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A New Wave of Board Diversity Derivative Litigation

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With a hot national spotlight on issues of racial diversity, equality, and inclusion, the composition of corporate boards of directors is facing increased scrutiny from the American public, legislators and the plaintiffs' bar. The plaintiffs' bar fired their first shot in July 2020 with a shareholder derivative complaint against the board of a Fortune 100 company, followed in quick succession by additional derivative lawsuits against the boards of a number of public companies that allegedly lack any racially diverse directors. The allegations are largely the same: the boards of directors of these public companies allegedly breached their fiduciary duties by failing to include diverse directors on their boards, despite statements of commitment to diversity, equality, and inclusion. With eight suits filed in just three months against some of the largest public companies in the country, copy-cat suits targeting public companies without racially diverse directors are likely to follow.

Lack of Board Diversity is the New #Metoo

At this writing, these new shareholder derivative lawsuits have targeted major companies that are incorporated in Delaware, but mostly headquartered in California, where plaintiffs have elected to file their suits in federal courts, rather than the Delaware Court of Chancery.

At the heart of each lawsuit lies a juxtaposition of two common elements: Each company is alleged to have a history of publishing claims that it promotes diversity, equality, and inclusion. But each company's actions are alleged to be quite different, falling short of these claims. Most of the complaints punctuate the point with photographs of current board members, showing an apparent lack of racial diversity.

Based on these allegations, plaintiffs purport to assert state law claims derivatively on behalf of the companies against the directors and officers for alleged breach of fiduciary duty and unjust enrichment, and for alleged proxy solicitation violations under Section 14(a) of the federal Securities Exchange Act.

Plaintiffs seek a broad array of remedies:

- calling for corporate board reform (including removal of existing board members to make way for new, diverse members) and claw-back of board compensation;

- demanding multi-million-dollar corporate donations to organizations supporting minority advancement, financial commitments to programs to hire, promote, and retain diverse talent, as well as investments in a diverse personnel talent pipeline by developing relationships with historically black colleges;

- requiring diversity training for board members; setting new corporate goals and policies for diverse hiring practices;

- publishing annual diversity reports, compensatory damages, punitive damages;
- and, *of course*, claiming plaintiff's attorneys' fees when and if any of these demands are met or awarded.

A Short Tutorial on Derivative Suits

Use of shareholder derivative actions as a tool to drive social change is an interesting one. A derivative action, by its very nature, presents significant hurdles for a shareholder plaintiff seeking to bring and maintain a claim.

A shareholder derivative lawsuit is not brought *against* the company. Instead, it is ostensibly brought to remedy harm done *to* the company and, indirectly, to its shareholders. But because responsibility for bringing claims on behalf of the company lies within the sound business judgment of the board of directors, a shareholder seeking to assert a claim on behalf of the company must first wrest control from the board by demonstrating a right to stand in the company's shoes. This can only be accomplished by meeting high pleading standards.

Shareholder standing to assert corporate claims turns on whether and how the shareholder has satisfied the "demand" requirement. Before usurping the board's prerogative to decide what action, if any, the company should take, shareholders first must make a demand on the board to take action, giving the board the opportunity to consider the claims and decide whether it is in the best interest of the company to pursue them. A derivative complaint must address this requirement by alleging facts showing either that: (1) the shareholder plaintiff made a pre-suit demand on the board, which the board wrongfully refused, or (2) a pre-suit demand would have been futile because a majority of the board could not exercise valid business judgment on the demand.[i] Courts review a board's refusal of a demand with deference to the board's business judgment, which is presumed valid, unless plaintiffs can rebut that presumption—which is very hard to do. Courts review allegations of demand futility based on high pleading requirements to show that a majority of the board is not sufficiently independent or disinterested to exercise valid business judgment on a demand because they either (a) are not independent of allegedly culpable actors, or (b) face a substantial likelihood of personal liability themselves.[ii] These are difficult hurdles to overcome and, as a result, many derivative suits are dismissed at the pleading stage.

As reflected in the board diversity lawsuits filed so far, shareholders almost always sue all members of the board and senior management. Though well-designed insurance can ameliorate personal liability risk, being targeted in a derivative suit does mean that individuals *may* face personal exposure with respect to any claims that survive a motion to dismiss. But there are safety nets. Delaware directors are held to a fiduciary standard of care, which is violated by gross negligence. Delaware law permits companies, however, to adopt an "exculpation" clause in their charter eliminating the personal liability of directors to the company or its shareholders for money damages for gross negligence. Consequently, any viable money-damages claim against a director who is sheltered by an exculpatory provision must be based on particularized factual allegations that the director breached the fiduciary duty of loyalty or acted in bad faith.

Problems for Plaintiffs in Sustaining a Board Diversity Derivative Action

Among the diversity lawsuits filed so far, it appears that a pre-suit demand was made only in one of them.[iii]. Otherwise, the plaintiffs have relied on allegations of demand futility to establish their standing to assert the company's claims.

Though shareholder plaintiffs often seek to inspect a company's books and records before filing suit (such as under Section 220 of the Delaware General Corporation Law)—in order to discover facts that might help satisfy the pleading requirements—the plaintiffs in this new wave of diversity suits appear to not have done so. As a result, their complaints lack details about the boards' internal processes and deliberations, and baldly allege that "any demand on them to bring this case would be a futile and useless act," without any detail as to why. Simply suing the members of the board is not enough to show that there is a "substantial likelihood of liability" amounting to a breach of loyalty or bad faith.

Plaintiffs also face enormous challenges in identifying and quantifying damage to the company caused by the absence of board diversity. Some plaintiffs look sideways for some evidence of corporate harm—such as, in the case of a large social media company, allegations that its failure to censor racially-tinged content and regulatory enforcement claims based on ad-targeting technology have negative consequences to the bottom line. Mostly, however, plaintiffs just allege that greater board diversity would lead to *more* corporate profits, apparently seeking lost profits as damages. Plaintiffs cite a 2018 report by McKinsey & Company that allegedly found that companies with the most diverse boards worldwide were 43 percent more likely to experience higher profits.[iv] Even if so, "43 percent more likely" is no guarantee that adding diverse members to a board will produce more profits, much less quantify them. The data may be interesting but does not appear to provide a legal basis for allowing a court to interfere with a board's business judgment about how best to address issues related to diversity.

Given the problem of showing damages, plaintiffs have demanded relief in the form of better corporate governance practices and procedures and more diversity, as well as donation of money to assist underrepresented communities. To the extent that companies agree to take such measures in response to—or in settlement of—these derivative suits, plaintiffs' lawyers will no doubt claim credit and seek a so-called "mootness" fee for achieving a "victory" on behalf of the company. The playbook can be seen in the old "disclosure-only" settlements and fee awards in merger cases. Delaware no longer looks approvingly on "disclosure-only" suits that fail to provide any real benefit to stockholders but appear motivated primarily to engineer a fee award in exchange for dismissal of the case.[v] Other jurisdictions have expressed similar skepticism.[vi]

Legislators, Regulators and Institutional Investors Pile On

The pressure on corporations to do more to improve diversity, equality, and inclusion within their organizations is not limited to the recent wave of shareholder derivative lawsuits. A *Newsweek* article recently identified the 20 largest public U.S. companies without a Black director on their board.[vii] This list evidently inspired at least some of the pending derivative suits. But the *Newsweek* list is not exhaustive, and companies should not assume they are safe from scrutiny if they were not named. Indeed, not all companies that have been hit with board diversity suits to date were identified on the list.

Institutional investors, such as BlackRock and Vanguard, are encouraging companies to disclose the racial diversity of their boards and are using their proxy votes to push this initiative.[viii] Additionally, many companies—both public and private—as well as nonprofit organizations, have accepted the Board Challenge, a pledge for boards to add a Black director within the next year, spearheaded by Altimeter Capital, Valence, the Boardlist, and supported by a number of institutions, including the NAACP.

Legislatures are also starting to focus on corporate diversity. In November 2019, the U.S. House of Representatives passed H.R. 5084, the "Improving Corporate Governance Through Diversity Act of 2019." This bill would require issuers of securities to disclose the racial, ethnic, and gender composition of their boards of directors and executive officers, as well as the status of any of those directors and officers as a veteran, and to disclose any plan to promote racial, ethnic, and gender diversity among these groups. The Securities and Exchange Commission would also be required to establish a Diversity Advisory Group to report on strategies to increase gender, racial, and ethnic diversity among board members.

The State of California already has taken it a step further. California Governor Gavin Newsom recently signed into law a follow-on to the state's 2018 requirement that all publicly traded companies headquartered in California include at least one woman on the board. The new law will require that, by the end of 2021, the same set of public companies must also have a minimum of one director from an underrepresented community. Other states may follow suit.

Does Your Company Walk the Walk?

In this environment, even if litigation risks seem remote, reputational risks are not. Directors should evaluate how their companies might fare if subjected to criticisms like those raised in the recent derivative cases. If the company has made public statements about social justice, diversity, and inclusion within the company, the board should review those statements. Are they statements of support, claims or promises of action? Do they discuss specific goals? Do they imply more than what the company may reasonably be able to accomplish? Does the company walk-the-walk or just talk-the-talk? The critical point is to make sure that assertions match what the company is willing and able to do. "Corporate platitudes and virtue signaling," as one plaintiff called it, may cause more harm than good if not backed up with action. Corporate policies and procedures should be reviewed to ensure that they are consistent with the company's strategy and with its public statements, and adequately implemented and enforced. Boards should periodically refresh their review of these matters.

Turning Lemons into Lemonade?

If a board receives a shareholder demand to take action to address diversity and inclusion, or even if a demand futility lawsuit is filed, this may provide an opportunity to adopt or update policies and programs and obtain shareholder and court approval of those efforts. For example, in 2018-2019, a similar wave of derivative lawsuits focused on #MeToo issues. Several of those cases settled, with the companies agreeing to relief akin to that sought in the current wave of diversity cases.

Most recently, in September 2020, Alphabet (Google's parent corporation) announced that it had settled its #MeToo derivative litigation, in which the co-lead counsel for the plaintiffs is the same law firm that filed the first six of the current diversity cases. Alphabet agreed to establish a $310 million diversity, equity, and inclusion fund to support what it is calling the "Workplace Initiative." The $310 million will be spent over 10 years to support a set of global initiatives and programs focusing on several key areas, including the hiring, progression, and retention of historically underrepresented talent at Google, fostering respectful, equitable, and inclusive workplace cultures, and helping historically underrepresented groups and individuals outside Google succeed with their businesses and in the digital economy and tech industry, including by supporting conferences and events and increasing access to digital tools and opportunities. When its settlement is approved by the court, Alphabet will have succeeded in developing a far-reaching program in support of diversity, equality, and inclusion, while avoiding at least some of the distraction, expense, and scrutiny that often accompanies shareholder litigation. Some might call that a win-win.

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[i] *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *see Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993) ("Because directors are empowered to manage, or direct the management of, the business and affairs of the corporation, 8 Del. C. § 141(a), the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.").

[ii] Plaintiffs must allege, for example, bad faith, intentional wrongdoing, facts showing that the board "utterly failed to implement any reporting or information system or controls" or "knew evidence of corporate misconduct" (red flags) and "consciously disregarded" a duty to act. *See Caremark Int'l Derivative Litig*., 698 A.2d 959 (Del. Ch. 1996).

[iii] Only the complaint against Cisco's board of directors pleaded that the plaintiffs had made a demand on the Company's board prior to filing suit. *See Klein v. Ellison, et al.*, No. 3:20-cv-04439 (N.D. Cal.).

[iv] The 2018 report is Vivian Hunt, Sara Prince, Sundiatu Dixon-Fyle, & Lareina Yee, *Delivering through Diversity*, McKinsey & Company, at 8 (Jan. 2018).

[v] *See, e.g.*, *In re Trulia Inc. Stockholders Litig.*, 129 A.3d 884, 898-99 (Del. Ch. 2016) (discussing the abuses of disclosure-only settlements and expressing doubts about the value of relief obtained through them).

[vi] *See, e.g.*, *In re Allied Healthcare S'holder Litig.*, 2015 WL 6499467, at *2 (N.Y. Sup. Ct. Oct. 23, 2015) (rejecting settlement and explaining that "in the area of derivative litigation, a culture has developed that results in cases of relatively worthless settlements (derivative actions are rarely tried to a verdict) that discontinue the action (with releases) resulting in the corporate defendants not opposing an agreed upon legal fee to class counsel").

[vii] *See* Kerri Anne Renzulli, *The 20 Largest U.S. Companies Without a Black Person on Their Board*, Newsweek, June 17, 2020, available at: https://www.newsweek.com/20-largest-public-us-companies-without-black-person-their-board-1511319.

[viii] BlackRock asserts that it expects boards of directors of the companies in which it invests to "be comprised of a diverse selection of individuals," which includes "consideration [of] the full breadth of diversity including personal factors, such as gender, ethnicity, and age; as well as professional characteristics, such as a director's industry, area of expertise, and geographic location." BlackRock Investment Stewardship report (January 2020), available at: https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf; *see*

also Vanguard's Investment Stewardship 2019 Annual Report, available at: https://pressroom.vanguard.com/news/Press-Release-vanguard-Releases-Annual-Investment-Stewardship-Report-083019.html (noting its "board diversity expectations of public companies").

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