WINSTON & STRAWN LLP

CLIENT ALERT

Securities Litigation Risk in the Evolving DEI Landscape

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President Trump has issued a series of executive orders targeting the private sector's initiatives related to Diversity, Equity, and Inclusion (DEI) and/or Diversity, Equity, Inclusion, and Accessibility (DEIA).[1] These and other recent executive actions and developments concerning DEI come on the heels of the Fifth Circuit's December 2024 decision striking down the Nasdaq's board diversity rule that would have required companies to have, or explain why they do not have, at least one female director and one director who self-identifies as an underrepresented minority or LGBTQ+.[2]

The U.S. disclosure regime does not require companies to disclose DEI-related programs or policies, per se. But in recent years, many companies disclosed DEI-related information as part of business, risk factors, human capital management, board and executive compensation, or other sections of their periodic SEC filings, proxy statements, and public disclosures. Even before the recent change in the DEI landscape, plaintiff firms and political groups had begun filing claims against companies, officers, and directors concerning their DEI-related disclosures. Companies have usually responded by rolling back or modifying their DEI-related policies.

Now that, more than ever, DEI-related disclosures will come under the microscope, it is critical for companies to evaluate the risks of their DEI programs and proactively mitigate the risk of investor claims that may arise from their pursuit of—or withdrawal from—DEI initiatives and their associated public statements. The rest of this alert describes risks facing companies relating to DEI-related disclosure and shareholder litigation and our key takeaways and recommendations.

SEC Enforcement. Under the Biden administration and during the tenure of then-SEC chair Gary Gensler, the SEC developed a DEIA Strategic Plan,[3] performed biennial collections of "Diversity Self-Assessment Submissions from Regulated Entities,"[4] which it used "to assess and report on progress and trends in regulated entity diversity-related activities,"[5] and identified DEI as a priority with respect to the SEC's regulation of capital markets.[6] While Paul Atkins has just been confirmed as chair of the SEC, it is hard to imagine the agency will continue on the same path. Instead, it is more likely that the agency will scrutinize companies' DEI- (and ESG-) related disclosures and, particularly following negative market events, examine whether they accurately conveyed to investors the companies' DEI practices and associated risks.

Shareholder Direct Actions. In the last few years, there have been several direct investor cases (typically putative class actions) alleging false DEI-related disclosures in companies' proxy statements and other public statements and filings, giving rise to claims under Sections 14(a) and 10(b) of the Securities Exchange Act of 1934 and related SEC Rules. Some have alleged that companies paid only lip service to DEI, while allowing discrimination against people from historically underprivileged communities to persist.[7] Others have alleged that companies went too far in their DEI-related programming, exposing the company to undisclosed risks of customer blowback or regulatory scrutiny.[8] The latter type of case seems likely to proliferate in the new climate.

Defendants have had some success in defeating such claims early based on arguing that statements about DEI initiatives were non-actionable puffery, forward-looking, or otherwise non-actionable.[9] However, in *Craig v. Target Corp*., the plaintiffs' Section 10(b) claim survived a motion to dismiss based on allegations that Target misleadingly downplayed or failed to warn shareholders of known risks of customer backlash associated with Target's "Pride Month" campaign in June 2023.[10]

As companies face increasing scrutiny of allegedly "illegal" DEI practices, courts may view the shareholders' theories advanced in *Target* to be increasingly plausible. Indeed, in their January 27 letter, 19 states' attorneys general urged Costco to "do the right thing by following the law and repealing its DEI policies," adding that "Costco's refusal to step away from discriminatory practices not only risks lawsuits but also jeopardizes the trust of its customers, employees, and investors." This type of government action—or associated employment discrimination litigation, customer complaints, supplier problems, or other issues linked to disputes over DEI—may lay the groundwork for more shareholder claims alleging that DEI programs created undisclosed litigation, reputational, and financial risks.

Derivative Litigation. Investors have also pursued DEI-related claims on a derivative basis, alleging that company officers and directors betrayed their fiduciary duties, wasted corporate assets, and otherwise harmed the company through misguided DEI efforts. Many of these cases preceded the current climate and indeed alleged a failure to adequately implement DEI, rather than excessive or "illegal" DEI practices. Those cases have often been dismissed for failure to show demand futility, on other procedural grounds, or for otherwise failing to state a claim.[11] But as companies face potential investigations, fines, settlements, or other litigation and regulatory exposure, derivative claims are likely to persist and will present risk.

Activism/Books and Records Demands. Section 220 demands have been on the rise in recent years, and shareholders can also demand a company's books and records to investigate DEI-related activities, which could later be used as evidence in litigation. In *Simeone v. Walt Disney Co*., the court held that mere disagreement with a business judgment, like a corporation's decision to take a political position, is not "evidence of wrongdoing" warranting Section 220 inspection.[12] However, Delaware courts may be more likely to find a credible basis for potential "wrongdoing or mismanagement" warranting a books and records inspection if a corporation's DEI initiatives are perceived to violate federal regulations or otherwise pose risks of civil or criminal investigations in view of policies promulgated by the administration.

Additionally, shareholder proposals targeting social issues have become increasingly popular.[13] All indications are that the trend will continue. This is yet another possible battleground for disputes with shareholders over DEI.

KEY TAKEAWAYS AND RECOMMENDATIONS

- Disclosures must reflect corporate practices. Companies have responded to the changing DEI landscape in different ways when it comes to their public disclosures. Many are carrying out audits, reviews, and revisions of their DEI-related programming and policies. In that process, some companies have stripped mention of DEI-related terminology or perceived buzzwords from their disclosures. Others have added more specific risk disclosures addressing risks of reputational harm, litigation, or regulatory scrutiny concerning the company's actual or perceived DEI practices or compliance with evolving DEI-related requirements. The most important thing is for the company's disclosures to match its practices. A significant change in how a company publicly discusses DEI will invite risk if its internal practices have not similarly changed.
- Disclosures should specify particular risks. As a general matter, more robust and more specific risk disclosures are likely to serve a company well in defending against investor claims. *Target* demonstrates that DEI-related risk

disclosures will not guarantee success at the motion to dismiss stage; however, if a company is aware of specific, DEI-related risks, a matching risk disclosure is likely to serve as a powerful defense—certainly more so than nondisclosure. To be sure, simply insofar as companies continue to pursue DEI-related policies, that in itself may constitute a risk for the companies to consider disclosing, depending on the circumstances.

- Where possible, identify DEI-related statements as forward-looking. Companies should endeavor to properly identify DEI-related statements as forward-looking or opinions to the extent they are subjective, aspirational, and/or aimed toward the future. All such statements should be clearly identified as such.
- Ensure proper oversight relating to DEI risks. Company management and directors need to ensure they are appropriately supervising DEI-related risks and that their oversight is described accurately in the company's proxy statement and other disclosures.

If you have any questions regarding this or related subjects or if you need assistance, please contact the authors of this article, Joe Motto, Kerry Donovan, and Claire Reitan, your Winston & Strawn relationship attorney, or any member of the DEI Compliance Task Force.

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[1] https://www.winston.com/en/insights-news/navigating-dei-under-the-trump-administration-key-considerations-for-employers

[2] *All. for Fair Bd. Recruitment v. Sec. & Exch. Comm'n*, 125 F.4th 159 (5th Cir. 2024).

[3] *SEC Issues New Strategic Plan for Diversity, Equity, Inclusion, and Accessibility* (Sept. 18, 2023), https://www.sec.gov/newsroom/press-releases/2023-183.

[4] *SEC Invites Regulated Entities to Submit Self-Assessments of Diversity Policies and Practices* (June 5, 2024), https://www.sec.gov/newsroom/press-releases/2024-68.

[5] *See id*.

[6] *A Mission for Inclusion: In Conversation with Gary Gensler*, https://www.sec.gov/sec-stories/mission-inclusion-conversation-gary-gensler.

[7] *See, e.g.*, *Lee v. Fisher*, 70 F.4th 1129 (9th Cir. 2023); *City of Pontiac Police & Fire Ret. System v. Jamison*, 2022 WL 884618 (M.D. Tenn. Mar. 24, 2022).

[8] *Craig v. Target Corp*., 2024 WL 4979234 (M.D. Fla. Dec. 4, 2024); *Simeone v. Walt Disney Co.*, 2023 WL 4208481 (Del. Ch. June 27, 2023).

[9] *See, e.g.*, *HRSA-ILA Funds v. Adidas AG*, 745 F. Supp. 3d 1127 (D. Or. 2024).

[10] *Target Corp*., 2024 WL 4979234.

[11] *See In re Danaher Corp. Shareholder Derivative Litig*., 549 F. Supp. 3d 59 (D.D.C. 2021) (dismissing plaintiffs' claims because they failed to show the statements were knowingly false under § 14(a) and failed to show that lack of diversity on the board was the cause of a corporate loss, and for failure to plead demand futility); *Foote v. Mehrotra*, 2023 WL 7214728 (D. Del. Nov. 2, 2023) (failure to meet the requirements of demand futility); *Ocegueda on behalf of Facebook v. Zuckerberg*, 526 F. Supp. 3d 637 (N.D. Cal. 2021) (dismissing claims because, among other things, plaintiff failed to plausibly plead demand futility); *Jamison*, 2022 WL 884618.

[12] *Walt Disney Co*., 2023 WL 4208481.

[13] Ishan Bhabha, Anne Cortina Perry, & Annie Kastanek, *Shareholders Pose Growing Risks to Companies' DEI Initiatives*, HLS Forum on Corp. Governance (Nov. 16, 2023), https://corpgov.law.harvard.edu/2023/11/16/shareholders-pose-growing-risks-to-companies-dei-initiatives.

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