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Federal Court Dismisses Derivative Complaint Seeking to Impose ESG Initiatives on a Public Company

By Rick Horvath, Peter Stone & Edward Han

In the past year, there has been a concerted effort by certain plaintiff firms to weaponize environmental, social, and governance ("ESG") principles to attack corporate boards. On March 19, 2021, the United States District Court for the Northern District of California in *Ocegueda v. Zuckerberg*, Ca. No. 3:20-cv-04444-LB (N.D. Cal. Mar. 19, 2021), struck a blow against these efforts by granting defendants' motion to dismiss. In dismissing plaintiff's complaint, the Court applied fundamental principles of corporate law which set a high pleading bar a plaintiff must clear to impose ESG initiatives on a public company through litigation. Hopefully, courts will continue to carefully apply these principles to deter this litigation strategy. Indeed, the adoption of ESG initiatives is fundamentally a business decision involving the board of directors and the stockholders, a decision that does not belong in the courtroom.

Background

In the second half of 2020, numerous complaints were filed in federal courts across the country, generally asserting that the boards of directors of defendant public companies (1) breached their fiduciary duties by failing to nominate a diverse set of candidates for election to the board of directors, in contravention of the companies' statements in favor of diversity, (2) breached their fiduciary duties by ignoring red flags of allegedly unlawful discriminatory employment practices within their organizations, and/or (3) violated the federal proxy laws and regulations by failing to disclose the companies' allegedly discriminatory practices in the companies' annual proxy statements seeking the election of the directors. These claims were derivative in nature, and sought both to recover damages for the corporations on whose behalf the complaints were purportedly brought and to impose corporate governance reforms.

Because these claims were derivative, plaintiffs were required to either first make a pre-litigation demand on the boards of directors of these companies to initiate litigation or plead particularized facts demonstrating such a demand would be futile. In each case, plaintiffs asserted demand would be futile. Perhaps tellingly, plaintiffs in these cases avoided filing their complaints in the Delaware Court of Chancery even though many of the corporations at issue had forum provisions in their constitutional documents requiring derivative claims and claims for breach of fiduciary duty to be brought in the Delaware court.

Applying Basic Principles of Corporate Law, the District Court Dismisses the First of these ESG Actions.

In the *Ocegueda* matter, the Court applied black letter law to dismiss plaintiff's complaint on several grounds.

First, regarding plaintiff's failure to plead demand futility, the Court noted, among other things, that plaintiff's "broad" allegations and conclusions "did not state facts specific to each director 'demonstrating that at least half of them could not have exercised business judgment in responding to a demand.'" *Ocegueda*, Slip Op. at 11 (quoting *Towers v. Iger*, 912 F.3d 523, 539 (9th Cir. 2018)). It also did not benefit plaintiff that the Court found plaintiff's conclusory allegations of the company's lack of diversity on the board of directors and in senior management were contradicted by the actual record of the board's composition and nomination process. *Id.* at 10.

Second, the Court gave an alternative basis for dismissing the state law breach of fiduciary duty claims: the company's Restated Certificate of Incorporation mandated those claims to be brought in the Delaware Court of Chancery. The Court severed those state law claims, even though the plaintiff purchased her shares before the forum provision was adopted, because the forum provision was adopted before the claims accrued. *Ocegueda*, Slip Op. at 14-15. The Court further noted, but did not decide, that the forum provision would appear to bar plaintiff's derivative claims for violation of the federal proxy laws. *Id.* at 14 & n.33.

Third, and finally, the Court held that the plaintiff failed to plausibly plead a violation of the federal proxy laws and regulations. In dismissing these proxy claims, the Court recognized that the statements by the corporation and its board of directors in support of diversity were either puffery or merely aspirational and, therefore, immaterial and non-actionable. In addition, as noted above, the Court found the complaint's broad allegations were insufficient to plead widespread misconduct. The Court further held that the alleged harms—compensation paid to directors and the retention of executives—was not caused by the stockholders' annual vote to elect the members of the board. The proxy, thus, was not an essential link for the alleged harms.

As is common practice in the Ninth Circuit, the Court granted plaintiff leave to amend the federal claims while also permitting plaintiff the opportunity to re-file the state law claims in Delaware. We will continue to follow the progress of this case and report on any further developments.

Impact on ESG Litigation

While not entirely foreclosing further attempts by plaintiffs to impose ESG initiatives on corporations through the litigation process, the *Ocegueda* decision demonstrates the difficulty of using litigation for such ends. Indeed, as we previously wrote, the adoption of ESG initiatives is inherently a business decision subject to the business judgment rule. Absent a legal mandate, a board of directors is not required to pursue any particular ESG initiative.[1] A board, however, is still answerable to the stockholders, who have the franchise to vote or withhold their votes at the annual election of directors if the stockholders are dissatisfied with the board's commitment to environmental or social concerns, for example.

As a result, the adoption of ESG initiatives is part of an ongoing dialogue between boards of directors and investors about the best path forward for public companies. Because that dialogue is ongoing, it would be premature for the courts to step in and impose ESG initiatives at the outset. While the *Ocegueda* decision did not have to consider how the plaintiff's claims would upset this dialogue, the decision nonetheless confirms the significant hurdles plaintiffs should face when they attempt to use litigation to address ESG concerns.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Palo Alto

Edward Han
1.650.320.1813
edwardhan@paulhastings.com

Peter M. Stone
1.650.320.1843
peterstone@paulhastings.com

San Francisco

Rick S. Horvath
1.415.856.7072
rickhorvath@paulhastings.com

[1] While legal mandates related to ESG initiatives are becoming more common, *see*, *e.g.*, SB 826 and AB 979 (California laws mandating board diversity), as a matter of corporate law, the ability to impose legal liability on directors for alleged corporate misconduct remains difficult for plaintiffs to plead and prove.