

Client Alert: Shareholders Pose Growing Risks to Companies' DEI Initiatives

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Shareholder activism, in the form of proposals, books and records demands, and litigation, is proving to be an increasingly prevalent tool in challenges to diversity, equity, and inclusion (DEI) policies. This client alert focuses on two types of shareholder activism gaining traction: shareholder proposals and shareholder litigation.

Activist shareholder groups have begun blanketing public companies with environmental, social, and corporate governance (ESG) proposals, implicating a wide array of issues from forced labor^[1] to abortion access^[2] to climate change.^[3] Initiatives addressing DEI efforts constitute a significant share of these social proposals. For example, recent shareholder proposals have demanded that companies audit “the Company’s impacts on civil rights and non-discrimination,”^[4] provide a “report to shareholders on the effectiveness of the Company’s diversity, equity, and inclusion efforts,”^[5] or adopt board-selection processes designed to increase diverse candidates.^[6] Over the last two years, these proposals have been increasing in quantity, and more of them are reaching a shareholder vote, in light of recent changes at the Securities and Exchange Commission (SEC).

Relatedly, shareholders—including several of these same activist shareholder groups submitting proposals—have begun filing suits seeking companies’ books and records or alleging breaches of fiduciary duty when companies espouse (or, conversely, insufficiently pursue) DEI goals. This trend may be accelerated as shareholders use the Supreme Court’s recent decision in *Students for Fair Admissions v. Harvard* to argue that DEI programs pose litigation risks and must be disclosed or discontinued.

Together, these trends underscore that shareholders have become key players when it comes to corporate DEI efforts and they can constitute a meaningful source of legal risk for companies with respect to DEI, regardless of the path they choose to chart.

Shareholder Proposals

Before a public company’s annual or special meeting of shareholders, shareholders have the ability to submit shareholder proposals, which are recommendations or requirements that the company or

its board of directors take a given action.^[7] The company then must determine whether to include the proposal in its proxy statement disseminated prior to the meeting; companies are required to include shareholder proposals provided they are procedurally proper and do not fall within one of several exceptions identified by the SEC.^[8]

These proposals have teeth: Once a proposal has been submitted, a company can face securities liability if it declines to include the proposal in its proxy materials and put the proposal up for a shareholder vote. And if the proposal passes, the company could be required to undertake a costly and publicly scrutinized audit^[9] or otherwise publicize information it would rather retain the option not to disclose.^[10]

Traditionally, shareholder proposals have focused on corporate governance issues. For example, shareholders commonly seek to curb executive pay, remove poison pills, declassify boards, and require the adoption of annual director elections by majority vote.^[11] In recent years, however, shareholder proposals on ESG-related topics have grown significantly in number, and activist groups on both sides of the issue have identified shareholder proposals as a powerful tool for pursuing their goals. Organizations filing these proposals take the view that these proposals will improve share value at the companies, for example because “boards that incorporate diverse perspectives can think more critically and oversee corporate managers more effectively.”^[12]

In the first half of 2022, social proposals jumped from 99 (in 2021) to 215 (2022), constituting roughly 40% of all shareholder proposals.^[13] In the first half of 2023, ESG proposals remained high, constituting roughly 35% of all shareholder proposals.^[14] And even as some DEI-related proposals declined in 2023 (for example, racial and civil rights audits), proposals seeking reports on the effectiveness of DEI efforts have increased in 2023, with 34 such proposals submitted in the 2023 proxy season.^[15] Meanwhile so-called “anti-ESG” proposals have grown by over 400% since 2020,^[16] with more than four dozen on track for votes in 2023.^[17] Recent changes to SEC policy have also increased the share of DEI-related proposals that successfully make it to a shareholder vote. In November 2021, the SEC announced that proposals that “raise issues with a broad societal impact, such that they transcend the ordinary business of the company” *must* be included in proxy materials.^[18] This change has significantly increased the rate at which ESG proposals (including those related to DEI initiatives) have made it to a shareholder vote. In 2021, nine proposals calling for racial equity or civil rights audits made it to a vote, and all failed. In 2022, 26 such proposals made it to a vote, and nine passed.^[19]

By way of example, As You Sow, an organization that describes itself as “empowering shareholders to change corporations for good,”^[20] has filed numerous shareholder proposals asking major corporations to, among other things, publicize “quantitative data on workforce composition and recruitment, retention, and promotion rates of employees by gender, race, and ethnicity.”^[21] Others

have submitted proposals asking companies to divulge “whether the Company participates in compensation and work force practices that prioritize Company financial performance over the economic and social costs and risks created by inequality and racial gender disparities” and urging companies to eliminate racial and gender disparity in pay.^[22] And still others have submitted proposals asking companies to “adopt a policy to encourage greater diversity for the board by requiring that the initial lists of candidates from which new management-supported director nominees ... that are chosen by the board ... should include qualified diverse candidates.”^[23]

On the other end of the spectrum, anti-DEI proposals are growing rapidly as well, with repeat players taking on a large role. The National Center for Public Policy Research, a self-described conservative think tank, has submitted multiple shareholder proposals suggesting that DEI efforts have a negative effect on white employees. For example, in one proposal submitted to Disney, shareholders requested that Disney commission a non-discrimination audit analyzing the impacts of Disney’s anti-racist employee training and arguing that such trainings are “themselves deeply racist and otherwise discriminatory.”^[24]

Shareholder Litigation

Shareholders can also resort to litigation to pursue their DEI goals, and indeed many shareholder groups from both sides of the ideological spectrum have done so recently.

DEI’s supporters have filed scores of lawsuits alleging that companies are falling short of their pledges to increase DEI efforts.^[25] For example, Wells Fargo has faced multiple shareholder class actions alleging that it violated the Securities Exchange Act of 1934 and Rule 10b-5.^[26] In one such suit, plaintiffs alleged that although Wells Fargo pledged that at least 50% of its interview candidates for most posted US roles above a certain salary would come from a historically underrepresented group, Wells Fargo conducted only “sham” interviews of diverse candidates.^[27] According to shareholders, Wells Fargo’s duplicity caused its share price to drop.^[28] The Northern District of California dismissed the suit (with leave to amend) roughly a year later,^[29] and plaintiffs filed their amended complaint three weeks later.^[30] A motion to dismiss hearing is set for January 30, 2024.^[31]

DEI opponents likewise have pursued shareholder litigation to accomplish their goals. For instance, the National Center for Public Policy Research (a repeat player in the shareholder proposal space) has sued Starbucks and its officers and directors, alleging that Starbucks’s commitment to DEI violates multiple statutes, among them the Civil Rights Act of 1866 (42 U.S.C. § 1981), Title VII of the Civil Rights Act (42 U.S.C. § 2000e-2), and various state civil rights statutes, and that these initiatives also breach Starbucks’s fiduciary obligations to their shareholders.^[32] The court dismissed the complaint on September 11, 2023.^[33] And earlier this year, America First Legal, a conservative legal organization involved in several anti-DEI lawsuits, filed a complaint on behalf of

an investor against Target alleging securities fraud violations and alleging a loss in share value due to Target's LGBTQ-themed merchandise.^[34]

Shareholders have also demanded companies' books and records—a request that is often a prelude to litigation—to investigate corporate DEI-related activities.^[35] These demands seek to evaluate the corporation's conduct and affairs and allege negative effects on the companies' financial condition from these commitments.^[36] When corporations have sought to withhold these records, arguing that the shareholders lack a proper purpose, the shareholders have gone so far as to sue to compel the production of that information, in the process arguing that these public commitments violate the corporations' fiduciary duties to their shareholders.^[37]

Key Takeaways

DEI is an important consideration for companies, boards, and shareholders, implicating far more than just abstract social policy. Adoption (or non-adoption) of various DEI proposals can have serious consequences for a company's bottom line, including in terms of public perception and workforce turnover. Shareholder activism shows no sign of obsolescence as a tool in the DEI arena. Here are actions we recommend corporations take:

1. Monitor the rapidly changing legal environment with respect to DEI-related shareholder proposals. The SEC is regularly issuing letters in response to these shareholder proposals that could provide additional assistance to corporations assessing whether to include such proposals in their proxy materials.^[38] Corporations should stay abreast of the trends in these proposals, as well as SEC approaches to them.
2. If you receive a DEI-related shareholder proposal, retain legal counsel to assess the proposal and whether it qualifies for any exemptions to inclusion in the proxy materials. Proposals that are overly broad or unduly intrusive into business decisions may sometimes be excluded, sparing companies significant legal risk.^[39]
3. Review internal policies regarding diversity initiatives, particularly as they pertain to the hiring of corporate officers and directors. These proposals, suits, and books and records demands underscore that even internal policies and practices could be subject to disclosure. Moreover, companies receiving government funds and subject to Title VI should exercise additional caution in reviewing for compliance in light of the Supreme Court's recent decision in *Students for Fair Admissions*, as that statute may give challengers a legal hook to argue the applicability of *Students for Fair Admissions* to corporate conduct. Even beyond Title VI, shareholders may argue that, in light of *Students for Fair Admissions*, DEI programs could pose material litigation risk that must be disclosed.

4. Review public statements regarding DEI commitments, including those on public-facing websites, in securities filings, and elsewhere to ensure they are up-to-date, accurately reflect the company’s DEI program, and compliant with the law.
5. Consider the risks both of committing to DEI efforts, as well as retreating from DEI commitments; activist shareholder actions target both sides of the issue. Regularly reassess compliance with the evolving law governing DEI initiatives and commitments.

Footnotes

[1] Letter from U.S. SEC, Div. of Corp. Fin., to Sam Whittington, Apple, Inc. (Dec. 20, 2021), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2021/saksapple122021-14a8.pdf>.

[2] Lowe’s, *Notice of Annual Meeting and Proxy Statement 2022* at 73 (2022), <https://corporate.lowes.com/sites/lowes-corp/files/2022-04/Lowes-2022-Proxy-Statement.pdf#page=87>.

[3] Letter from U.S. SEC, Div. of Corp. Fin., to Brian V. Breheny, Counsel to JPMorgan Chase & Co. (Mar. 25, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/sierrajpmorgan032522-14a8.pdf>; Letter from U.S. SEC, Div. of Corp. Fin., to Ning Chiu, Counsel to Morgan Stanley (Mar. 25, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/sierramorgan032522-14a8.pdf>.

[4] Letter from U.S. SEC, Div. of Corp. Fin., to Michael Kaplan, Counsel to Meta Platforms, Inc. (Apr. 2, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/ncpprmeta040222-14a8.pdf>.

[5] Letter from U.S. SEC, Div. of Corp. Fin., to Margaret M. Madden, Pfizer Inc. (Feb. 10, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/leventhalwaltonpfizer021022-14a8.pdf>; Letter from U.S. SEC, Div. of Corp. Fin., to Sarkis Jebejian, Counsel to Eli Lilly & Co. (Mar. 10, 2023), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2023/overwaylilly031023-14a8.pdf> (same); *see also* Letter from U.S. SEC, Div. of Corp. Fin., to W. Scott Seeley, NextEra Energy, Inc. (Mar. 4, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/youngnextera030422-14a8.pdf> (seeking report on “the outcomes of the Company’s diversity, equity, and inclusion efforts”).

[6] Letter from U.S. SEC, Div. of Corp. Fin., to Brian V. Breheny, Counsel to JPMorgan Chase & Co. (Mar. 17, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/nlpcjpmorgan031722-14a8.pdf>.

[7] SEC Rule § 240.14a-8, <https://www.sec.gov/divisions/corpfin/rule-14a-8.pdf>.

[8] *Id.* at (i) (Question 9).

[9] In 2022, racial equity or civil rights audit proposals passed at companies such as McDonald’s, Johnson & Johnson, and Home Depot. *See* Brigid Rosati et al., *2022 Investor Voting Report*, Harv. L. Sch. F. on Corp. Governance (Feb. 14, 2023), <https://corpgov.law.harvard.edu/2023/02/14/2022-investor-voting-report/>.

[10] Although the majority of such proposals are “precatory”—in other words, nominally non-binding—the guidelines of the largest and most influential proxy advisory firms require companies to act upon shareholder resolutions that pass, lest the board face

opposition in subsequent director elections or other shareholder backlash. See Kobi Kastiel & Yaron Nili, *In Search of the “Absent” Shareholders: A New Solution to Retail Investors’ Apathy*, 41 Del. J. Corp. L. 55 (2016).

[11] Kosmas Papadopoulos, *The Long View: The Role of Shareholder Proposals in Shaping U.S. Corporate Governance (2000-2018)*, Harv. L. Sch. F. on Corp. Governance (Feb. 6, 2019), <https://corpgov.law.harvard.edu/2019/02/06/the-long-view-the-role-of-shareholder-proposals-in-shaping-u-s-corporate-governance-2000-2018/>; see also Renee Jones, SEC, Address at Council of Institutional Investors: *the Shareholder Proposal Rule: A Cornerstone of Corporate Democracy* (Mar. 8, 2022), <https://www.sec.gov/news/speech/jones-cii-2022-03-08>.

[12] See Letter to Brian V. Breheny at attachment, *supra* note 6.

[13] Tom P. Skulski & Glenn O’Brien, *2022 Proxy Season—Shareholder Proposal Review*, Harv. L. Sch. F. on Corp. Governance (Oct. 3, 2022), <https://corpgov.law.harvard.edu/2022/10/03/2022-proxy-season-shareholder-proposal-review/>.

[14] ISS Corp. Solutions, *U.S. Shareholder Proposals Jump to a New Record in 2023*, (May 24, 2023), <https://www.isscorporatesolutions.com/library/us-shareholder-proposals-jump-to-a-new-record-in-2023/#:~:text=Among%20Social%20topics%2C%20DEI%20tops,or%20civil%20rights%20equity%20audits>.

[15] David A. Bell & Ron C. Llewellyn, *What’s Next for Diversity Shareholder Proposals? A Look at Recent Trends*, Mondaq (Sept. 22, 2023), <https://www.mondaq.com/unitedstates/diversity-equity--inclusion/1369064/whats-next-for-diversity-shareholder-proposals-a-look-at-recent-trends>.

[16] *Id.*

[17] Heidi Welsh, *Anti-ESG Shareholder Proposals in 2023*, Harv. L. Sch. Forum on Corp. Governance (June 1, 2023), <https://corpgov.law.harvard.edu/2023/06/01/anti-esg-shareholder-proposals-in-2023/>.

[18] Press Release, SEC, *Shareholder Proposals: Staff Legal Bulletin No. 14L (CF)* (Nov. 3, 2021), <https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals>.

[19] Skulski & O’Brien, *supra* note 13.

[20] As You Sow, <https://www.asyousow.org> (last accessed Oct. 3, 2023).

[21] See Letter to W. Scott Seeley, *supra* note 5; see also Letter to Sarkis Jebejian, *supra* note 5 (similar).

[22] Letter from U.S. SEC, Div. of Corp. Fin., to Jennifer H. Noonan, Counsel to Tractor Supply Co. (Mar. 9, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/mcritchietractor030922-14a8.pdf>.

[23] Letter to Brian V. Breheny, *supra* note 6.

[24] See, e.g., Letter from U.S. SEC, Div. of Corp. Fin., to Lillian Brown, Counsel to The Walt Disney Co. at attachment (Jan. 19, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/ncpprwaltdisney011922-14a8.pdf>.

[25] See David Hood, *Lawsuits Challenge Corporate Diversity Pledges After Floyd*, Bloomberg Law (Apr. 7, 2023), <https://news.bloomberglaw.com/esg/host-of-companies-sued-alleging-unmet-diversity-equity-pledges> (identifying 40 suits filed between 2020 and 2023 because of allegedly misleading statements about DEI commitments).

[26] *Id.*; *see, e.g.*, Complaint, *Ardalan v. Wells Fargo & Co.*, No. 22-cv-3811 (N.D. Cal. June 28, 2022), ECF No. 1.

[27] *See generally* Complaint, *Ardalan*, No. 22-cv-3811.

[28] *See id.*

[29] Order Granting Motion to Dismiss, *id.* (N.D. Cal. Aug. 18, 2023), ECF No. 112.

[30] Amended Complaint, *id.* (N.D. Cal. Sept. 8, 2023), ECF No. 116.

[31] Minute Entry, *id.* (N.D. Cal. Oct. 5, 2023), ECF No. 120.

[32] *See* Complaint, *Nat'l Ctr. For Pub. Pol'y Rsch. v. Schultz*, No. 22-cv-267 (E.D. Wash. Nov. 7, 2022), ECF No. 1-2.

[33] Order, *id.* (E.D. Wash. Sept. 11, 2023), ECF No. 35.

[34] *See* Complaint, *Craig v. Target Corp.*, No. 23-cv-599 (M.D. Fla. Aug. 8, 2023), ECF No. 1.

[35] *See* Letter from Gene Hamilton, America First Legal, to Target Corp. re: Demand to Inspect Books and Records of Target Corporation Under Minnesota Stat. Ann. 302A.461 (June 6, 2023), https://media.aflegal.org/wp-content/uploads/2023/06/06134129/06062023-Target-Demand-Letter.pdf?_ga=2.125187466.1634202524.1688330939-37909907.1688330939 (seeking Target's books and records to assess Target's "diversity targets," commitment to LGBTQ rights, and sale of purportedly "anti-Christian imagery").

[36] *Id.*

[37] *See, e.g., Simeone v. The Walt Disney Co.*, No. 2022-1120, __ A.3d __, 2023 WL 4208481 (Del. Ch. Ct. June 27, 2023) (suit demanding Disney's books and records and alleging that Disney's public opposition to Florida's "Don't Say Gay" bill was a breach of fiduciary duty).

[38] *See, e.g.*, Letter to Margaret M. Madden, *supra* note 5.

[39] *See, e.g.*, Letter from U.S. SEC, Div. of Corp. Fin., to Todd E. Davies, Deere & Co. (Jan. 3, 2022), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/ncpprdeere010322-14a8.pdf>.

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