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RECENT DEVELOPMENTS IN SHAREHOLDER DERIVATIVE LITIGATION CONCERNING DIVERSITY IN CORPORATE LEADERSHIP

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The Situation: A number of shareholder derivative lawsuits in federal court have been filed seeking to hold directors and officers of major companies accountable for alleged failures to uphold their companies' stated commitment to diversity and inclusion. While additional cases continue to be filed, courts have granted motions to dismiss in several early cases.

The Result: Multiple defendants have won motions to dismiss on the procedural grounds that forum-selection clauses mandate that shareholder derivative claims be brought in the Delaware Court of Chancery. One defendant won a motion to dismiss on substantive grounds because of shortcomings in plaintiff's claims under Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act").

Looking Ahead: So far, plaintiffs in these actions have not had much success. But all it takes is one case to survive a motion to dismiss for plaintiffs to validate their legal strategy. At the same time, environmental, social, and governance ("ESG") issues remain an area of scrutiny, as evidenced most recently by the U.S. Securities and Exchange Commission's ("SEC") focus on ESG disclosures, under Chair Gary Gensler. As a result, we expect more ESG-based shareholder actions in the future, including with respect to diversity and other social issues.

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Background on Shareholder Diversity Suits

Jones Day has continued to monitor a series of lawsuits filed in federal court since last July, relating to an alleged lack of diversity among corporate leadership. As discussed in our September 2020 Commentary,[1] these lawsuits generally allege that defendant officers and directors made material misstatements and omissions to investors regarding their companies' professed commitment to achieving and maintaining diversity and inclusion. According to the lawsuits, the alleged lack of diversity demonstrates that defendants have made no real efforts to achieve diversity and inclusion.

Since our last Commentary, four additional lawsuits have been filed in California. Like the six previously filed actions, these lawsuits have been filed against large public companies, primarily by the same California-based plaintiffs' law firm. The claims in these recent suits are similar to the ones from the earlier cases, including alleged violations of Section 14(a) of the Exchange Act for material misstatements in annual proxy statements, and claims against the companies' directors and officers alleging that they violated their fiduciary duties by failing to achieve diversity and inclusion.

Legal Implications

While new lawsuits continue to be filed, defendants in several cases have won motions to dismiss on various grounds. Most notably, in March 2021, Northern District of California Magistrate Judge Laurel Beeler granted Facebook's motion to dismiss plaintiff's claim under Section 14(a) of the Exchange Act on the grounds that plaintiff (i) failed to make a pre-suit demand or plead demand futility with particularity, and (ii) failed to plead an actionable false statement. With respect to the latter holding, Judge Beeler found that defendants' statements regarding diversity in the company's proxy statements were aspirational, and thus nonactionable. Judge Beeler also found that plaintiff did not adequately allege facts sufficient to support a claim of widespread unlawful practices because the factual allegations were largely incorrect. Plaintiff also failed to identify any basis for inferring that the diversity-related statements formed an essential link to a loss-generating corporate action. The court also severed the Section 14(a) claim from the ac-

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companying state law claims and dismissed the state law claims under *forum non conveniens* because Facebook's forum-selection clause in its certificate of incorporation required the derivative action to be filed in the Delaware Court of Chancery.

In May, Oracle also won its motion to dismiss on similar grounds. Northern District of California Magistrate Judge Jacqueline Scott Corley dismissed plaintiffs' Section 14(a) claim because plaintiffs did not make a pre-suit demand and failed to allege demand futility with particularity. Specifically, Judge Corley found that plaintiffs failed to plead particularized facts supporting an inference that the challenged statements were false or misleading given that the aspirational statements in question were not capable of objective verification. Therefore, plaintiffs failed to plead that any director faced a substantial likelihood of liability. Additionally, like the Facebook case, the Section 14(a) claim was severed from the state law claims, and the state law claims were dismissed under *forum non conveniens* because Oracle's bylaws included a forum-selection clause requiring derivative actions to be brought in the Delaware Court of Chancery.

The Gap won its motion to dismiss in April on narrower grounds. There, Northern District of California Magistrate Judge Sallie Kim dismissed plaintiff's Section 14(a) claim and related state law claims under *forum non conveniens* because The Gap had a forum-selection clause in its bylaws requiring derivative actions to be filed in the Delaware Court of Chancery. Judge Kim found that plaintiff failed to demonstrate that enforcing the forum-selection clause against the Section 14(a) claim would contravene a strong public policy of the Northern District of California. Judge Kim did not discuss plaintiff's Section 14(a) claims in much detail, but this decision, along with the Facebook and Oracle decisions, may indicate an emerging pattern. The forum-selection clauses in these cases have been clear, resulting in a major hurdle for plaintiffs. Coupled with an inability to meet the pleading requirements associated with Section 14(a) claims, we expect plaintiffs to continue to be dismissed out of federal court, barring a change in strategy.

Despite these and other early successes, companies should remain focused on ESG disclosures, especially given recent indications from SEC Chair Gary Gensler. The SEC has made it clear that it believes ESG reporting is important, and that it deems arguments in favor of a single global ESG reporting framework as persuasive. An overhaul of the ESG disclosure framework may very well prompt a wave of similar lawsuits focusing on potential forms of liability for company leadership related to diversity and other ESG-related goals.

Three Key Takeaways

1. Defendants are finding early success in their motions to dismiss. Plaintiffs have largely been unable to circumvent forum-selection clauses and have similarly not had much luck in pursuing Section 14(a) claims.

2. This is not to say that plaintiffs will never be able to survive early motion practice. With increasing opportunities to pursue these claims, plaintiffs may ultimately find the right mix of facts and judicial forums to get their claims past motions to dismiss.

3. Companies should keep a close eye on their ESG disclosures, as well as any developments related to ESG reporting reforms. Despite early wins for several defendants, shareholder derivative litigation concerning

diversity has shown no signs of slowing down. Indeed, such litigation will likely increase as companies face increasing pressure from various stakeholders to set and meet more tangible diversity and other ESG targets, and if ESG disclosure reform is implemented. We anticipate more ESG-based shareholder actions in the future.

The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

ENDNOTES:

[1] https://www.jonesday.com/en/insights/2020/09/shareholder-derivative-litigation-concerning-diversity-in-corporate-leadership-is-an-emerging-trend.

PRIVATE EQUITY FIRMS CONTINUE TO FACE INCREASED RISK OF FCA LIABILITY IN A POST-COVID WORLD

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Private equity ("PE") firms have recently become targets of False Claims Act ("FCA") actions. This new risk faces portfolio companies that do business with the government, which necessarily exposes those portfolio companies to FCA litigation. The companies and their executives have faced this risk for decades. But now, in an environment where fighting corruption has been elevated all the way to national-security status, and with a politically-safe tactic of filling government coffers, the Department of Justice (with assist from whistleblowers) is sinking its hooks into what it and the public may perceive as deep-pocketed PE firms.

General FCA Liability and Recent Trends

The FCA imposes civil liability with significant monetary penalties. Each year the government uses the FCA to recover billions of dollars from individuals and companies that defraud it. Damages can often triple the amount the government paid, with additional penalties for each submitted false claim. The aggregate amount of damages and penalties can quickly add up, resulting in exposure to potential liability that is many times more than the amount initially received from the government.

The Department of Justice ("DOJ") is not the only source for an FCA action. FCA actions may be initiated by private whistleblowers, known as relators in a *qui tam* lawsuit. The government can, but need not, join those suits. Or it could go it alone: In 2020, there was a drastic increase in the number of cases filed directly by the government without a whistleblower, with an increase of almost 69%, likely indicating a trend of government-initiated FCA cases. To that end, government officials will use more robust data analysis to identify or confirm fraudulent use of government money.

Officials have highlighted current enforcement priorities under the FCA, starting with pandemic-related fraud. FCA enforcement of the multiple COVID-19 financial assistance programs created by the federal government, including Provider Relief Funds and the Paycheck Protection Program, has already begun and will almost certainly continue for years to come. Additionally, the federal government will focus on enforcement actions related to the worsening opioid epidemic, fraud targeting the elderly population, electronic health records, telehealth, and cybersecurity.

FCA Liability Specific to Private Equity Firms

Over the past few years, PE firms have gained focus as a source of significant funds to contribute to recovery in FCA actions. Indeed, toward the end of 2020, any for-profit entity that borrowed more than $2 million in Paycheck Protection Program funds was required to disclose whether a PE firm owned more than 20% of its outstanding equity securities. These types of disclosures will make it easier for the government to identify PE firms as potential targets of FCA enforcement.

And the government may not need much help finding its targets. The most recent example of aggressive prosecution against PE firms involves the July 21, 2021, $15.3-million resolution of kickback and false-billing allegations, of which amount $1.8 million was agreed to be paid by a private investment company. The underlying claim was that Alliance Family of Companies, a national medical testing company, induced physicians to order unnecessary tests by giving free interpretation reports of those tests, which, in turn, allowed the physicians to bill the government as if they had done the interpretations themselves.

The government also alleged other billing misconduct by the company. What was the PE firm's part in the scheme—did it help the company with its scheme or somehow encourage it? Apparently not. The PE firm, according to the government, learned of the kickbacks before it made the investment and allowed it to continue after it became a minority shareholder of the company. That was enough to put the PE firm in the government's crosshairs.

The Alliance settlement is part of a trend of the government's pursuit of PE firms for supposed FCA violations. A government official stated that enforcement efforts may target PE firms if their portfolio companies received funds under the CARES Act, noting that "[w]hen a private equity firm invests in a company in a highly-regulated space like health care or the life sciences, the firm should be aware of laws and regulations designed to prevent fraud." The official further noted that "[w]here a private equity firm takes an active role in illegal conduct by the acquired company, it can expose itself to False Claims Act liability." He additionally warned that PE firms will be held accountable if they "knowingly engage[] in fraud related to the CARES Act." If recent cases are any indication—and they should be—then the government appears to have taken a broad view of what "active role" means in this context: something that could approach a negligence standard. If the government believes that the PE firm should have learned of FCA misconduct in its pre-investment due diligence process, and it goes through with the investment, then it assumes liability.

Even before the Alliance settlement and before the CARES Act was passed, PE firms had already paid large settlements. One 2019 case involving a PE firm resulted in a settlement of $21.05 million—with the PE firm contributing an undisclosed amount toward the settlement. Notably, in its press release announcing the settlement, the DOJ highlighted that both the prosecution and end result were a sign of the government's "continuing commitment to hold all responsible parties to account" for submitting false claims to the government. This suggests that PE firms face FCA risk when they are more than just a passive investor in the portfolio company and exert a certain level of control. This is typically demonstrated through active participation on the portfolio company's board of directors (as was true in the Alliance case) or involvement in the day-to-day operations of the portfolio company.

Later, in November 2020, a PE firm paid $1.5 million to settle FCA claims against it, where, as was the case in the Alliance matter, the firm's portfolio company allegedly engaged in improper activities before the PE firm acquired it. Those practices continued after the company's acquisition, which created liability for the PE firm. Therefore, PE firms should be aware that a portfolio company's ongoing improper or fraudulent activity that begins before acquisition can nonetheless result in FCA enforcement actions.

And in 2021, for the first time, an FCA case against a PE firm survived full summary judgment and headed toward trial. Through issuing an opinion, a federal court weighed in on the FCA's legal standards as they apply to PE firms. Most notably, the court confirmed the challenges facing PE firms.

First, it disposed of the scienter element by noting that it could be satisfied by showing that a reasonable jury could conclude the PE firm acted with deliberate ignorance or reckless disregard of the portfolio company's non-compliance.

Second, "if a reasonable person would understand" that certain regulatory compliance conditions are material to receiving government funds, then the plaintiff establishes the materiality element.

Third and finally, a controlling PE firm's "knowing ratification" of its portfolio company's pre-established improper procedures, which continue after the acquisition of the company, can satisfy the causation requirement under the FCA, and that ratification can be shown by the PE firm's participation on the board of the company, as well as having the "power to fix the regulatory violations." Although the case is just the view of one district judge, it shows an uphill battle that PE firms face in attempting to dismiss the case even after engaging in the costly discovery stage.

How to Protect Yourself and Mitigate Risk

It is imperative that PE firms are aware of their portfolio companies that face FCA risk and take action to limit their potential exposure. FCA risk should also be a significant focus of due diligence going forward.

If the portfolio company becomes the subject of a FCA inquiry by the DOJ or other government agency, or is alerted by a whistleblower of potential liability, the initial response is critical and has long-lasting consequences throughout the entire life of the investigation or lawsuit. PE firms should retain experienced counsel versed in FCA law as soon as they become aware of a potential issue to ensure they respond appropriately and effectively. Retention of counsel also a clear message to the government that the company is taking the matter very seriously. It also ensures that the work product and communications during this critical time is privileged and, if matters turn contentious with a plaintiff or the government, would not be viewed as just a business-motivated inquiry.

Suggested Best Practices

- Ensure your portfolio companies that do business with the government have robust and proactive compliance programs that address their industry's specific risk areas. PE firms should promote enforcement of the compliance programs and on-going training. Doing so early on in the acquisition will, at the very least, limit the PE firm's liability.

- Be mindful of how you provide oversight to your portfolio companies, with the understanding that by participating in decision-making you are assuming certain responsibilities.
- If you are concerned about risk from your current portfolio companies, retain experienced counsel to assess those that are a potential threat. Counsel could apprise you of any potential or actual issues and guide you through how to proactively address those issues and mitigate your risk. For new acquisitions, ensure FCA risk is evaluated during the due diligence phase, particularly because courts will almost certainly assume that PE firms gained sufficient knowledge of the issues during the pre-investment stage.
- If you become aware of an issue, either through a whistleblower or through a government investigation, immediately retain experienced counsel to conduct an independent, internal investigation and represent the company through the life of the matter.

REGULATION OF CRYPTOS IN THE U.S. IS BEGINNING TO TAKE SHAPE

By Todd Ehret

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As rapidly as sentiment and prices swing in the highly volatile cryptocurrency markets, so too do the prospects for a more-defined regulatory framework that would add clarity to the booming sector.

In recent weeks there have been several signs that financial regulators have re-emphasized enforcement and rulemaking related to cryptocurrencies. The stepped-up enforcement indicates an intention to quickly rein in abuses and signals regulatory intent, while regulators seek authority to establish a more structured rules environment.

Earlier this year there was widespread expectations for a more-defined and crypto-friendly regulatory framework with the change in leadership in Washington. However, the optimism quickly nosedived after the U.S. Securities and Exchange Commission ("SEC") released its annual regulatory agenda.[1] Noticeably absent was any mention of cryptos.

Prices of bitcoin collapsed over the same period from a high around $62,000 in late April to a low of $29,600 on July 20. Prices have rebounded to around $45,000 in the past several weeks. The price recovery has occurred as the regulatory winds have also shifted.

Over the summer, lawmakers on Capitol Hill called for stricter regulations, SEC Chairman Gary Gensler voiced a need for congressional authorization to act on new regulations, and the SEC and the U.S. Commodity Futures Trading Commission ("CFTC") announced several enforcement actions related to cryptos.

The recent developments signal that although cryptos may not officially be on the SEC rulemaking agenda, they are a high priority.

Gensler's Push for Oversight and Authorization

The crypto industry was enthusiastic and opti-