such aspirational statements is not without limits. And directors should press management to ensure that a company's publicized aspirations about inclusion and diversity are, in fact, reflected in the company's policies, practices and workplace culture.

Regularly reassess workplace culture and compliance policies.

Boards should consider conducting regular, independent assessments of company policies, practices and procedures related to diversity, inclusion and compliance to ensure alignment with changing laws and best practices.

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[1] Verdict, Crest v. Padilla, No. 19STCV27561 (Cal. Super. May 13, 2022).

[2] Order on Mot. for Summary J., Crest v. Padilla, No.20ST-CV-37513 (Cal. Super. Ct. Apr. 1, 2022).

[3] Ocegueda v. Zuckerberg, No. 20-cv-04444 (N.D. Cal. July 2, 2020); Klein v. Ellison, No. 20-cv-4439 (N.D. Cal. July 2, 2020); Kiger v. Mollenkopf, No. 21-409-RGA (D. Del. July 17, 2020); Esa v. NortonLifeLock Inc., No. 5:20-cv-05410 (N.D. Cal. Aug. 5, 2020); In re Danaher Corp. S'holder Derivative Litig., No. 1:20-cv-02445 (D.D.C. Sept. 1, 2020); Lee v. Fisher, No. 3:20-cv-06163 (N.D. Cal. Sept. 1, 2020); Falat v. Sacks, No. 8:20-cv-01782 (C.D. Cal. Sept. 18, 2020); City of Pontiac Gen. Emps.' Ret. Sys. v. Bush, No. 5:20-cv-06651 (Sept. 23, 2020); Emps.' Ret. Sys. of Rhode Island v. Silverman, No. 3:20-cv-08438 (N.D. Cal. Nov. 30, 2020); Foote v. Micron Tech. Inc., No. 21-cv-00169 (D. Del. Feb. 9, 2021); Lee v. Phillip Frost, No. 1:21-cv-20885 (S.D. Fla. Mar. 5, 2021); Phyllis Gianotti v. Lloyd H. Dean, No. 2021-0642 (Del. Ch. Jul. 28, 2021).

[4] Dismissal Order, City of Pontiac Gen. Emps.' Ret. Sys. v. Bush, 20-cv-06651-JST (N.D. Cal. Mar. 1, 2022).

[5] See, e.g., City of Monroe Emps.' Ret. Sys. v. Rupert Murdoch, No. 2017-0833 (Del. Ch. Nov. 20, 2017); Stein v. Knight, No. 18CV38553 (Or. Cir. Ct. Aug. 31, 2018); Shabbouei v. Potdevin, No. 2018-0847 (Del. Ch. Nov. 21, 2018); N. California Pipe Trades Pension Plan v. Hennessey, No. 19-CIV-00149 (Cal. Super. Jan. 9, 2019); Thomas P. DiNapoli. v. Stephen A. Wynn, No. A-18-770013-B (Feb. 22, 2018); Rudi v. Wexner, 2:20-cv-03068-MHW-EPD (S.D. Ohio June 16, 2020).

[6] See, e.g., Here's What Companies Are Promising to Do to Fight Racism, N.Y Times, Aug. 30, 2020, available at https://www.nytimes.com/article/companies-racism-george-floyd-protests.html.

[7] See, e.g., Compl. ¶¶ 230-36, 269-70, Falat, No. 8:20-cv-01782; see also Compl. ¶¶ 192-203, Ocegueda, No. 20-cv-04444; Compl. ¶¶ 150, 156, 162, Lee, No. 1:21-cv-20885; Compl. ¶ 54, Esa, No. 5:20-cv-05410.

[8] Compl. ¶¶ 69-73; 103-105, Falat, No. 8:20-cv-01782; see also Compl. ¶ 9, Ocegueda v. Zuckerberg, No. 20-cv-04444; Compl. ¶¶ 98-118, Esa, No. 5:20-cv-05410.

[9] Compl. ¶ 5, Falat, No. 8:20-cv-01782; see also Compl. ¶¶ 102-103, In re Danaher Corp. S'holder Derivative Litig., No. 1:20-cv-02445; Compl. ¶ 89, Klein v. Ellison, No. 20-cv-4439 (N.D. Cal. July 2, 2020).

[10] Compl. ¶¶ 222-229, Falat, No. 8:20-cv-01782; see also Compl. ¶ 6, Esa, No. 5:20-cv-05410.

[11] Compl. ¶¶ 236-247, Falat, No. 8:20-cv-01782; Compl. ¶¶ 179-184, Klein, No. 20-cv-4439.

[12] See, e.g., Compl. ¶¶ 35, Falat, No. 8:20-cv-01782; Compl. ¶ 30, Ocegueda, No. 20-cv-04444; Compl. ¶¶ 43-45, In re Danaher, No. 1:20-cv-02445; Compl. ¶ 16, Klein, No. 20-cv-4439.

[13] See, e.g., Compl. ¶¶ 35, Falat, No. 8:20-cv-01782; Compl. ¶ 30, Ocegueda, No. 20-cv-04444; Compl. ¶¶ 43-45, In re Danaher, No. 1:20-cv-02445; Compl. ¶ 16, Klein, No. 20-cv-4439.

[14] See, e.g., Compl. ¶¶ 35, Falat, No. 8:20-cv-01782; Compl. ¶ 30, Ocegueda, No. 20-cv-04444; Compl. ¶¶ 43-45, In re Danaher, No. 1:20-cv-02445; Compl. ¶ 16, Klein, No. 20-cv-4439.

[15] See, e.g., Compl. ¶¶ 35, Falat, No. 8:20-cv-01782; Compl. ¶ 30, Ocegueda, No. 20-cv-04444; Compl. ¶¶ 43-45, In re Danaher, No. 1:20-cv-02445; Compl. ¶ 16, Klein, No. 20-cv-4439.

[16] Rales v. Blasband, 634 A.2d 927, 930 (Del. 1993).

[17] Id.

[18] See, e.g., Dismissal Order at 14, Lee, No. 1:21-cv-20885 (Plaintiffs failed to "plead facts suggesting Defendants were involved in preparing the Proxy Statements or that Defendants 'had knowledge that any disclosure or omissions were false or misleading ...'"); Dismissal Order at 11-12, In re Danaher, No. 1:20-cv-02445 ("Even if the Shareholders had made that showing, they also have not alleged specific facts connecting the Directors to the statements or facts showing that the Directors acted intentionally.").

[19] See, e.g., Dismissal Order at 14-15, Lee, No. 1:21-cv-20885 ("Plaintiffs fail to plead particularized facts showing the Proxy Statements were actually false and misleading"); Dismissal Order at 5, Kiger v. Mollenkopf, No. 21-409-RGA (D. Del. Nov. 15, 2021) ("The Inclusion Statement is not actionable because Plaintiffs have failed to allege any facts supporting a reasonable inference that it was false or misleading."); Dismissal Order at 11, In re Danaher, No. 1:20-cv-02445 ("But the Shareholders have not shown demand futility because they have not alleged with particularity that the challenged statements are false.").

[20] Dismissal Order at 7, Klein, No. 20-cv-4439.

[21] Id.

[22] 8 Del. C. 102(b)(7).

[23] Falat v. Sacks, No. 8:20-cv-01782, 2021 WL 1558940, at *6 (C.D. Cal. Apr. 8, 2021); Ocegueda, 526 F. Supp. 3d at 647-648.

[25] Falat, 2021 WL 1558940, at *6.

[26] See, e.g., Ocegueda, 526 F. Supp. 3d at 648-650; Dismissal Order at 4, Esa v. NortonLifeLock Inc., No. 5:20-cv-05410 (N.D. Cal. Aug. 5, 2020); Klein v. Ellison, No. 20-cv-4439, 2021 WL 2075591, at *8 (N.D. Cal. May 1, 2021).

[27] See Ocegueda, 526 F. Supp. 3d at 651 (statement that Facebook "is committed to diversity" was "non-actionable puffery."); Dismissal Order at 4, Kiger v. Mollenkopf, No. 21-409-RGA (D. Del. Nov. 15, 2021); Falat, 2021 WL 1558940, at *6 (statement that Monster "seek[s] to capture diversity in [its]

candidates" is puffery); Klein, 2021 WL 2075591, at *7 (alleged misrepresentations about the company's commitment to Board diversity were unactionable "aspirational statements") (quotation marks and citation omitted).

[28] Dismissal Order at 5, Kiger, No. 21-409-RGA.

[29] Ocegueda, 526 F. Supp. 3d at 654; see also Dismissal Order at 23, Lee v. Frost, No. 1:21-cv-20885 (S.D. Fla. Sept. 1, 2021) ("Put differently, 'the losses to the company must have resulted directly from the ... Proxy Statement vote, not from the omission itself[.]'") (citing In re The Home Depot, 223 F. Supp. 3d 1317, 1331 (N.D. Ga. 2016)).

[30] See Dismissal Order at 21, In re Danaher Corp. S'holder Derivative Litig., No. 1:20-cv-02445 (D.D.C. June 28, 2021); Dismissal Order at 24, Lee, No. 1:21-cv-20885; Dismissal Order at 7-8, City of Pontiac Gen. Empls.' Ret. Sys v. Bush, No. 20-CV-06651-JST (N.D. Cal. March 1, 2022).

[31] Dismissal Order at 21, In re Danaher, No. 1:20-cv-02445, Dismissal Order at 24, Lee, No. 1:21-cv-20885.

[32] AmerisourceBergen Corp. v. Lebanon County Emps.' Ret. Fund, 243 A.3d 417, 430 (Del. 2020).

[33] Id. at 437.

[34] See Emps.' Ret. Sys. of Rhode Island v. Facebook, Inc., No. 2020-0085-JRS, 2021 WL 529439 (Del. Ch. Feb. 10, 2021); but see Durham v. Grapetree LLC, 246 A.3d 566 (Del. 2021) (affirming denial of inspection of informal records where board presentation and minutes were deemed sufficient).

[35] Complaint at 2, Kiger v. Qualcomm Inc., No. 2022-0226 (Del. Ch. 2022).

[36] Stone v. Ritter, 811 A,2d 362, 370 (Del. 2006) (quoting In re Caremark, 698 A.2d 959, 967(Del. 1996)).

[37] See In re Boeing Company Derivative Litigation¸ No. 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. 2021).

[38] SEC Proposed rules to Enhance and Standardize Climate-Related Disclosures for Investors, SEC (Mar. 21, 2022), available at https://www.sec.gov/news/press-release/2022-46.
target='_blank' style='color: #990000'>Ocegueda v. Zuckerberg, 526 F. Supp. 3d 637, 647 (N.D. Cal. 2021).

[24] Falat v. Sacks, No. 8:20-cv-01782, 2021 WL 1558940, at *6 (C.D. Cal. Apr. 8, 2021); Ocegueda, 526 F. Supp. 3d at 647-648.

[25] Falat, 2021 WL 1558940, at *6.

[26] See, e.g., Ocegueda, 526 F. Supp. 3d at 648-650; Dismissal Order at 4, Esa v. NortonLifeLock Inc., No. 5:20-cv-05410 (N.D. Cal. Aug. 5, 2020); Klein v. Ellison, No. 20-cv-4439, 2021 WL 2075591, at *8 (N.D. Cal. May 1, 2021).

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[28] Dismissal Order at 5, Kiger, No. 21-409-RGA.

[29] Ocegueda, 526 F. Supp. 3d at 654; see also Dismissal Order at 23, Lee v. Frost, No. 1:21-cv-20885 (S.D. Fla. Sept. 1, 2021) ("Put differently, 'the losses to the company must have resulted directly from the ... Proxy Statement vote, not from the omission itself[.]'") (citing In re The Home Depot, 223 F. Supp. 3d 1317, 1331 (N.D. Ga. 2016)).

[30] See Dismissal Order at 21, In re Danaher Corp. S'holder Derivative Litig., No. 1:20-cv-02445 (D.D.C. June 28, 2021); Dismissal Order at 24, Lee, No. 1:21-cv-20885; Dismissal Order at 7-8, City of Pontiac Gen. Empls.' Ret. Sys v. Bush, No. 20-CV-06651-JST (N.D. Cal. March 1, 2022).

[31] Dismissal Order at 21, In re Danaher, No. 1:20-cv-02445, Dismissal Order at 24, Lee, No. 1:21-cv-20885.

[32] AmerisourceBergen Corp. v. Lebanon County Emps.' Ret. Fund, 243 A.3d 417, 430 (Del. 2020).

[33] Id. at 437.

[34] See Emps.' Ret. Sys. of Rhode Island v. Facebook, Inc., No. 2020-0085-JRS, 2021 WL 529439 (Del. Ch. Feb. 10, 2021); but see Durham v. Grapetree LLC, 246 A.3d 566 (Del. 2021) (affirming denial of inspection of informal records where board presentation and minutes were deemed sufficient).

[35] Complaint at 2, Kiger v. Qualcomm Inc., No. 2022-0226 (Del. Ch. 2022).

[36] Stone v. Ritter, 811 A,2d 362, 370 (Del. 2006) (quoting In re Caremark, 698 A.2d 959, 967(Del. 1996)).

[37] See In re Boeing Company Derivative Litigation¸ No. 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. 2021).

[38] SEC Proposed rules to Enhance and Standardize Climate-Related Disclosures for Investors, SEC (Mar. 21, 2022), available at https://www.sec.gov/news/press-release/2022-46.