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# ILE

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RESEARCH PAPER NO. 22-23

# The Making and Meaning of ESG

**Elizabeth Pollman**

*UNIVERSITY OF PENNSYLVANIA CAREY LAW SCHOOL*

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# The Making and Meaning of ESG

Law Working Paper N° 659/2022
October 2022

Elizabeth Pollman
University of Pennsylvania and ECGI

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ECGI Working Paper Series in Law

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For valuable comments and discussions, thanks to Rick Alexander, Doug Chia, Madison Condon, Paul Dickinson, Jared Ellias, Kornelia Fabisik, Jill Fisch, Elisabeth de Fontenay, George Georgiev, Georg Kell, Virginia Harper Ho, Scott Hirst, Ann Lipton, Erik Lidman, Tom Lin, Dorothy Lund, Amelia Miazad, James Nelson, Mariana Pargendler, David Pitt-Watson, Adriana Robertson, Anne Tucker, Ellen Quigley, David Wood, the participants of the Women in Law and Finance Workshop at The Wharton School, the Corporation in Society Workshop at Utrecht University, and the 2022 ECGI Global Corporate Governance Colloquium at Oxford University.

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## Abstract

ESG is one of the most notable trends in corporate governance, management, and investment of the past two decades. It is at the center of the largest and most contentious debates in contemporary corporate and securities law. Yet few observers know where the term comes from, who coined it, and what it was originally aimed to mean and achieve. As trillions of dollars have flowed into ESG-labeled investment products, and companies and regulators have grappled with ESG policies, a variety of usages of the term have developed that range from seemingly neutral concepts of integrating "environmental, social, and governance" issues into investment analysis to value-laden notions of corporate social responsibility or preferences for what some have characterized as "conscious" or "woke" capitalism.

This Article makes three contributions. First, it provides a history of the term ESG that was coined without precise definition in a collaboration between the United Nations and major players in the financial industry to pursue wide-ranging goals. Second, it identifies and examines the main usages of the term ESG that have developed since its origins. Third, it offers an analytical critique of the term ESG and its consequences. It argues that the combination of E, S, and G into one term has provided a highly flexible moniker that can vary widely by context, evolve over time, and collectively appeal to a broad range of investors and stakeholders. These features both help to account for its success, but also its challenges such as the difficulty of empirically showing a causal relationship between ESG and financial performance, a proliferation of ratings that can seem at odds with understood purposes of the term ESG or enable "sustainability arbitrage," and tradeoffs between issues such as carbon emissions and labor interests that cannot be reconciled on their own terms. These challenges give fodder to critics who assert that ESG engenders confusion, unrealistic expectations, and greenwashing that could inhibit corporate accountability or crowd out other solutions to pressing environmental and social issues. These critiques are not necessarily fatal, but are intertwined with the characteristic flexibility and unfixed definition of ESG that was present from the beginning, and ultimately shed light on obstacles for the future of the ESG movement and regulatory reform.

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Keywords: environmental, social, governance, ESG, sustainability, corporate social responsibility, corporate purpose, stakeholder capitalism, socially responsible investment, impact investing, corporate law, securities regulation, SEC, climate disclosure, board diversity, human capital management

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## INTRODUCTION

ESG is at the center of global dialogue on corporate governance, management, and investment. Remarkably, it has "risen from an obscure and niche concept to a widely used term around the world."[1] As the creation and uptake of the term ESG took place gradually, then suddenly, its ubiquity has given way to assumptions that "everyone understands what they are referring to."[2]

ESG as an acronym for "environmental, social, governance" is a common denominator of the discourse using the term, but a deeper examination reveals that little beyond that understanding is fixed. The word that follows the famous refrain of "environmental, social, governance" shapeshifts from "criteria" to "factors," "standards," "strategies," "risks," "issues," "activity," or even "goals." Does ESG refer to "three criteria to evaluate a company's sustainability performance"?[3] Is it a "set of standards for a company's operations that socially conscious investors use to screen potential investments"?[4] Does it "put . . . money to work with companies that strive to make the world a better place"?[5] Or perhaps more broadly is it a new term or synonym for "corporate social responsibility" (CSR) or its cousin "sustainability"? Could the answer be that ESG simultaneously refers to all of the above?

As usage of the term ESG runs the gamut, trillions of dollars flow into ESG-labeled investment products, companies are implementing ESG strategies, and regulators are designing ESG policies. ESG investment currently represents an astounding one third of all professionally managed assets.[6] Views about the performance implications from ESG and the usefulness of ESG evaluations grow increasingly polarized – for some, ESG is seen to have enormous influence on corporate and investor behavior, for others it has none,[7] or worse it is marketing or greenwashing that misleads investors or stakeholders, inhibits corporate accountability, or displaces other concepts and proposed solutions for societal problems.[8] Popular use of the term ESG has even seemed to take on some of

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[1] George Serafeim, *ESG: Hyperboles and Reality*, Harvard Business School Research Paper Series Working Paper 22-031 (Dec. 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3966695.
[2] Serafeim, *supra* note 1. A Google Trend chart shows the ESG term had relatively little worldwide attention from 2004 to 2016 when it began to gradually rise and then explode by 2019. Google Trends, ESG, https://trends.google.com/trends/explore?date=all&q=esg.
[3] Alyce Lomax, *What is ESG Investing & What Are ESG Stocks?*, THE MOTLEY FOOL (May 2, 2022), https://www.fool.com/investing/stock-market/types-of-stocks/esg-investing/.
[4] Environmental, Social, Governance (ESG) Criteria, INVESTOPEDIA (Feb. 23, 2022), https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp.
[5] E. Napoletano & Benjamin Curry, *Environmental, Social And Governance: What is ESG Investing?*, FORBES (Feb. 24, 2022), https://www.forbes.com/advisor/investing/esg-investing/.
[6] Andrew A. King & Kenneth P. Pucker, *ESG and Alpha: Sales or Substance?*, INSTITUTIONAL INVESTOR (Feb. 25, 2022), https://www.institutionalinvestor.com/article/b1wxqznltqnyzj/ESG-and-Alpha-Sales-or-Substance.
[7] Serafeim, *supra* note 1, at 2.
[8] *See, e.g.*, King & Pucker, *supra* note 6 (concluding based on empirical research and interviews with industry practitioners that "flows of money into ESG funds represent a marketing-induced trend that will neither benefit the planet nor provide investors with higher returns – but might defer needed government regulation"); Aswath Damodaran, *ESG's Russia Test: Trial by Fire or Crash and Burn?*, MUSINGS ON MARKETS (Mar. 28, 2022), https://aswathdamodaran.blogspot.com/2022/03/esgs-russia-test-moment-to-shine-or.html ("ESG is, at its core, a feel-good scam that is enriching consultants, measurement services and fund



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these normative views or culture-laden notions that transcend technical ideas of investment screens, financial materiality, reporting, or the like. In common parlance, one regularly hears things such as "startups need ESG,"[9] buying a certain asset class is "not very ESG"[10] or that companies can "be" or "not be" ESG.[11] More colorfully, tech billionaire Elon Musk has exclaimed: "I am increasingly convinced that corporate ESG is the Devil Incarnate."[12]

As varied language and notions around ESG proliferate, this Article endeavors to provide an in-depth examination of the term itself and its implications. Although commonly used, few know where the term comes from, who coined it, and what it was originally aimed to mean and achieve. The first contribution of the Article is thus to provide a history of the term ESG that has been missing from the debate and scholarly literature.[13]

Further, as the term spreads from its origins and takes on diverse meanings, the potential arises for confusion, unrealistic expectations, and co-optation to serve different goals. More simply, participants in the debate about ESG might talk past each other as they use the term to refer to different concepts.[14] Indeed, the rise of ESG has coincided with a renaissance in thinking about corporate purpose and growing interest in sustainability and stakeholder capitalism, adding to the mix of concepts and terminology

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managers, while doing close to nothing for the businesses and investors it claims to help, and even less for society."); THE ECONOMIST, *ESG Should Be Boiled Down to One Measure: Emissions* (July 21, 2022), https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions (arguing that ESG " is often well-meaning" but "risks setting conflicting goals for firms, fleecing savers and distracting from the vital task of tackling climate change" and so "[i]t is an unholy mess that needs to be ruthlessly streamlined").

[9] Edward Robinson, *Startups Need ESG*, QUARTZ (Jan. 17, 2022), https://qz.com/emails/quartz-forecast/2113257/%E2%9C%A6-do-startups-need-esg/.

[10] *See, e.g.*, Oliver Telling, *ESG's Dirty Secret: Is Do-Good Investing Profitable, Or Even Doing Good?*, INVESTORS' CHRONICLE (Mar. 18, 2021), https://www.investorschronicle.co.uk/news/2021/03/18/esg-s-dirty-secret/ (quoting commentary that gold is "not very ESG").

[11] *See, e.g.*, Alan R. Palmiter, *Capitalism, Heal Thyself*, Wake Forest University School of Law Working Paper (Dec. 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3940395 (examining the "effect of being ESG" and the "effect of not being ESG" for companies); David F. Larcker, Brian Tayan & Edward M. Watts, *Seven Myths of ESG*, Stanford Closer Look Series (Nov. 4, 2021), https://www.gsb.stanford.edu/faculty-research/publications/seven-myths-esg (observing "we cannot always tell whether an initiative is truly ESG").

[12] @elonmusk, Twitter (Apr. 2, 2022, 10:14 PM), https://twitter.com/elonmusk/status/1510485792296210434. The tweet came in reply to one by prominent venture capitalist Marc Andreessen, who perhaps sardonically noted in response to a comparison of energy usage by clothes dryers in the U.S. and bitcoin mining that "Dirty clothes are ESG." *Id.*

[13] *See* Part I *infra*. Scholarly literature to date has not focused on the history of ESG and how it was originally conceived. Recent articles on U.S. and international corporate governance systems have notably included brief descriptions of coinage of the term through United Nations initiatives. *See* Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563 (2021) (providing an account of the "complex governance system in the United States composed of law, institutions, and culture that orients corporate decisionmaking toward shareholders"); Mariana Pargendler, *The Rise of International Corporate Law*, 98 WASH. U. L. REV. 1765 (2021) (arguing that "international corporate law" is a solution to "interjurisdictional externalities" and "political capture by domestic interest groups").

[14] *See, e.g.*, King & Pucker, *supra* note 6 ("ESG investing is not precisely defined.").



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in contemporary debates.[15] In a survey of institutional investors, three-quarters of respondents said there is a lack of clarity around ESG terminology.[16] The second contribution of the Article is thus to identify and examine the main usages for the term ESG that have developed over time.

Specifically, the Article finds that ESG was coined to describe a set of issues to be integrated into enhanced financial or investment analysis, and has taken on meanings related to risk management, been treated as a synonym or subset of CSR or sustainability, and characterized as a preference or activity. It has taken on connotations both positive and negative, as value-laden notions of "conscious" versus "woke" capitalism give way to perceptions of ESG as ideological, political, and subject to backlash. Parsing these varied meanings is important for understanding and shaping fiduciary duties, regulatory debate, and legal reforms around the globe as well as discourse in scholarly, political, and business spheres that impact the direction of one of the most significant trends of the twenty-first century.

Finally, as the term has now been in circulation for nearly two decades, it is time for an accounting of the promise and perils of putting E, S, and G together in one term. The third contribution of the Article is therefore an analytical critique of the term ESG and its consequences. It argues that the combination of E, S, and G into one term has provided a highly flexible moniker that can vary widely by context, evolve over time, and collectively appeal to a broad range of investors and stakeholders. These features both help to account for its success as a global phenomenon, but also its challenges such as the ongoing struggle to empirically show a causal relationship between ESG and financial performance, the explosion of ESG ratings that can seem inconsistent with each other or understood purposes of the term, and tradeoffs between important issues that cannot be reconciled without further negotiation or dispute.

Critics seize on these challenges to assert that ESG engenders confusion, unrealistic expectations, and greenwashing that could mislead investors or stakeholders, or crowd out other problem-solving efforts through public channels and democratically-elected representatives. Some additionally argue that ESG politicizes corporate activity or gives corporate boards and executives leeway to pursue their own ideological agendas or increase agency costs.

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[15] For a sampling of literature on corporate purpose, sustainability, and stakeholder capitalism, see RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD (Elizabeth Pollman & Robert B. Thompson eds., 2021); THE CAMBRIDGE HANDBOOK OF CORPORATE LAW, CORPORATE GOVERNANCE AND SUSTAINABILITY (Beate Sjåfjell & Christopher M. Bruner eds., 2020); COLIN MAYER, PROSPERITY (2018); ALEX EDMANS, GROW THE PIE: CREATING PROFIT FOR INVESTORS AND VALUE FOR SOCIETY (2020); REBECCA HENDERSON, REIMAGINING CAPITALISM IN A WORLD ON FIRE (2020); GEORGE SERAFEIM, PURPOSE + PROFIT: HOW BUSINESS CAN LIFT UP THE WORLD (2022); Doug Sundheim & Kate Starr, *Making Stakeholder Capitalism a Reality*, HARV. BUS. REVIEW (Jan. 22, 2020), https://hbr.org/2020/01/making-stakeholder-capitalism-a-reality; Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *Stakeholder Capitalism in the Time of COVID*, YALE J. ON REGUL. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4026803.

[16] Swasti Gupta-Mukherjee, *Climate Action Is Too Big for ESG Mandates*, STAN. SOCIAL INNOVATION REV. (Sept. 29, 2020), https://ssir.org/articles/entry/climate_action_is_too_big_for_esg_mandates.



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Such critiques are not fatal, but this Article shows they will continue to plague the ESG movement as they are intertwined with the characteristic flexibility and unfixed definition of the term ESG that goes back to its origins. A host of consequences follow from these enduring critiques, ranging from stoking an ESG backlash that imperils corporate and investor initiatives to adding significant obstacles for regulators engaged in ESG-related rulemaking such as the Securities and Exchange Commission's climate disclosure proposal.[17] The history and development of ESG illuminates the fragile alliances and wide-ranging motivations of global players that helped to create a big tent for the term to get mainstream buy-in, as well as its precarious path forward.

The Article proceeds as follows. Part I tells the story of how ESG was coined and the strategic considerations and goals of doing so. Part II examines how various actors use the term with diverse meanings today. Part III analyzes the consequences – perhaps intended and unintended – of attempting to address such a wide range of issues under one acronym and explores the implications for the future of ESG and related legal reforms.

## I. THE CREATION AND DIFFUSION OF ESG

The consideration of corporate governance and corporations' relationships with stakeholders, communities, the environment, and society writ large has a long history. Corporations and their role in society and purpose have been the subject of perpetual debate, going back to early corporations.[18] Over the past century, from the famous debate between Professors Adolf Berle and Merrick Dodd,[19] to the coining of the term "corporate social responsibility" in the mid-twentieth century,[20] and the rise of "corporate

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[17] *See infra* Part III.B.

[18] For an exploration of the history of corporate purpose through the purpose clause of charters from the Middle Ages to the twenty-first century, see Elizabeth Pollman, *The History and Revival of the Corporate Purpose Clause*, 99 TEX. L. REV. 1423 (2021). For a sampling of contemporary literature adding to the rich history of "corporate purpose" debate, *see, e.g.*, Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 94 (2020) (arguing against "the flaws and dangers" of "stakeholder governance"); Jill E. Fisch & Steven Davidoff Solomon, *Should Corporations Have a Purpose?*, 99 TEX. L. REV. 1310, 1310 (2021) (arguing that corporate purpose serves an "instrumental function" to "facilitate the goals of corporate participants"); Edward Rock, *For Whom Is the Corporation Managed in 2020?: The Debate over Corporate Purpose*, 76 BUS. L. 363, 364-67 (2021) (summarizing the contemporary corporate purpose debate including statements and proposals from academics, business leaders, and politicians); Leo E. Strine, Jr., *Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock*, 76 BUS. L. 397, 400 (2021) (arguing that the American corporate governance system "needs an overhaul to fit a 21st century economy"); COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD 6 (2019) (discussing corporate purpose in terms of fulfilling business objectives rather than maximizing profits and noting related social and moral values in corporate purpose); The British Academy, *The Future of the Corporation: Principles for Purposeful Business* (Nov. 2019), https://www.thebritishacademy.ac.uk/publications/future-of-the-corporation-principles-for-purposeful-business/ (examining the case for reforming business "around its purposes, trustworthiness, values and culture" and solving the problems of "people and planet").

[19] Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

[20] HOWARD R. BOWEN, SOCIAL RESPONSIBILITIES OF THE BUSINESSMAN 6 (1953). For literature tracing the history of corporate social responsibility, see Archie B. Carroll, *A History of Corporate Social Responsibility: Concepts and Practices*, *in* THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY 19, 25 (Andrew



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governance" and its linkage with shareholder primacy,[21] the discourse and engagement with various questions related to the societal role of corporations, the duties of corporate directors, and externalities and impacts on stakeholders have taken many twists and turns.

This Part aims its focus at providing an original account of the specific history of the term ESG and its diffusion in the early twenty-first century. Although the United Nations (UN) does not typically feature in contemporary discussions of ESG, it played a critical role in bringing about the term and mobilizing its spread.[22] The story begins with this international organization and its eventual connection and responsiveness to senior executives of global financial institutions, followed by a host of related initiatives and efforts that helped to spread the term until it reached rapid uptake in mainstream discourse.

### A. The Foundation for ESG: The United Nations' Shift toward Collaboration with Business and Launch of the Global Compact

Since its founding in 1945, the UN has catalyzed and sponsored a number of initiatives relating to the world economy, development, the environment, human rights, and related issues affecting business and markets. Scholars and experts have recounted the changing tone of engagement between the UN and the business community over the decades. According to John Ruggie, "[h]istorically, UN entities have expressed varying degrees of ambivalence about the market generally and globalization in particular."[23] Earlier in its history, "[t]he UN saw itself as the champion of social justice and distributive policies and viewed the global economic system as more of an impediment than a solution to these ends."[24] Other scholars have explained that "[b]eginning in the 1950s, the UN was prompted to keep its distance from the corporate sector by the Cold War environment and the need to display a relative impartiality toward market economy and planned economy advocates alike."[25] An "antibusiness prejudice,"[26] or even "animosity," pervaded "the UN paradigm until the end of the Cold War."[27]

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Crane, Dirk Matten, Abagail McWilliams, Jeremy Moon & Donald S. Siegel eds., 2008); Ming-Dong Paul Lee, *A Review of the Theories of Corporate Social Responsibility: Its Evolutionary Path and the Road Ahead*, 10 INT'L J. MGMT. REVS. 53 (2008); Mauricio Andres Latapí Agudelo, Lara Jóhannsdóttir & Brynhildur Davídsdóttir, *A Literature Review of the History and Evolution of Corporate Social Responsibility,* 4 INT'L J. CORP. SOC. RESP. 1 (2019); Elizabeth Pollman, *Corporate Social Responsibility, ESG, and Compliance*, *in* THE CAMBRIDGE HANDBOOK OF COMPLIANCE 662 (Benjamin van Rooij & D. Daniel Sokol eds., 2021).

[21] *See* Lund & Pollman, *supra* note 13, at 2569-78 (tracing coinage of the term "corporate governance" alongside the widespread adoption of shareholder primacy and the shareholder wealth maximization norm).

[22] *See* Pargendler, *supra* note 13, at 1794 ("UN initiatives not only coined the concept of ESG, but also critically mobilized support for the spread and influence of ESG factors around the globe, in addition to the dissemination of a business and human rights agenda more broadly.").

[23] John Gerard Ruggie, *The United Nations and Globalization: Patterns and Limits of Institutional Adaptation*, 9 GLOBAL GOVERNANCE 301, 303 (2003).

[24] *Id.*

[25] Jean-Phillipe Thérien & Vincent Pouliot, *The Global Compact: Shifting the Politics of International Development?*, 12 GLOBAL GOVERNANCE 55, 57 (2006).

[26] SYDNEY SAMUEL DELL, THE UNITED NATIONS AND INTERNATIONAL BUSINESS ix (1990).

[27] Thérien & Pouliot, *supra* note 25.



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One notable reflection of this oppositional relationship with the private sector was the New International Economic Order (NIEO), a UN effort launched by a coalition of developing countries known as the G-77 that aimed at "structural reform and global redistribution" to aid the "global south."[28] A controversial aspect of the NIEO's platform in the 1970s and early 1980s involved an attempt to regulate transnational corporations.[29] During this time, the "UN systematically defended the notion that the transnationals, left to themselves, would further enlarge the gap between developed and developing countries."[30] And for many years, a Commission on Transnational Corporations, created after the declaration of the NIEO, pursued the drafting and adoption of a Code of Conduct for transnational corporations[31]—an effort that faced significant opposition as anti-business, especially from the United States, and was eventually phased out in 1992 when negotiations were formally suspended.[32] By around this time, various other initiatives were underway that shifted focus, such as the UN-sponsored Brundtland Report on the environment and development, published in 1987 that coined the term "sustainability."[33] The UN Commission (now Council) on Human Rights also increased in prominence and became more active in examining how the UN might influence multinational corporations.[34]

Most notably, however, it was in the 1990s that the UN opened up to the corporate sector, described as "a change of 180 degrees."[35] It was in this phase that Kofi Annan, then-Secretary General of the UN, lay the groundwork for the initiative that created the term ESG.[36] Following a meeting with leaders of the International Chamber of Commerce in 1998, Annan acknowledged: "There is great potential for the goals of the United Nations—promoting peace and development—and the goals of business—

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[28] *Id.* at 57-58 (discussing how "developing countries entered the organization en masse" in the 1960s and "the rise of the North-South conflict led the UN to make the regulation of the private sector, and of transnational corporations in particular, one of its top development priorities for over a generation"); *see also* Jennifer Bair, *Corporations at the United Nations: Echoes of the New International Economic Order?*, 6 HUMAN. INT'L J. HUM. RTS. HUMANITARIANISM DEV. 159, 159-63 (2015) (discussing the NIEO).
[29] Bair, *supra* note 28, at 159; Ruggie, *supra* note 23, at 303-04.
[30] Thérien & Pouliot, *supra* note 25, at 57-58.
[31] Bair, *supra* note 28, at 159.
[32] *Id.* at 160; *see also* Pargendler, *supra* note 13, at 1795.
[33] REPORT OF THE WORLD COMMISSION ON ENVIRONMENT AND DEVELOPMENT: OUR COMMON FUTURE (1987), https://sustainabledevelopment.un.org/content/documents/5987our-common-future.pdf. An earlier event, the 1972 UN Conference on the Human Environment "brought the industrialized and developing nations together to delineate the 'rights' of the human family to a healthy and productive environment." *Id.* For an analysis of eight different conceptual frameworks of the term sustainability that have arisen since it was coined in the 1980s, see Aliette K. Frank, *What is the Story with Sustainability? A Narrative Analysis of Diverse and Contested Understandings*, 7 J. ENV'T STUD. & SCI. 310 (2017).
[34] Bair, *supra* note 28, at 160.
[35] Thérien & Pouliot, *supra* note 25, at 58-59 (quoting Gerd C. A. Junne, *International Organizations in a Period of Globalization: New (Problems) of Legitimacy*, *in* THE LEGITIMACY OF INTERNATIONAL ORGANIZATIONS (Jean-Marc Couicaud & Veijo Heiskanen eds., 2001)); *see also* Georg Kell, *Relations with the Private Sector*, *in* THE OXFORD HANDBOOK OF INTERNATIONAL ORGANIZATIONS 738-39 (Jacob Katz Cogan, Ian Hurd & Ian Johnstone eds. 2017) (describing the "fundamental change in relationship between the UN and the private sector" that "started to take shape with the 1997 appointment of Kofi Annan" and the launch of "the Global Compact and subsequent engagements that brought about a historic shift in the relationship").
[36] Kell, *supra* note 35, at 743 n.54.



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creating wealth and prosperity—to be mutually supportive."[37] The UN began to set up a host of public-private partnerships during this new period, reflecting a shift toward understanding business as part of the solution for advancing its goals.[38]

The key moment of this shift on the path to ESG was a speech at the Davos World Economic Forum in 1999 in which Kofi Annan proposed a "Global Compact," directly urging business leaders to join the UN in promoting principles that would provide a foundation for a sustainable global economy. The explosive surge in globalization at the end of the twentieth century was accompanied by gaps in global rule making on labor standards, human rights, and environmental protection—in turn feeding fears that a backlash against globalization might grow.[39] Annan explained:

> Globalization is a fact of life. But I believe we have underestimated its fragility. The problem is this. The spread of markets outpaces the ability of societies and their political systems to adjust to them, let alone to guide the course they take. History teaches us that such an imbalance between the economic, social and political realms can never be sustained for very long. The industrialized countries learned that lesson in their bitter and costly encounter with the Great Depression. In order to restore social harmony and political stability, they adopted social safety nets and other measures, designed to limit economic volatility and compensate the victims of market failures. Our challenge today is to devise a similar compact on the global scale, to underpin the new global economy.[40]

Furthermore, he noted that until people around the world have confidence that certain minimum standards and security will prevail, "the global economy will be fragile and vulnerable—vulnerable to backlash from all of the 'isms' of our post-cold-war world: protectionism, populism, nationalism, ethnic chauvinism, fanaticism and terrorism."[41] He thus called on firms and business associations "to embrace, support and enact a set of core values in the areas of human rights, labour standards, and environmental practices."[42] In return, he offered assistance from the UN in "incorporating these agreed values and principles into [] mission statements and corporate practices" and facilitating a dialogue with other social groups.[43] Further, he noted that various interest groups were exerting "enormous pressure" for "restrictions on trade and investment," but he preferred to pursue the UN's "proclaimed standards" through the voluntary Global Compact that was "mutually supportive" of the UN and business.[44]

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[37] United Nations, Cooperation Between United Nations and Business, press release SG/2043, Feb. 9, 1998.
[38] Thérien & Pouliot, *supra* note 25, at 59; Ruggie, *supra* note 23, at 304-05.
[39] Ruggie, *supra* note 23, at 309-10.
[40] Press Release, UN-Secretary-General, Secretary-General Proposes Global Compact on Human Rights, Labour, Environment, in Address to the World Economic Forum in Davos (Feb. 1., 1999), https://www.un.org/press/en/1999/19990201.sgsm6881.html.
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*



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The Global Compact became operational in 2000, supported by various UN agencies and transnational nongovernmental organizations, with nine (now ten) principles on human rights, labor, environment, and anti-corruption.[45] Although the Compact attracted critique for its nonbinding structure and embrace of corporate trade and investment, participation "increased constantly," and became "more and more diverse in terms of geography and economic sectors."[46] Within just a couple years, approximately 1,000 firms were signatories to the Compact.[47] Building on these efforts, in 2003, the UN increased its focus on environmental matters by convening the first Institutional Investor Summit on Climate Risk, which led to the creation of the Investor Network on Climate Risk—"a politically active group of seventy investors representing seven trillion [dollars] in assets."[48]

Subsequently, senior executives of financial institutions and other companies that were signatories to the Global Compact "repeatedly expressed to the then U.N. Secretary General and to the Global Compact" the need for further efforts.[49] In January 2004, Kofi Annan "wrote to the CEOs of 55 of the world's leading financing institutions inviting them to join in a [new] initiative," under the auspices of the Global Compact, titled "Who Cares Wins."[50] Out of this initiative came a report using the new term "ESG" and recommendations for different actors "on how to better integrate environmental, social and corporate governance issues in asset management, securities brokerage services and associated research functions."[51]

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[45] Ruggie, *supra* note 23, at 310-13; *see also* UN Global Compact, Our Mission, https://www.unglobalcompact.org/what-is-gc/mission.

[46] Thérien & Pouliot, *supra* note 25, at 62-69.

[47] *Id.* at 67.

[48] Pargendler, *supra* note 13, at 1795-96.

[49] THE GLOBAL COMPACT, WHO CARES WINS: CONNECTING FINANCIAL MARKETS TO A CHANGING WORLD vii (2004) [hereinafter WHO CARES WINS] [listed as 2005 in some sources, e.g., https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/publications/publications_report_whocareswins__wci__1319579355342]. A list of then-recent initiatives by institutional investors on ESG issues in the report included: "climate change, corporate governance, issues relating to the pharmaceutical industry, the disclosure of payments to governments and the management of corruption and bribery cases." *Id.* at 21; *see also id.* (Exhibits 14-17).

[50] *Id.* at vii.

[51] *Id.* (executive summary). Around this time, the United Nations Environment Programme Finance Initiative (UNEP FI) Asset Management Working Group, a group of asset managers and pension funds led by Paul Clements-Hunt, Ken Maguire, and Yuki Yasui, had also been exploring "Social, Environmental and Governance issues in the context of capital market analysis." Paul Clements-Hunt, *The Evolution of ESG*, MEDIUM (Feb. 3, 2020), https://medium.com/artificial-heart/the-evolution-of-esg-4bd984657eb0; *see also* Elliot Wilson, *The United Nations Free-Thinkers Who Coined the Term 'ESG' and Changed the World*, EUROMONEY (Oct. 1, 2021), https://www.euromoney.com/article/294dqz2h1pqywgbyh3zls/esg/the-united-nations-free-thinkers-who-coined-the-term-esg-and-changed-the-world. In 2004, the Asset Management Working Group commissioned studies by brokerage house analysts on the materiality of ESG issues to equity pricing. *See* UNEP FI, THE MATERIALITY OF SOCIAL, ENVIRONMENTAL AND CORPORATE GOVERNANCE ISSUES TO EQUITY PRICING: 11 SECTOR STUDIES (2004), https://www.unepfi.org/publications/investment-publications/the-materiality-of-social-environmental-and-corporate-governance-issues-to-equity-pricing/. It found "agreement that environmental, social and corporate governance issues affect long-term shareholder value" and "[i]n some cases those effects may be profound." *Id.* at 4. A number of UNEP FI members also participated in the Who Cares Wins Initiative and, as discussed below, UNEP FI played an important role in helping to catalyze the spread of ESG at a critical early juncture.



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### B. The Coining of ESG: The *Who Cares Wins* Report

Of the fifty-five invited, eighteen financial institutions from nine countries with total assets under management of over 6 trillion US dollars participated at the outset in the joint initiative with the UN, and with financial sponsorship from the Swiss Government.[52] The endorsing financial institutions included some of the world's largest banks including Goldman Sachs, Morgan Stanley, UBS, Credit Suisse Group, Deutsche Bank, HSBC, Banco do Brasil, BNP Paribas, as well as insurance companies such as Aviva, and investment advisors such as Innovest.[53]

For the goals of "stronger and more resilient financial markets," "sustainable development," "improved trust in financial institutions," and "awareness of mutual understanding of involved stakeholders," the report from the first convening of the joint initiative argued, above all, for a "better inclusion of environmental, social and corporate governance (ESG) factors in investment decisions."[54] In the view of the initiative participants, such ESG integration will "ultimately support the implementation of the Global Compact principles throughout the business world"[55]—reflecting the mutually supportive collaboration by the financial industry and the UN that were at the heart of the initiative.

On the financial industry side of this equation, the report further noted that "investment markets have a clear self-interest in contributing to better management of environmental and social impacts in a way that contributes to the sustainable development of global society."[56] A section of the report labeled "investment rationale" noted that studies confirmed "the business case" for "good management of ESG issues contribut[ing] to shareholder value creation."[57] It explained that "[c]ompanies with better ESG performance can increase shareholder value by better managing risks related to emerging ESG issues, by anticipating regulatory changes or consumer trends, and by accessing new markets or reducing costs" and "hav[ing] a strong impact on reputation and brands."[58] Companies should not focus on single issues, but instead the "entire range of ESG issues relevant to their business."[59]

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[52] WHO CARES WINS, *supra* note 49, at executive summary. Two additional organizations, Mitsui Sumitomo Insurance and China Minsheng Bank, later joined as endorsing institutions of the Who Cares Wins Initiative. CONFERENCE REPORT, INVESTING FOR LONG-TERM VALUE: INTEGRATING ENVIRONMENTAL, SOCIAL AND GOVERNANCE VALUE DRIVERS IN ASSET MANAGEMENT AND FINANCIAL RESEARCH (2005), https://www.ifc.org/wps/wcm/connect/9d9bb80d-625d-49d5-baad-8e46a0445b12/WhoCaresWins_2005ConferenceReport.pdf?MOD=AJPERES&CVID=jkD172p.

[53] WHO CARES WINS, *supra* note 49 (endorsing institutions). Ivo Knoepfel has been credited as the author of the report. *See* Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/?sh=1019d6f51695.

[54] WHO CARES WINS, *supra* note 49, at 3.

[55] *Id.* at vii.

[56] *Id.*

[57] *Id.* at 9.

[58] *Id.*

[59] *Id.*



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Alongside these articulated goals and rationales, three points about the report's strategic choice of terminology stand out. First, the use of ESG, in contrast to other existing terms, was deliberate and emphasized throughout the report. It explained:

> Throughout this report we have refrained from using terms such as sustainability, corporate citizenship, etc., in order to avoid misunderstandings deriving from different interpretations of these terms. We have preferred to spell out the environmental, social and governance issues which are the topic of this report.[60]

Correspondingly, the report includes a list of examples for each E, S, and G, such as climate change and related risks, human rights, and management of corruption and bribery issues. It also notes that "ESG issues relevant to investment decisions differ across regions and sections."[61] With the benefit of hindsight, contemporary readers might indeed note that certain issues are missing on the list of examples that have become a prominent focus of ESG efforts in some regions in recent years such as human capital management and board diversity.[62]

Second, the report explained why the initiative participants included the G in their framing of ESG:

> Sound corporate governance and risk management systems are crucial pre-requisites to successfully implementing policies and measures to address environmental and social challenges. This is why we have chosen to use the term "environmental, social and governance issues" throughout this report, as a way of highlighting the fact that these three areas are closely interlinked.[63]

By way of example, the report noted that "better transparency and disclosure" and "linking executive compensation to longer-term drivers of shareholder value and improving accountability" can play a key role in implementing many recommendations.[64] It cited then-recent findings and recommendations released by the Conference Board Commission on Public Trust and Private Enterprise, laying out "best practice suggestions" on executive compensation, corporate governance, and audit and accounting issues, in the wake of 2001-2002 corporate scandals such as at Enron,

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[60] *Id.* at 1-2.
[61] *Id.* at 6.
[62] The report lists example issues such as "[w]orkplace health and safety", "human rights", and "board structure and accountability," but not human capital management and disclosure or board and workforce diversity. *See id.* at 6. For a discussion of human capital management, and the wide range of issues it encompasses beyond workplace health and safety, and its context in the ESG movement, see George S. Georgiev, *The Human Capital Management Movement in U.S. Corporate Law*, 95 TULANE L. REV. 639 (2021). For a discussion of various rules and initiatives on board diversity, and the ESG movement's inclusion of diversity, equity, and inclusiveness, see Chris Brummer & Leo E. Strine, Jr., *Duty and Diversity*, 75 VAND. L. REV. 1 (2022).
[63] WHO CARES WINS, *supra* note 49, at 2.
[64] *Id.*



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WorldCom, and other companies.[65] With this framing, in the view of the initiative participants, G was not an anachronistic appendage or dissimilar concept, but rather a vital and connected set of issues and means of execution for relevant E and S issues.

Similarly, the report emphasized the possibility of mainstreaming the integration of ESG issues into "normal research and fund management functions."[66] It even provided a graphic illustrating "[o]ne (of many) possible organisational paths leading from mainstream [], to first generation screening []; to partial ESG integration in different asset classes []; to full ESG integration in research and portfolio management processes."[67] Notably, this language suggested an evolutionary process for investing practices toward more holistic analysis and presented a contrast to the Socially Responsible Investment (SRI) movement,[68] which had been around for decades and was based on ethical and moral criteria, using mostly negative screens.[69] Sprinkled throughout the report were quotes from executives of large companies, financial institutions, and asset managers emphasizing the theme of alignment of ESG issues with risk-adjusted financial performance and shareholder value,[70] and how consideration of these issues "should be part of every financial analyst's normal work."[71]

Third, the report also suggested that in framing ESG issues and the need to integrate them into mainstream investment analysis, it would take a broad approach and use longer time horizons in construing issues that could be material:

> This report focuses on issues which have or could have a material impact on investment value. It uses a broader definition of materiality than commonly used — one that includes longer time horizons (10 years and beyond) and intangible aspects impacting company value. Using this broader definition of materiality, aspects relating to generally accepted principles and ethical guidelines (e.g. the universal principles underlying the Global Compact) can have a material impact on investment value.

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[65] *Id.* (citing CONFERENCE BOARD COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE: FINDINGS AND RECOMMENDATIONS (2004)).

[66] *Id.* at 38.

[67] *Id.* at 39 (Figure 7).

[68] Marina Welker & David Wood, *Shareholder Activism and Alienation*, 52 CURRENT ANTHROPOLOGY (2011), https://www.journals.uchicago.edu/doi/full/10.1086/656796 (tracing the history of the SRI movement).

[69] *See, e.g.*, John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980); Maria O'Brien Hylton, *Socially Responsible Investing: Doing Good Versus Doing Well In An Inefficient Market*, 42 AM. U. L. REV. 1 (1992); George Djurasovic, *The Regulation of Socially Responsible Mutual Funds*, 22 J. CORP. L. 257, 261-62 (1997); Benjamin J. Richardson, *Fiduciary Relationships for Socially Responsible Investing: A Multinational Perspective*, 48 AM. BUS. L.J. 597 (2011). For an exploration of the contrasts of SRI and ESG, see Blaine Townsend, *From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing*, 1 J. IMPACT & ESG INVESTING 1 (2020); Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing By a Trustee*, 72 STAN. L. REV. 381 (2020).

[70] *See* WHO CARES WINS, *supra* note 49, at 1, 3, 4, 9, 21.

[71] *Id.* at 21, 27.



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This language conceptually tied the report's framing of the term ESG to issues relevant to investment value, as articulated in "the investment rationale," but made clear that it was not constricting itself to traditional or narrow notions of materiality.[72]

The report concluded by stating the initiative participants' intentions for outreach to start a process "to further deepen, specify and implement the recommendations outlined in th[e] report."[73] This included plans to approach accounting standard-setting bodies (FASB, IASB, etc.), professional and self-regulatory organizations (AIMR, EFFAS, NYSE, NASDAQ, FAS, etc.), and investor relations associations (NIRI, DIRK, etc.).[74] Further, the participants planned to approach their own clients to assess their interest and needs for ESG-related research and investment services, and to engage platforms like the UNEP Finance Initiative, The Conference Board, and the World Economic Forum to start dialogue with investors, companies, regulators, stock exchanges, accountants, consultants, and NGOs.[75]

### C. The Diffusion of ESG: The Flywheel of UN Initiatives, Financial Institutions, Institutional Investors, and Their Networks

An acronym that might have been viewed as nothing more than a defined term in a technocratic report has instead seen a "meteoric rise."[76] The strategic framing of putting E, S, and G together was not inherently sticky; it was amplified through a number of UN initiatives and institutional support that helped to spread the term through the global investment community to investors and stakeholders around the world. While the term ESG was mentioned in fewer than 1% of earnings call in the years immediately following the *Who Cares Wins* report, by 2021 it was mentioned in nearly one-fifth of earnings calls and a survey found that 72% of institutional investors implemented ESG factors.[77]

One of the early boosts to using the ESG frame came immediately on the heels of the *Who Cares Wins* report. The United Nations Environment Programme Finance Initiative (UNEP FI) Asset Management Working Group, composed of thirteen asset managers and pension funds, commissioned the international law firm Freshfields Bruckhaus Deringer to produce a study analyzing whether integration of ESG issues into investment policy was voluntarily permitted, legally required, or hampered by law and

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[72] Subsequent discussions, particularly in Europe, have focused on the concept of "double materiality" to describe "how corporate information can be important both for its implications about a firm's financial value, and about a firm's impact on the world at large." *See* Henry Engler, *"Double Materiality": New Legal Concept Likely to Play in Debate Over SEC's Climate Plan*, THOMSON REUTERS (Apr. 12, 2022), https://www.thomsonreuters.com/en-us/posts/investigation-fraud-and-risk/sec-double-materiality-climate/.

[73] *See* WHO CARES WINS, *supra* note 49, at 40.

[74] *Id.*

[75] *Id.*

[76] *See* McKinsey Quarterly, *Five Ways that ESG Creates Value*, Nov. 14, 2019, https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value.

[77] Debbie Carlson, *Mentions of 'ESG' and Sustainability are Being Made on Thousands of Corporate Earnings Calls*, MARKETWATCH (July 19, 2021), https://www.marketwatch.com/story/mentions-of-esg-and-sustainability-are-being-made-on-thousands-of-corporate-earnings-calls-11626712848.



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regulation.[78] The issue of fiduciary duty was a particularly thorny potential obstacle to spreading ESG. For years, many observers interpreted the law in jurisdictions around the world, including the United States, as requiring portfolio managers and other trustees to solely pursue profit maximization in investment practice and decision-making.[79] Under the "sole interest rule" of trust fiduciary law, a trustee must consider only the interest of the beneficiary, and consideration of the trustee's own sense of ethics or an attempt to obtain collateral benefits for third parties could be seen as a violation of the duty of loyalty.[80] The integration of ESG issues into investments by portfolio managers and other trustees was thus "vastly ambiguous and often resisted based on a belief that taking account of such issues was legally prevented."[81]

The Freshfields report concluded that "the links between ESG factors and financial performance are increasingly being recognised" and so "integrating ESG considerations in an investment analysis… is clearly permissible and is arguably *required* in all jurisdictions."[82] The report came to be regarded as "[t]he single most effective document for promoting the integration of environmental, social, governance (ESG) issues into institutional investment."[83] It did not end all debate about fiduciary duties,[84] but, crucially, it provided institutional investors with a go-to resource to cite for legal analysis from a highly-respected global firm that supported taking action on ESG integration consistent with their fiduciary duties.

The following year, the UNEP FI and the UN Global Compact launched the Principles for Responsible Investment (PRI)—again, a group of leading institutions jointly engaged with the UN to push forward the larger project of understanding the investment implications of ESG.[85] Under the PRI, institutional investor signatories can voluntarily commit to supporting and implementing six core principles that channel their power toward promoting the disclosure of ESG issues by portfolio companies and the

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[78] UNEP Finance Initiative, *A Legal Framework for the Integration of Environmental, Social and Governance Issues Into Institutional Investment* (foreward-p.1), Oct. 2005, https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf. UNEP FI

[79] Fiduciary 21, Fiduciary Duty In the 21st Century, https://www.fiduciaryduty21.org/about.html; Schanzenbach & Sitkoff, *supra* note 69, at 381.

[80] Schanzenbach & Sitkoff, *supra* note 69, at 381.

[81] Fiduciary 21, *supra* note 79.

[82] *Id.* at 13 (emphasis added).

[83] UN ENV'T PROGRAMME FIN. INITIATIVE, FIDUCIARY RESPONSIBILITY: LEGAL AND PRACTICAL ASPECTS OF INTEGRATING ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT 13 (2009); *see also* Joakim Sandberg, *Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective*, 101 J. BUS. ETHICS 143, 144 (2011) (describing the influence of the Freshfields report).

[84] Schanzenbach & Sitkoff, *supra* note 69, at 385-92 (distinguishing between ESG pursued for a direct benefit of risk-adjusted return versus for collateral benefits to third parties or for moral and ethical reasons, and discussing continued "confusion" and disagreement about fiduciary duties and ESG investing).

[85] In 2005, Kofi Annan invited a group of the world's largest institutional investors to develop the PRI. It is a "20-person investor group drawn from institutions in 12 countries [a]nd supported by a 70-person group of experts from the investment industry, intergovernmental organisations and civil society." PRI, About the PRI, https://www.unpri.org/about-us/about-the-pri.



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integration of ESG issues in investment analysis, ownership policies, and within the investment industry itself.[86]

By this time, efforts at standard setting for "impact" or "sustainability" reporting started to evolve as well. The Global Reporting Initiative (GRI), which had launched its guidelines in 2000, the same year as the UN Global Compact, had initially focused on environmental conduct principles following public outcry over the Exxon Valdez oil spill.[87] By the mid-2000s, "demand for GRI reporting and uptake from organizations steadily grew," and the guidelines were expanded and GRI opened up offices around the world.[88] Most critically, it broadened its focus from environmental conduct principles to ESG issues, and eventually transitioned from providing guidelines to global standards for reporting.[89]

The *Who Cares Wins* initiative, which originally coined the term ESG, also continued its efforts through 2008 in "a series of closed-door/invitation-only events for investment professionals, providing a platform for asset managers and investment researchers to engage with institutional asset owners, companies and other private and public actors on ESG issues."[90] Each event in the series looked in-depth at "a particular element of ESG mainstreaming," from the interface between investors and companies to the role of ESG in emerging markets investment.[91] A much larger universe of institutions had participated in initiative events by this time—from new bank participants such as Citigroup to companies like Nestlé and Royal Dutch Shell, and a wide array of non-profit organizations.[92]

The initiative culminated in a final report that identified impediments to wider uptake of ESG by the financial industry and offered a set of recommendations for each of the key market actors in the system.[93] It noted that "progress has not been uniform": "corporate governance is the concept that most easily captures mainstream minds" and

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[86] PRI, What Are the Principles for Responsible Investment?, https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment; *see also* Virginia E. Harper Ho, *'Enlightened Shareholder Value': Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 81-82 (2010) (discussing the primary goals of the PRI and the six principles). These efforts expanded in subsequent years. For example, the PRI and UNEP FI launched a joint initiative that led to a 2019 report declaring that fiduciary duties requires investors to incorporate ESG issues into investment analysis and decisions, and a Global Statement on Investor Obligations and Duties with over one hundred signatories from fifty countries. UN ENV'T PROGRAMME FIN. INITIATIVE & PRINCIPLES FOR RESPONSIBLE INV., FIDUCIARY DUTY IN THE 21ST CENTURY: FINAL REPORT 8, 52 (2019).

[87] GRI, Mission & History, https://www.globalreporting.org/about-gri/mission-history/.

[88] *Id.*

[89] *Id.*

[90] Int'l Fin. Corp., Who Cares Wins, 2004-2008: Issue Brief at 2 [hereinafter IFC Issue Brief].

[91] THE GLOBAL COMPACT, OUTCOMES OF THE WHO CARES WINS INITIATIVE 2004-2008: FUTURE PROOF? EMBEDDING ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES IN INVESTMENT MARKETS (2008) [hereinafter WCW FUTURE PROOF?], https://documents1.worldbank.org/curated/en/476811468158704493/pdf/476600WP0Futur10Box338858B01PUBLIC1.pdf.

[92] *Id.* at 43-44. The global financial crisis was underway in 2008, at the conclusion of the Who Cares Wins initiative, and participants viewed it as having "reinforced the necessity for the financial industry to more diligently manage their risks, including those related to [ESG] issues." *Id.* at 3.

[93] IFC Issue Brief, *supra* note 90, at 2.



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the understanding and integration of financially-material environmental issues had also "advanced greatly."[94] The quality and amount of coverage of social/stakeholder issues, employee relations and human capital, and business ethics had lagged.[95] It was "understandable that change has sometimes been slow" because ESG "is about doing traditional investments better" and so it is "necessarily long term and adds value at the margin."[96] With "the learning phase [] drawing to a close" and "a springboard for scaling up ESG integration" in place, however, it ultimately observed that the majority of industry professionals that had participated in the initiative "believe that the investment system is well on track for ESG issues becoming mainstream."[97] Indeed, in less than a decade the groundwork had been set for the term ESG to reach ubiquity in subsequent years.

Notably, to arrive at this point, a fragile alliance had to come together under a big tent to create and focus attention on the new term of ESG. Although not explicitly spelled out in reports, the history reflects a wide array of interests being negotiated through this time, starting with the vision of some true believers in environmental and social progress who catalyzed the international investment community and financial industry to become a driving force for uptake.[98] The E in ESG held out promise for making progress on environmental issues for financial institutions and institutional investors, particularly in Europe, that had been working on climate initiatives and engagement on "sustainability" dating back to the 1980s and the UN-commissioned Brundtland Report. Incorporating S into ESG was particularly important for labor-affiliated pension funds, and reflected various principles that the UN had championed through its work on the Global Compact and earlier efforts focused on developing economies. The G was already widely embraced by mainstream players and conventional notions of law and finance,[99] and thereby provided legitimacy or cover for attempts at making progress on environmental and social issues.[100]

Coining ESG and framing it as a new concept for mainstream investing practices gave it the potential for success beyond that achieved by earlier efforts under the guise of "ethical investing" or SRI, which had largely used negative screening of "bad" firms and could be "depicted as rabidly ideological,"[101] or CSR that had often taken the limited form

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[94] WCW FUTURE PROOF?, *supra* note 91, at 16.
[95] *See id.* at 24 (charting significantly different amounts and quality of coverage of ESG issues, with GHG emissions and other environmental issues and risks far ahead of social/stakeholder issues, employee relations and human capital, and business ethics).
[96] *Id.* at 17.
[97] *Id.* at 16.
[98] *See, e.g.*, Wilson, *supra* note 51 (describing how key thinkers at the United Nations who believed in the importance of sustainability and environmental and social issues strategized on how to engage asset and pension fund managers and "build a bridge between . . . freewheeling capital markets, and . . . the corset-tight area of multilaterals, with its love of hierarchy and procedure").
[99] *See, e.g.*, Lund & Pollman, *supra* note 13, at 2575-78 (describing "the reign of shareholder primacy and good governance"); Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 359 (2016) (arguing that corporate governance is "politically palatable" as "a midway solution between markets and government" that "appeals to progressives as a path for social and economic change in the face of political resistance to state intervention, while pleasing conservative forces as an acceptable concession to deflect greater governmental intrusion in private affairs").
[100] *See* Clements-Hunt, *supra* note 51 (noting that governance "dominate[d] the business world" and was "familiar" to the business and investment community).
[101] Wilson, *supra* note 51.



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of corporate philanthropy. However, navigating these varied interests and packaging ESG for the mainstream also involved a compromise or shift in approach for the previous generation of advocates — ESG was crafted in the language of conventional finance as aligning with long-term risk adjusted value, envisioning that at some point values and value would converge, but without fully working out the details at the time.

Later accounts from key participants described a purposeful attempt to "shift the conversation away from personal ethics and toward material issues" that could engage asset and pension fund managers, and capital market players generally, in language that the investment and financial industry understood.[102] The very ordering of the letters E, S, and G reflects this strategic positioning and fragile alliance – one account noted: "S was the real problem, the outlier the investment chain felt most uncomfortable with and, possibly, with a whiff of socialism about it [that] could open the Pandora's box of labour rights and even human rights issues."[103] The solution was to "stick S in the middle" to "protect it" from "lobbyists uncomfortable with anything which challenged the Milton Friedman doctrine" and then "weld environment upfront and live with G at the end."[104] Even with this solution, in the early years after the term ESG was coined, cultural clashes between "more capitalist Anglo-Saxon investors" and European fund managers emerged and had to be navigated to launch initiatives such as the Principles for Responsible Investment.[105]

These varied efforts and strategies eventually paid off in terms of mainstreaming ESG. After significant groundwork laid by a wide array of actors, the "Big Three" asset managers – BlackRock, Vanguard, and State Street – started to speak in the language of ESG and offer ESG funds. By 2017, Larry Fink, the chairperson and CEO of BlackRock, the world's largest asset manager, said in his annual letter to CEOs that BlackRock looks to ESG factors for "essential insights into management effectiveness and thus a company's long-term prospects."[106] In subsequent years, he emphasized the importance of ESG and tied the term to other buzzwords such as "sustainability," "corporate purpose," and "stakeholders," while conveying the notion that "purposeful companies, with better environmental, social, and governance (ESG) profiles, have outperformed their peers," and "broad-market ESG indexes are outperforming their counterparts."[107]

Furthermore, the Big Three have not only spoken the language of ESG in their public outreach, but also in their direct engagement with portfolio companies and crafting of voting policies on topics spanning ESG disclosure, carbon emissions, and board

[102] *Id.*
[103] Clements-Hunt, *supra* note 51.
[104] *Id.*; *see also* Michael Baxter, *Can Judges Save the World? The Troubled History of ESG and the Fiduciary Duty*, GRC WORLD FORUMS (Apr. 19, 2022), https://www.grcworldforums.com/can-judges-save-the-world-the-troubled-history-of-esg-and-the-fiduciary-duty/4930.article (quoting Paul Clements-Hunt that "'S' was put in the middle to 'stop it from falling off the side'").
[105] Wilson, *supra* note 51.
[106] BlackRock, Larry Fink's 2017 Letter to CEOs, https://www.blackrock.com/corporate/investor-relations/2017-larry-fink-ceo-letter.
[107] BlackRock, Larry Fink's 2021 Letter to CEOs, https://www.blackrock.com/corporate/investor-relations/2021-larry-fink-ceo-letter.



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diversity.[108] Scholars and commentators have expressed concern over the rising power held in the hands of these large asset managers, and have explained their advocacy on ESG issues with theories ranging from client demand to marketing to millennials.[109] Regardless of motivation, ESG notably exploded in popular usage as the world's largest asset managers tied significant portions of their own business models to the label and adopted voting policies related to ESG disclosures and issues.[110] Corporate governance battles such as shareholder proposals on environmental and social policy, and ESG-related shareholder activism, also sharply rose in recent years.[111] As ESG-related investing has soared into the trillions of dollars, the emergence of niche investment funds touting contrarian "anti-ESG" strategies reflects a sign of the new times and just how mainstream the term has become over the past two decades.[112]

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[108] Dorothy S. Lund, *Asset Managers as Regulators*, USC Law Legal Studies Paper No. 22-12 (June 21, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3975847 (forthcoming U. PA. L. REV.); *see also* Tim Bowley & Jennifer G. Hill, *The Global ESG Stewardship Ecosystem*, ECGI Law Working Paper No. 660/2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4240129 (describing "ESG stewardship" across the "transnational network of different non-state actors, including globally-active institutional investors, international institutions and agencies, non-governmental organizations, investor networks and representative bodies, as well as the various service providers that support the governance activities of institutional investors").

[109] *See, e.g.,* John C. Coates, IV, *The Future of Corporate Governance Part I: The Problem of Twelve*, 1, 5–6 (Harv. Pub. L. Working Paper No. 19-07, Sept. 20, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 (raising concern about the concentration of power in the hands of a small number of large asset managers that lack democratic legitimacy and electoral accountability); Zohar Goshen & Doron Levit, *Common Ownership and the Decline of the American Worker*, Columbia Law & Econ. Working Paper No. 653, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3832069 (forthcoming DUKE L.J.) (arguing that the concentration of ownership in large institutional investors exacerbates income inequality by shifting wealth from labor to capital); Lund, *supra* note 108 (arguing that large asset managers have acted as "private regulators" by establishing standards and mandates on various ESG issues in response to client demand); Jeff Schwartz, *Public Mutual Funds*, *in* CAMBRIDGE HANDBOOK ON INVESTOR PROTECTION, Arthur Laby ed., forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3821388 (arguing that large asset managers engage in stewardship "just enough to ward off public opprobrium and potential regulation"); Michal Barzuza, Quinn Curtis & David Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243 (2020) (describing ESG activism by the Big Three and arguing that "index funds are locked in a fierce contest to win the … assets of the millennial generation, who place a significant premium on social issues in their economic lives").

[110] As one indication, one of the most popular websites on corporate law and governance featured the term ESG for the first time in 2008, reached approximately 100 incidents of the term in 2017, the year that BlackRock's Larry Fink first mentioned it in his annual letter to CEOs, and 2022 is on track to reach over 500 incidents of the term ESG. *See* HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE, https://corpgov.law.harvard.edu.

[111] *See, e.g.*, The Conference Board, 2022 Proxy Season Preview and Shareholder Voting Trends: Environmental & Social Proposals in General, https://www.conference-board.org/publications/pdf/index.cfm?brandingURL=environmental-and-social-proposals-in-general-brief-1; Kai H.E. Liekefett et al., *Shareholder Activism and ESG: What Comes Next, and How to Prepare*, HARV. L. SCH. FORUM ON CORP. GOV. (May 29, 2021), https://corpgov.law.harvard.edu/2021/05/29/shareholder-activism-and-esg-what-comes-next-and-how-to-prepare/.

[112] *See, e.g.*, Saijel Kishan & Bloomberg, *'It's a Whirligig': ESG Pioneer Expects Shakeout for Funds Hyped by 'Fairy Dust'*, FORTUNE (Mar. 20, 2022), https://fortune.com/2022/03/20/whirligig-esg-pioneer-expects-shakeout-for-funds-hyped-by-fairy-dust-russia-paul-clements-hunt-hairobi-blended-capital-group/ (noting "ESG has ballooned into an industry embraced by the giants of Wall Street and Europe's financial hubs" and as a "global market adds up to about $40 trillion of assets"); Jeff Benjamin, *Anti-woke Strategies Emerge as Flip Side of ESG*, INVESTMENTNEWS (Dec. 22, 2021), https://www.investmentnews.com/anti-woke-



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## II. THE EVOLVING AND VARIED USAGES OF ESG

As the ESG term was pushed out of closed-door meetings of financial institutions convened by the United Nations and into reports, further dialogue with a large network of market actors, and frameworks such as the PRI, it spread quickly and in ensuing discourse it became used in a variety of ways. Different usages of ESG are not necessarily mutually exclusive, but in some instances overlapping or in tension with each other. These varied usages and understandings of ESG reflect a diversity of views about justifications for the concept, its utility, and the like, as well as an untethering or lack of connection to the original framing from the *Who Cares Wins* report.

This Part examines several common ways in which the term ESG has been given meaning to date, starting from the primary sense in which the term ESG was used, as factors for integrating in investment analysis, and exploring evolving usage such as ESG as a means of risk management, as a synonym for CSR or sustainability, or as a preference or activity. Additional variations and usages are undoubtedly possible and consensus on the meaning of ESG does not currently exist.[113] Scholars have previously observed that ESG lacks a "common theorization"— an agreement or shared beliefs establishing a common discourse on a term or concept.[114] Without such a common theorization, convergence on things such as ESG ratings is less likely,[115] and regulatory approaches may vary.[116] A host of other implications arise from the strategic choice to combine E, S, and G in one term, and from the varying usages that have developed, which this Article takes up in subsequent discussion.

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strategies-emerge-as-flipside-of-esg-215345 (discussing the launch of the "BAD ETF" offering exposure to the gambling, alcohol and pharmaceutical industries in response to the "proliferation of ESG funds flooding the market, despite a general lack of clarity"); Liam Denning, *The Tricky Politics of Anti-ESG Investing*, WASH. POST (May 19, 2022), https://www.washingtonpost.com/business/energy/the-tricky-politics-of-anti-esg-investing/2022/05/19/a3100d84-d763-11ec-be17-286164974c54_story.html (discussing the launch of Strive Asset Management with an "anti-ESG thesis").

[113] *See* Elad L. Roisman, Comm'r, SEC, Keynote Speech at the Society for Corporate Governance National Conference (July 7, 2020), https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020 ("[T]here is not consensus on what, exactly, 'ESG' means."); *see also* Stavros Gadinis & Amelia Miazad, *Corporate Law & Social Risk*, 73 VAND. L. REV. 1401, 1414 (2020) ("Despite trillions of dollars poured into ESG investments, a decade of corporate soul searching, and a bevy of standard setters, one would be hard-pressed to come up with a consistent definition for this phenomenon."); Larcker et al., *supra* note 11, at 1 (noting that "considerable uncertainty exists over what ESG is" and "[d]espite the near universal push for ESG, consensus does not exist about the problem ESG is expected to solve").

[114] *See* Aaron K. Chatterji, Rodolphe Durand, David I. Levine & Samuel Touboul, *Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers*, 37 STRAT. MGMT. J. 1597 (2016).

[115] *See, e.g.*, Robert G. Eccles & Judith C. Stroehle, *Exploring Social Origins in the Construction of ESG Measures* (July 12, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3212685 (noting whether different raters measure the same construct in a similar way would also contribute to a greater likelihood of convergence on ratings).

[116] *See, e.g.*, JANE MCADAM, CLIMATE CHANGE, FORCED MIGRATION, AND INTERNATIONAL LAW 15 (2012) (exploring how the conceptualization of climate change can "dramatically change the way it is perceived and regulated").



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### A. ESG as Factors for Investment Analysis

The *Who Cares Wins* report did not provide a singular definition of ESG beyond the acronym—but it repeatedly referred to being "a joint effort of financial institutions" to "develop guidelines and recommendations on how to better integrate environmental, social and governance issues in asset management, securities brokerage services and associated research functions."[117] Indeed, this language featured as a subtitle on the cover of the report.[118] As noted above, the report also listed example issues that fall under each E, S, and G, and focused on "issues which have or could have a material impact on investment value," while noting that it took a broad view of materiality and saw the G as interlinked with the E and S.[119] Although the report sometimes referred to broader goals such as "contribut[ing] to the sustainable development of global society," invoking language in the spirit of the UN Global Compact, it heavily emphasized the "business case" justification and alignment with long-term value for shareholders.[120] On the whole, the picture that emerges from the report is that ESG refers to "information," "issues," "factors," or "criteria" that should be integrated into "normal" and "mainstream" investment analysis.[121] The report did not explain in any detail how such integration should be done.

The term ESG has been, and is, often still used in this vein as a way of referring to a set of issues that should be integrated into investment analysis.[122] As a tool, ESG is often broken into component parts of E, S, and G, and explained by reference to underlying content that would be relevant to investor decision-making. In this framing, ESG is not synonymous with ethical investing, but rather viewed as integral to mainstream investment strategy.[123]

To take S as an example, as one scholar explained, "In the context of responsible investment, the S is meant to better evaluate how well positioned a company is for the long term, the reputational value it or its products gain from goodwill, the stability and long-term efficiency of its workforce, potential costs of labour conflicts, the political risk of conflicts with communities, the legal and reputational risks that it runs from potential

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[117] WHO CARES WINS, *supra* note 49, at vii.
[118] *Id.* (cover), i.
[119] *Id.* at 2, 6.
[120] *See id.* at 3, 9-10.
[121] *See id.* passim.
[122] *See, e.g.*, Ron Lieber, *The Rush to E.S.G., With or Without Elon Musk*, N.Y. TIMES (June 18, 2022), https://www.nytimes.com/2022/06/18/your-money/esg-investing-stocks-elon-musk.html (quoting Domini Impact Investments' founder defining ESG as "a more robust set of material data points from which an investment adviser can make a decision"); *cf.* Alex Edmans, *The End of ESG*, ECGI Fin. Working Paper No. 847/2022, at 5, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4221990 (describing ESG as "a set of long-term value factors").
[123] *See* Kishan & Bloomberg, *supra* note 112 (describing view that "ESG is often wrongly conflated with ethical investing" and instead "the strategy involves measuring investment risks tied to issues such as climate change, human-rights violations in supply chains and poor corporate governance" and "by addressing those challenges, there are opportunities to make money"); Stuart Kirk, *ESG Must Be Split In Two*, FIN. TIMES (Sept. 2, 2022), https://www.ft.com/content/4d5ab95e-177e-42d6-a52f-572cdbc2eff2 (explaining that "portfolio managers, analysts and data companies have understood ESG investing for years" as "taking [ESG] issues into account when trying to assess the potential for risk-adjusted returns of an asset" and this is "very different" from "'ethical' or 'green' or 'sustainable' assets").



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problems with its supply chain employment practices or community protests, and so on."[124] Notably, there are a variety of ways in which the idea of stakeholders, social issues, and society may enter into ESG investment practice. Social information, for instance, might be integrated into valuation, into investment mandates such as exclusionary screens, or into standards of practice or principles that corporations are meant to adopt or against which their behavior will be measured.[125] A variety of frameworks for evaluating and engaging corporations on social issues have developed, closely linked to ESG as a tool for investment or vehicle for investor-corporate dialogue.[126]

### B. ESG as Risk Management

The broad scope of potential issues that could come under the words "environmental, social and governance," the wide-ranging and potentially diverging incentives of the UN and the financial industry, and the lack of specificity in definition by the *Who Cares Wins* initiative, opened up the possibility of the term ESG taking on a variety of meanings. By 2008, the year in which the initiative concluded, a survey of over 300 fund managers, of whom only 23% self-identified as "socially responsible investors," found that over 70% viewed ESG as a tool to identify investment opportunities as well as to manage risk.[127]

For many mainstream investors and asset managers, the key justification for incorporating ESG factors into investment analysis relates to their potential impact on portfolio-level risk-adjusted returns or the relationship between ESG factors and risk management at the company level.[128] Although not unqualified, a large body of research has found correlations between corporate financial and ESG performance, and some evidence of financial materiality of ESG factors to portfolio risk-adjusted returns.[129]

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[124] David Wood, *What Do We Mean by the S in ESG? Society as a Stakeholder in Responsible Investment* 553, *in* THE ROUTLEDGE HANDBOOK OF RESPONSIBLE INVESTMENT (Tessa Hebb, James P. Hawley, Andreas G. F. Hoepner, Agnes L. Neher, David Wood eds., 2015).
[125] *Id.* at 556-59.
[126] *Id.* at 560.
[127] Harper Ho, *supra* note 86, at 88 (citing Danyelle Guyett, *ESG Ratings of Fund Managers—a Step Closer Towards the Mainstreaming of ESG Integration*, MERCER (July 4, 2008)).
[128] Virginia Harper Ho, *Sustainable Investment & Asset Management: From Resistance to Retooling* (Mar. 23, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4064317; *see also* Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 647 (2016) (discussing "the exercise of shareholder power to promote firm management, mitigation, and disclosure of risk, including nonfinancial environmental, social, and governance (ESG) risks"). On ESG and systematic risk, see John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk* (Eur. Corp. Governance Inst., Working Paper No. 541, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3678197; Jeffrey N. Gordon, *Systematic Stewardship*, J. CORP. L. (forthcoming 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782814.
[129] *See* SERAFEIM, *supra* note 15, at 50-51 (describing study of 2,300 hundred companies that were improving performance on material ESG issues and finding they outperformed their competitors by more than 3% annually); Ulrich Atz, Zongyuan (Zoe) Liu, Christopher C. Bruno & Tracy Van Holt, *Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions*, 8-9, 20-22 (2021), https://ssrn.com/abstract=3708495 (surveying 1,141 primary peer-reviewed papers and 27 meta-reviews published between 2015 and 2020 and finding evidence of a positive association between sustainability and financial performance at the firm level and risk-mitigating effects at the portfolio level); Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence From More Than 2,000 Empirical Studies*, 5 J. SUSTAINABLE



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Based on interviews and roundtable discussions with over three hundred participants, including the largest asset managers, investment banks, pension funds, proxy advisors, hedge funds, leading investors and sustainability advocates, Stavros Gadinis and Amelia Miazad found that "companies are using ESG on the ground" to help "identify and manage social risks to their business."[130] According to their findings, "ESG has evolved into a separate corporate function, whose mission is to monitor and manage the risks facing the company due to environmental and social impact."[131]

Unlike internal controls and accounting which operate under an externally-driven, rules-based framework, "ESG represents an attempt by companies to self-regulate their conduct."[132] Thus, in this understanding of ESG, "[t]he values that ESG promotes do not originate from an abstract moralistic philosophy of 'doing the right thing,' nor are they dictated by a central standard setter . . . [r]ather, they arise following a wide-ranging consultation with stakeholders, who are better positioned to take notice of potentially catastrophic company operations."[133] In an era in which bad public relations or corporate scandals could have devastating effects on a company's operations and brand value, engaging stakeholders such as consumers and employees through "ESG practices" can provide useful information to manage key relationships and mitigate risk.[134] Instead of

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FIN. & INV. 210, 220-21, 225-26 (2015) (aggregating nearly 2,200 studies and concluding that the majority found positive correlations between corporate financial and ESG performance but portfolio-level studies had more mixed results); Tensie Whelan, Ulrich Atz, Tracy Van Holt & Casey Clark, *ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Between 2015-2020*, NYU Stern Center for Sustainable Business Working Paper (Feb. 2021), https://www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/esg-and-financial-performance (examining the relationship between ESG and financial performance in more than 1,000 research papers from 2015-2020 and finding a positive relationship for 58% of the "corporate" studies focused on operational metrics and 33% positive performance for investment studies typically focused on risk-adjusted attributes); *cf.* Jan-Carl Plagge & Douglas M. Grim, *Have Investors Paid a Performance Price? Examining the Behavior of ESG Equity Funds*, 46 J. PORTFOLIO MGMT. 123 (Feb. 2020) (finding that "return and risk differences of ESG funds can be significant but appear to be mainly driven by fund-specific criteria rather than by a homogeneous ESG factor"); Schanzenbach & Sitkoff, *supra* note 69, at 454 (noting "there is theory and evidence in support of risk-return ESG" but "this support is far from uniform, is often contextual, and in all events is subject to change, especially as markets adjust to the growing use of ESG factors").

[130] Gadinis & Miazad, *supra* note 113, at 1410.

[131] *Id.* at 1415.

[132] *Id.*

[133] *Id.* at 1426; *see also* Wood, *supra* note 124, at 562 (explaining that ESG, and particularly S, plays a role as "a lens with which to view corporate value, by identifying places where corporations or investments improve their financial performance through more effective management of human relations with employees, communities, or other stakeholders").

[134] *See* Gadinis & Miazad, *supra* note 113, at 1432-35; *see also* Gillian Tett, *ESG Exposed in a World of Changing Priorities*, FIN. TIMES (June 2, 2022), https://www.ft.com/content/6356cc05-93a5-4f56-9d18-85218bc8bb0c ("[T]he concept of ESG has moved from being a narrow area of activism – driven by people who want to change the world – to a sphere of risk management for corporate boards – where it is shaped by the knowledge that companies that ignore ESG issues can face reputational damage and the loss of customers, investors and employees."); Allison Herren Lee, *Keynote Address by Commissioner Lee on Climate, ESG, and the Board of Directors*, HARV. L. SCH. FORUM ON CORP. GOV. (June 30, 2021), https://corpgov.law.harvard.edu/2021/06/30/keynote-address-by-commissioner-lee-on-climate-esg-and-the-board-of-directors/ (discussing the role of corporate boards to mitigate ESG risks). For an argument against director oversight liability extending to ESG, see Stephen M. Bainbridge, *Don't Compound the*



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simply being a tool for evaluating a broader set of investment factors, ESG has taken on meaning as a set of practices for proactive risk management, whether at the firm or portfolio level.

### C. ESG as Corporate Social Responsibility or Sustainability

A different interpretation or meaning ascribed to ESG in contemporary parlance is a belief that it represents "a step towards a better world" that is tied to beneficial long-term social outcomes.[135] In short, ESG gets equated, or conceptually combined, with CSR. A variation of this equates ESG with a different term—sustainability.

For some, this usage may stem from a nuanced understanding or belief that broad social benefits may flow from using ESG as a tool for enhanced investment analysis. The preamble to the Principles for Responsible Investment itself draws this link, declaring, "We also recognize that applying these Principles may better align investors with broader objectives of society."[136] The original *Who Cares Wins* report also included language about broader social benefits—reflecting the UN's goals in the initiative and the values it aimed to serve through the Global Compact.[137] Thus, some usage of ESG reflects an understanding or belief that using it as a tool for enhanced investment analysis might create social benefits that non-ESG-related investing might not provide.[138] Although the use of ESG information in investment decision-making is not the same as pursuing broad social benefits, some view the two as inextricably linked and so language around ESG takes on the flavor of CSR discourse. For example, Lynn LoPucki suggested the following connection: "CSR is the abstract idea that corporations have a moral responsibility to voluntarily integrate environmental, social, and governance ('ESG') improvements into their business operations for the benefit of shareholders, other stakeholders, society as a whole, and the environment."[139] Stated differently, "CSR is adherence to the actual values of corporate stakeholders, and ESG is a set of measurements from which conclusions about CSR can be drawn."[140]

For others, they may simply think that ESG is a new synonym for CSR.[141] Some may have inferred this understanding from notions that the types of environmental and social issues that are often discussed under the term ESG are the same or similar as those

*Caremark Mistake by Extending it to ESG Oversight*, UCLA School of Law, Law-Econ Res. Paper No. 21-10 (2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3899528.

[135] Wood, *supra* note 124, at 553.

[136] PRI, What Are the Principles for Responsible Investment?, https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment#:~:text=Signatories'%20commitment&text=We%20also%20recognise%20that%20applying,with%20broader%20objectives%20of%20society.

[137] *See* WHO CARES WINS, *supra* note 49, at vii.

[138] Wood, *supra* note 124, at 553.

[139] Lynn M. LoPucki, *Repurposing the Corporation Through Stakeholder Markets*, 55 UC DAVIS L. REV. 1445, 1447 (2021).

[140] *Id.* at 1448. A common variation is to combine ESG and CSR, perhaps to straddle the various meanings and connotations. *See generally, e.g.*, Mark J. Roe, *Corporate Purpose and Corporate Competition*, 99 WASH U. L. REV. 223 (2021) (referring throughout to "CSR/ESG" and "ESG/CSR").

[141] *See* Larcker et al., *supra* note 11, at 2 (noting that a viewpoint "held by many investors and members of the public, is that ESG is synonymous with corporate responsibility").



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of previous eras that were labeled CSR. For example, one scholar described ESG "as a subcategory of CSR and uses a metrics-driven format to measure a company's commitment to social responsibilities."[142] Others have observed, "the ESG movement sounds like older corporate social responsibility (CSR) movement—but with a new name."[143]

In this understanding of ESG as a synonym for CSR, it encompasses notions of moralistic or ethical value. It is a "normative (values-based) argument" to "inject social consciousness into both corporate and individual investment decisions."[144] Participants in the system that had been focused on values-driven activity imbued the term ESG with their views and in turn helped shape others' understanding of the values being promoted by ESG-related activity. For example, researchers have traced how the different "origins, philosophies, and 'purposes' of ESG" shaped the methods and data characteristics of two important ESG data vendors.[145] Whereas Innovest developed a financial value-oriented methodology, KLD by contrast took a values-driven approach.[146]

The *Who Cares Wins* initiative did not resolve the potential tensions between these approaches to understanding ESG – it emphasized the "business case" from the financial industry perspective but also promoted notions that the UN's goals would be served, which arose out of Kofi Annan's concern for building a social safety net around the globe and addressing gaps in human rights, labour standards, and environmental practices. This potential ambiguity left open the interpretation that ESG was a new term for what used to be called CSR and many market participants, non-profit organizations, and the like maintained such orientation and refocused their efforts into the new ESG movement.

### D. ESG as Ideological Preference

Finally, another characterization of ESG is that it represents "a preference or taste among some companies or investors."[147] In this common and controversial conceptualization, ESG is a means of "expressing a preference"[148]—like "voting" with one's money as a consumer or investor.[149]

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[142] Thomas Lee Hazen, *Social Issues in the Spotlight: The Increasing Need to Improve Publicly-Held Companies' CSR and ESG Disclosures*, 23 U. PA. J. BUS. L. 740, 745-46 (2021).

[143] Nives Dolšak, Jennifer J. Griffin & Aseem Prakash, *Is ESG Simply the Old CSR Wine in a New Bottle?*, REG. REV. (Mar. 28, 2022), https://www.theregreview.org/2022/03/28/dolsak-griffin-prakash-is-esg-old-csr-wine-in-new-bottle/.

[144] Larcker et al., *supra* note 11, at 2.

[145] Robert G. Eccles, Linda-Eling Lee & Judith C. Stroehle, *The Social Origins of ESG? An Analysis of Innovest and KLD* (Aug. 20, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3318225.

[146] *Id.*

[147] Serafeim, *supra* note 1, at 14.

[148] *See id.*

[149] *See* Kell, *supra* note 53; *see also* Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 402 (2021) ("For some years, investing on the basis of ESG considerations was thought to be a preference predicated on ethical, political, religious, or other objectives rather than an investment strategy grounded in financial risk and return."); Schanzenbach & Sitkoff, *supra* note 69 (differentiating between ESG investing for moral or ethical reasons, which they call "collateral benefits ESG," and ESG investing for risk and return benefits, which they call "risk-return ESG").



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As Georg Kell explained, "The rise of ESG investing can also be understood as a proxy for how markets and societies are changing and how concepts of valuation are adapting to these changes."[150] Corporations are challenged to adapt to changing consumer and investor preferences that "favor[] smarter, cleaner and healthier products and services," and "to leave behind the dogmas of the industrial era when pollution was free, labor was just a cost factor and scale and scope was the dominant strategy."[151]

In this spirit, investors and a wide range of stakeholders seek to align their activities with an expression of their values, whether political, ethical, or social, and ESG is a label vaguely signifying some level of attention to issues beyond the purely financial.[152] It is in this sense that one might hear that a company "is" or "is not" "very ESG" or that is possible to "do ESG."[153] And this usage contributes to some seeing ESG as "a virtue signal,"[154] a marketing tool for companies, asset managers, and service providers that lends itself to greenwashing,[155] or even equating ESG with an ideological preference for "woke capitalism."[156]

In turn, this understanding of ESG as a preference has catalyzed a "backlash" as it is not seen as a neutral concept or activity but rather one that is value-laden and ideologically or politically tilted.[157] Former Vice President Mike Pence, for example,

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[150] Kell, *supra* note 53.

[151] *See id.* For an argument that "index funds have engaged in a pattern of competitive escalation in their policies on [ESG] issues" in response to preferences of millennials as investors, customers, and employees, see Barzuza et al., *supra* note 109.

[152] This view is illustrated by a 2021 survey by Broadridge finding that retail investors, particularly millennials aged between 25 to 40, seek to express their environmental and social preferences. Broadridge, *From the Retail Trading Frenzy to Growing ESG Trends, What Will Be in Proxy Season 2021?* (May 3, 2021), https://www.prnewswire.com/news-releases/from-the-retail-trading-frenzy-to-growing-esg-trends-what-will-be-in-proxy-season-2021-301281582.html. On whether investors are willing to sacrifice returns for social interests, see Scott Hirst, Kobi Kastiel & Tamar Kricheli-Katz, *How Much Do Investors Care About Social Responsibility*? (manuscript on file with author).

[153] *See supra* notes 8 & 9; *see also* Matt Levine, *Everyone Wants to Do ESG Now*, BLOOMBERG (Mar. 21, 2022), https://www.bloomberg.com/opinion/articles/2022-03-21/everyone-wants-to-do-esg-now.

[154] *See* Dolšak et al., *supra* note 143; *see also* Gadinis & Miazad, *supra* note 113, at 1415 (observing the "definitional ambiguousness [of ESG] has given rise to a common misperception of ESG as a random and ever-sprawling assortment of objectives, influenced by fads and trends rather than hard business logic.").

[155] *See, e.g.*, Aswath Damodaran, *The ESG Movement: The "Goodness" Gravy Train Rolls On!*, MUSINGS ON MARKETS (Sept. 14, 2021), https://aswathdamodaran.blogspot.com/2021/09/the-esg-movement-goodness-gravy-train.html.

[156] *See* Andrew Ross Sorkin et al., *Larry Fink Defends Stakeholder Capitalism*, N.Y. Times (Jan. 18, 2022), https://www.nytimes.com/2022/01/18/business/dealbook/fink-blackrock-woke.html (discussing BlackRock CEO Larry Fink's rebuttal to claims that ESG is "bowing to anti-business interests" and that "stakeholder capitalism" is "woke"); Kenneth Rapoza, *How The 'Woke' Capitalists Can Save America*, FORBES (Apr. 5, 2020), https://www.forbes.com/sites/kenrapoza/2020/04/05/how-the-woke-capitalists-can-save-america/?sh=3ee8507271ed (noting that international investment fund managers and the World Economic Forum have made ESG "a talking point for a good 10 years now, largely in response to the old lefty, anti-neoliberal World Social Forum" and "[t]hey all talk about diversity, equality, justice"); Paul Polman, *Critics of 'Woke' Capitalism Are Wrong*, FIN. TIMES (Jan. 24, 2022), https://www.ft.com/content/34cf61c7-345d-4277-bf18-c1dbdd8a91fc (discussing "woke capitalism").

[157] *See* Trillions, *The ESG Backlash*, BLOOMBERG (May 11, 2022), https://www.bloomberg.com/news/audio/2022-05-11/the-esg-backlash-podcast (observing critical views that large asset managers have supported ESG and become too "woke" and formed an "ideological



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penned a scathing op-ed vehemently opposing ESG as "a pernicious strategy" that is "inherently political" and "allows the left to accomplish what it could never hope to achieve at the ballot box or through competition in the free market."[158] He championed the view that "the next Republican president and GOP Congress should work to end the use of ESG principles nationwide," and suggested that "government intervention" to stop "the ESG craze" is necessary for "the free market" to "be truly free."[159]

The irony of this latter statement is not lost on those with an understanding of the history of the term. As we have seen, it was in fact coined by an initiative including market actors such as the world's largest banks and participants in the financial industry who subsequently spread it through market activity and private initiatives, with investors choosing ESG-related investment vehicles and an industry growing up to serve client demands. ESG was pitched from its beginning as aligning with financial materiality and the pursuit of long-term value maximization in capital markets. Furthermore, corporations have long been sites of contestion for social and political issues and values, centuries before the term ESG was ever uttered.[160]

Nonetheless, ESG has notably entered a new phase of possible meanings as politicians tout it as a hot button issue or proxy for other values and beliefs. Battlelines appear sharply drawn by politics, from the rise of "[c]onservative or anti-ESG shareholder proposals"[161] to new "anti-ESG" funds.[162] Increasingly, headlines are filled with proposals

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cartel"); Richard Morrison, *The ESG Backlash*, NAT'L REV. (Mar. 9, 2022), https://www.nationalreview.com/2022/03/the-esg-backlash/ (discussing how "[c]onservatives have come to see this collection of business trends" towards ESG as "yet another 'woke' assault on mainstream society" and have "growing opposition to ESG" that will cause it "to hit a wall of resistance"); Aron Cramer, *After a Backlash Summer, ESG Needs to Get Back in the Game*, FORTUNE (Sept. 20, 2021), https://fortune.com/2021/09/20/esg-backlash-summer/ (observing "the backlash against the momentum driving widespread adoption of [ESG] policies became a thing").

[158] *See* Mike Pence, *Republicans Can Stop ESG Political Bias*, WALL ST. J. (May 26, 2022), https://www.wsj.com/articles/only-republicans-can-stop-the-esg-madness-woke-musk-consumer-demand-free-speech-corporate-america-11653574189 (arguing for "[s]tates, cities and Congress" to take action "by adopting measures to discourage the use of ESG principles").

[159] *Id.*

[160] *See, e.g.*, CORPORATIONS AND AMERICAN DEMOCRACY (Naomi R. Lamoreaux & William J. Novak eds., 2017) (exploring U.S. law and history from the founding to the present on the topic of corporations and their role in American democracy); Margaret M. Blair & Elizabeth Pollman, *The Derivative Nature of Corporate Constitutional Rights*, 56 WM. & MARY L. REV. 1673 (2015) (examining the two-hundred-year history of corporate constitutional rights including the extension of First Amendment rights to corporations); ADAM WINKLER, WE THE CORPORATIONS (2018) (chronicling the "civil rights movement" of corporations for rights under the U.S. Constitution).

[161] Clara Hudson, *Conservative Shareholder Proposals Rise Amid Anti-ESG Rumbles*, BLOOMBERG LAW (Aug. 31, 2022), https://news.bloomberglaw.com/esg/conservative-shareholder-proposals-rise-amid-anti-esg-rumbles; Ruth Saldanha, *Anti-ESG Proxy 'Explosion' Ends With a Whimper, Not a Bang*, MORNINGSTAR (Aug. 15, 2022), https://www.morningstar.ca/ca/news/225811/anti-esg-proxy-explosion-ends-with-a-whimper-not-a-bang.aspx.

[162] Silla Brush & Saijel Kishan, *The Anti-ESG Crusader Who Wants to Pick a Fight with BlackRock*, BLOOMBERG (Sept. 1, 2022), https://www.bloomberg.com/news/articles/2022-09-01/woke-inc-author-s-firm-targets-blackrock-esg-investing#xj4y7vzkg; David Isenberg, *'Anti-Woke' and Sin ETFs Could Get Caught Up in SEC Rules Scrutiny*, FIN. TIMES (Aug. 31, 2022), https://www.ft.com/content/26ce80e6-fcfb-4dff-a565-bd7e23ee364b; *see also* Emma Boyde, *Biblical ETF Provider Renounces ESG Labels in War with 'Liberal Activists'*, FIN. TIMES (Aug. 31, 2022), https://www.ft.com/content/b6f92b25-8a64-4b04-be70-af65f8d491d2.



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to oust ESG or its proponents from the mainstream, such as by claiming the "ESG investing giants" are breaching their fiduciary duties or should be broken up.[163] State politicians and officials from so-called "red states" have attracted attention to the anti-ESG cause by banding together to oppose ESG disclosures,[164] banning state pension funds from screening for ESG risks,[165] probing ESG scores,[166] and limiting contracts with state entities to companies that do not "boycott" energy companies.[167] Such anti-ESG activities might come at a cost.[168] And in turn, these attacks on ESG are countered and parried, often by asserting value alignment reminiscent of the original *Who Cares Wins* report,[169] or the reality of externalities,[170] reflecting that whether ESG is ideological or political is itself up for debate.

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[163] Dan Morenoff, *Break Up the ESG Investing Giants*, WALL ST. J. (Aug. 31, 2022), https://www.wsj.com/articles/break-up-the-esg-investing-giants-state-street-blackrock-vanguard-voting-ownership-big-three-competitor-antitrust-11661961693?st=nuajzp9fq8rkvha; Jed Rubenfeld & William P. Barr, *ESG Can't Square With Fiduciary Duty*, WALL ST. J. (Sept. 6, 2023), https://www.wsj.com/articles/esg-cant-square-with-fiduciary-duty-blackrock-vanguard-state-stree-the-big-three-violations-china-conflict-of-interest-investors-11662496552.

[164] Patrick Morrisey, Comments on Proposed Rule Titled "Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices," Aug. 16, 2022, https://ago.wv.gov/Documents/2022.08.16%20ESG%20Funds%20Comment.pdf; Lesley Clark, *Red States Decry "Woke Left" SEC Proposal for ESG Investing*, E&E NEWS (Aug. 18, 2022), https://www.eenews.net/articles/red-states-decry-woke-left-sec-proposal-for-esg-investing/.

[165] Frances Schwartzkopff, *GOP Fury Over ESG Triggers Backlash With US Pensions at Risk*, BLOOMBERG (Aug. 25, 2022), https://www.bloomberg.com/news/articles/2022-08-25/esg-pros-say-republican-anti-woke-bashing-hurts-regular-savers; *see also* Ropes & Gray, *State Regulation of ESG Investment Decision-making by Public Retirement Plans: An Updated Survey* (Aug. 9, 2022), https://www.ropesgray.com/en/newsroom/alerts/2022/August/Navigating-State-Regulation-of-ESG-Investments-by-Investment-Managers.

[166] Zach C. Cohen, *Republicans Are Focusing on a New Economic Threat: ESG Scores*, BLOOMBERG (Aug. 11, 2022), https://www.bloomberg.com/news/articles/2022-08-11/esg-as-economic-threat-catches-on-as-theme-in-key-senate-race#xj4y7vzkg; ValueEdge Advisors*, Eighteen U.S. States Join Missouri Probe Into Morningstar ESG* (Aug. 19, 2022), https://valueedgeadvisors.com/2022/08/19/eighteen-u-s-states-join-missouri-probe-into-morningstar-esg-reuters/.

[167] Kate Aronoff, *The Deranged Demands of the "Anti-ESG" Movement*, NEW REPUBLIC (Aug. 29, 2022), https://newrepublic.com/article/167550/desantis-anti-esg-movement; Brooke Masters & Patrick Temple-West, *Companies Attack Texas Over 'Politicized' ESG Blacklist*, FIN. TIMES (Aug. 29, 2022), https://www.ft.com/content/8031aaad-efc6-4829-ac02-bd9c151974f4.

[168] *See, e.g.*, Daniel G. Garrett & Ivan T. Ivanov, *Gas, Guns, and Governments: Financial Costs of Anti-ESG Policies* (July 11, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4123366 (finding that state laws prohibiting municipalities from contracting with counterparties with certain ESG policies imposes significant financial cost); *see also* Leslie Norton, *While Criticizing ESG Investing, Florida, Texas Public Pensions Have Overwhelmingly Supported ESG Resolutions*, MORNINGSTAR (Sept. 7, 2022), https://www.morningstar.com/articles/1113157 (noting that public pension funds from Texas and Florida voted in favor of ESG shareholder proposals in 2021 between 85% and 99% of the time before uptick in politicization).

[169] *See, e.g.*, BlackRock Response to Attorneys General of the States Listed as Signatories of the August 4, 2022 Letter, AXIOS (Sept. 8, 2022), https://www.axios.com/2022/09/08/blackrock-strikes-back-at-esg-critics ("We believe investors and companies that take a forward-looking position with respect to climate risk and its implications for the energy transition will generate better long-term financial outcomes."); *see also* SERAFEIM, supra note 15, at 135 (asserting that those who are not yet on board with ESG "will be left behind" as they have not kept up with "their peers and understanding why industry behavior has changed"); Edmans, *supra* note 122, at 5 ("It makes no sense to politicize ESG issues, when we'd never politicize other drivers of both shareholder and stakeholder value, such as innovation and resilience. . .").

[170] *See, e.g.*, McKinsey, *Does ESG Really Matter—And Why?*, MCKINSEY QUARTERLY (Aug. 10, 2022), https://www.mckinsey.com/business-functions/sustainability/our-insights/does-esg-really-matter-and-



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The variety of usages of ESG that have developed over time reflect a diverse set of justifications, purposes, and views. Understanding the origins of the term helps shed light on how the possibility of these wide-ranging usages was left open at the outset by the lack of a more specific definition and conceptual grounding. Although ESG was coined to describe the types of issues to be integrated into investment analysis by the financial industry, it was connected to notions of more active engagement to manage environmental and social issues that could mitigate risks and create long-term value, and to UN goals and the principles of the Global Compact that more broadly aimed at producing social benefits, security, and sustainable development. As the term spread, it took on varied associations and meanings that reflect these underlying themes but also in some instances are quite far from where it began.

## III. THE PROMISE AND PERILS OF THE ESG MONIKER

While ESG has become "pervasive,"[171] and taken on various meanings, the strategic choice to coin the term, putting together a wide variety of issues into one acronym, has received little focused examination. It is admittedly difficult to disentangle aspects of the conceptual and rhetorical construction of the term from underlying substantive debate of the merits of ESG that has ensued, and the notion of consequences flowing from such construction must necessarily be caveated in terms of causation that cannot be definitively ascribed. Nonetheless, as the term has now been in circulation for nearly two decades, it is possible to look back to gain insights into impacts of the choice to put E, S, and G into one term and better understand current regulatory challenges and potential paths for the future of ESG.

### A. The Flexible, Big Tent Approach of ESG and its Alignment Story

The combination of E, S, and G into one acronym has provided a highly flexible term that can vary widely by context, evolve over time, and collectively appeal to a broad range of investors and stakeholders. To explore the advantages of constructing ESG as an umbrella term, each one of these aspects should be considered in turn.

First, ESG was specifically designed to be globally applicable and customizable by context. As the *Who Cares Wins* report explained: "ESG issues relevant to investment decisions differ across regions and sections."[172] Instead of specifying what issues were intended to be integrated into investment analysis, this was left open beyond the words "environmental, social, and governance" and a short list of examples. One of the key examples of an ESG issue provided was the management of corruption and bribery—a topic that is particularly significant in some developing economies around the world and one of the pillars of the Global Compact, but is not front of mind in other geographic

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why?cid=soc-web (noting a key response to ESG critics is "the acute reality of externalities" and how regulators, stakeholders, employees put pressure on companies to change as part of social license to operate).

[171] Larcker et al., *supra* note 11, at 1.

[172] *See supra* note 61.



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areas such as the United States, where board diversity is instead a top issue that has gained traction under the ESG acronym but did not appear on the original list.

Second, ESG was pitched at a highly generic level of phrasing and deliberately avoided words that were already loaded with connotations such as "responsibility," "citizenship," or "sustainability." Instead, the phrase simply combined categories of broad topics, which allows not only for variance by region or context, as discussed above, but also an evolution over time in meaning. Specific sub-issues can change in importance or conceptualization and still fit under the umbrella of the term ESG. For instance, "climate change and related risks" was listed as an example under E, and it has been a primary focus in the ESG movement, and as other issues such as water risks and biodiversity come to be appreciated they can be integrated without change to the existing term.[173] Similarly, "workplace health and safety" was listed as an example under S, and as a broader array of issues related to workers came into focus and took on the label of "human capital management," this too could easily be fit within the existing umbrella of ESG.[174] Further, as ESG was not coined by regulators as a legal term of art, investors themselves could be the drivers of the evolution over time in their areas of focus.[175]

Third, and perhaps most importantly, ESG has served as a "big tent"[176] that collectively appeals to a broad range of investors and stakeholders, contributing to the ability of the concept to gain momentum in mainstream audiences. Whereas efforts under the label of CSR faced headwinds and were marginalized with the rise in shareholder primacy and wealth maximization in the late twentieth century, as researchers began to explore links to financial performance and build a "business case" it opened up a pathway for integration in the existing "corporate governance machine" of law, markets, and culture oriented towards shareholders.[177] The *Who Cares Wins* initiative explicitly framed ESG in terms of the business case for integrating issues into mainstream investment

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[173] *See, e.g.*, World Economic Forum, *We Need to Rethink ESG to Ensure Access to Water and Sanitation for All*, Aug. 20, 2021, https://www.weforum.org/agenda/2021/08/rethink-esg-to-ensure-access-to-water-and-sanitation-for-all/; Thomas Helm, *Biodiversity Concerns Set To Be The Next Frontier After Climate Change*, IFLR (Feb. 21, 2022), https://www.iflr.com/article/2a647jipe3beilnnbt0qo/biodiversity-concerns-set-to-be-the-next-frontier-after-climate-change.

[174] *See, e.g.*, Georgiev, *supra* note 62, at 639 (noting that human capital management has quickly rose in "prominence and uptake" and is "broadly fitting within the rubric of environmental, social, and governance (ESG) factors").

[175] *See* Wolf-Georg Ringe, *Investor-Led Sustainability in Corporate Governance* (Sept. 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3958960 (arguing that "ESG engagement has the potential to become a very powerful driver towards a more sustainability-oriented future" because "investor-led priorities would follow a more flexible and dynamic pattern rather than complying with inflexible pre-defined criteria"); *see also* Ann Lipton, *ESG Investing, or, If You Can't Beat 'Em, Join 'Em*, *in* RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD (Elizabeth Pollman & Robert Thompson eds., 2021) (describing ESG as an "intervention" that "leans into, rather than resisting, shareholder power" and exploring "whether the investor class is the right constituency to craft social policy").

[176] *See* Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821, 1825 (2021) ("The breadth of topics embraced by ESG, and the breadth of motivations spurring the ESG movement, has created a big tent that has undoubtedly served a purpose in terms of helping the various causes of those involved to gain momentum."); *see also* Curtis et al., *supra* note 149, at 401 (""ESG is a rough label for an amalgamation of voices, interest groups, and substantive concerns.").

[177] Lund & Pollman, *supra* note 13, at 2613.



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analysis, chose a term that was facially more neutral than other existing terms, interjected "governance" which had widespread buy-in from mainstream market actors, and emphasized the theme of aligning goals between those of the financial industry and the UN.[178] This allowed for understanding ESG as value enhancing, and thus threading the needle of legal debates and creating a "business opportunity" for a wide range of institutional players such as asset managers, ratings agencies, accounting firms and the like.[179]

At the same time, "values-based investors who care about whether, and how, corporations address (at least certain) ESG topics due to religious or sociopolitical commitments"[180] also found the ESG term and concept attractive. As the discussion above examines, for many observers ESG indeed became associated with CSR in various ways ranging from a view of alignment of value and values to a more direct equating of ESG as CSR in a new bottle. Creating a term that could present itself as neutral or value-enhancing, while at the same time welcoming proponents of previous "social"-related concepts, enabled a diverse group of investors and stakeholders to embrace activity under such a term.

### B. The Combination Giving Rise to Challenges and Critiques

Although coining the term ESG helped to create a flexible, big tent that could gain support from a diverse group of investors and stakeholders, it did not resolve tensions between different views of the purpose of ESG or the lack of consensus about the fundamental problem it is addressing. The combination of E, S, and G into one term has given rise to several challenges that are increasingly becoming apparent.

First, the characteristic flexibility that the term embodies by allowing for a variety of understandings of meaning, and a broad array of issues across space and time, has come with several potential downsides. An important challenge that has proven enduring in this regard is the difficulty of pinpointing empirically the relationship between ESG and economic performance. An enormous amount of research has focused on the question and come up short in providing a definitive conclusion. Although significant evidence exists of such a link, the studies often bundle ESG issues together or rely on ESG performance ratings that do so, and often leave unanswered which, if any, corporate policies or activities are actually related to financial performance and whether the relationship is causal.[181] We can understand this challenge, at least in part, as a function of the lack of clear definition of ESG and the fact that it is combining sometimes disparate

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[178] *Supra* notes 57 & 70.

[179] *See* Lund & Pollman, *supra* note 13, at 2614-15; *see also* Rose, *supra* note 176, at 1823 ("ESG proponents also include members of an emerging corps of people and institutions who profit from the movement, including corporate sustainability officers, providers of ESG ratings and indices, accounting firms that offer ESG-related services, and managers of specialized ESG-investment vehicles."); Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1992 (2020) (observing that "[r]ising interest in ESG investing has [] generated a huge market opportunity for the providers of ESG indices and metrics, who are [] capitalizing on this key moment").

[180] *See* Rose, *supra* note 176, at 1822-23.

[181] *See id.* at 1825-27; *see also* Atz et al., *supra* note 129.



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and changing issues.[182] The mixed empirical evidence gives both proponents and critics of ESG something to point to in debates that continue to rage on.

Similarly, the flexibility and wide-ranging understandings of the term ESG contribute to a multitude of issues and approaches, with an ever-growing list of sub-topics to the three components and more than six hundred ESG ratings organizations and rankings worldwide, and substantial variation among ratings.[183] For some, this diversity is not problematic or it is viewed as a temporary situation as regulators around the world move to require disclosure of additional ESG-related information and companies provide more information on a voluntary basis. And, although proponents acknowledge there is room for improvement in ESG ratings, they counter that does not mean that they are useless.[184] But for others, the constant expansion of sub-topics fitting under the big tent of ESG contributes to a sense that the term is too nebulous or so capacious that it is ultimately meaningless or will collapse under its own weight.[185] Likewise, the multitude of ESG ratings is evidence to some observers that they are "inconsistent" and "subjective."[186] Moves to consolidate disparate ESG ratings systems could also prove problematic as it could lock in inadequate standards in areas such as S that have lagged in development and been more difficult to find alignment among investors in assessing and quantifying.[187] These concerns about ESG issues and ratings, together with other challenges, in turn feed a range of critiques.

One such related challenge is that because ESG was coined in a way that combines wide-ranging issues, companies with diverging performance on E, S, or G can receive ratings that seem at odds with understood purposes of the term ESG.[188] For example, electric vehicle manufacturer Tesla has been included in many ESG-labeled mutual funds

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[182] *See, e.g.*, Curtis et al., *supra* note 149, at 402 ("One challenge to analyzing the relationship between ESG and economic performance is the absence of a clear definition of ESG."). Meta analyses of ESG studies have likewise reported a range of results, and the approach has been criticized on the basis that "the different measures and methods used by scholars make it impossible to form a meaningful synthesis." King & Pucker, *supra* note 6.

[183] *See* Curtis et al., *supra* note 149, at 403.

[184] *See* Serafeim, *supra* note 1, at 18. For example, a study found ESG ratings helpful in predicting future ESG related news. *Id.* (citing George Serafeim & Aaron Yoon, *Stock Price Reactions to ESG News: The Role of ESG Ratings and Disagreement*, REVIEW OF ACCOUNTING STUDIES (forthcoming)).

[185] *See, e.g.*, Swasti Gupta-Mukherjee, *Clarity, Climate and Principles: Aligning Social and Economy Value Through Finance*, ASPEN INSTITUTE (July 6, 2022) (noting concern that "making ESG issues a laundry-list of social and environmental factors . . . could be counterproductive").

[186] *See* Rose, *supra* note 176, at 1827; *see also* Hester M. Peirce, Comm'r, SEC, Scarlet Letters: Remarks Before the American Enterprise Institute (June 18, 2019), https://www.sec.gov/news/speech/speech-peirce-061819 (observing substantial variation in ESG ratings and questioning the viability of accurate evaluation).

[187] *See, e.g.*, Michael Posner, *Does Tesla Deserve to Be Treated as an ESG Champion?*, ETHICAL SYSTEMS (Feb. 8, 2022), https://www.ethicalsystems.org/does-tesla-deserve-to-be-treated-as-an-esg-champion/. Although S is frequently pointed to as lagging, the first "ESG"-related disclosure requirement that the SEC implemented as such was notably for human capital management. *See* Georgiev, *supra* note 62.

[188] A variation of this critique concerns the proliferation of approaches to ESG reporting. *See, e.g.*, Leo E. Strine, Jr., Kirby M. Smith & Reilly Steel, Caremark *and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective* Caremark *and EESG Strategy*, 106 IOWA L. REV. 1885, 1911-12 (2021) (noting the challenge that the proliferation of ESG reporting is "inefficient, encourages greenwashing and gamesmanship of the kind that has characterized corporate governance ratings, and threatens to engage companies more in the rhetoric of EESG than the reality of managing a corporation with the goal of being other-regarding toward company stakeholders and society").



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and exchange-traded funds, but observers have pointed to potentially problematic S issues for the company, ranging from a string of racial and sexual discrimination lawsuits and employee reports of a "culture of racism," to supply chain concerns about the production of cobalt which may involve child labor and safety hazards.[189] Ironically, Elon Musk, the CEO of Tesla, has himself called out that "Exxon is rated top ten best in world for environment, social & governance (ESG) by S&P 500, while Tesla didn't make the list!"[190] He followed that "ESG is a scam. It has been weaponized by phony social justice warriors."[191] Although less hyperbolic, investors have similarly registered surprise when they realize that ESG funds they are invested in have large holdings in bank stocks instead of the wind and solar companies they are expecting.[192] Reporting by the *Wall Street Journal* "revealed that eight of the 10 biggest ESG funds in 2019 were invested in oil and gas companies."[193] After Russia invaded Ukraine, the U.S. media brought to light that a number of ESG funds hold stakes in Russian assets ranging from state-backed energy companies to government bonds.[194] Indeed, ESG has been criticized by those who think it does not do enough "good for the world" and instead is "just capitalism at its slickest: ingenious marketing in the service of profits."[195]

Not only do the ratings reflect a combination of wide-ranging issues that can create a mismatch with expectations for the ESG label, the ratings themselves may be unreliable and are not subject to standardized approaches, which also stems at least in part from the lack of a fixed definition of ESG and its components. The ratings reflect structural measurement and reporting problems arising from data that is incomplete, largely unaudited, and voluntarily disclosed.[196] One study of six top ESG ratings firms concluded that "ratings from different providers disagree substantially" and "the

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[189] *See id.*; *Black Tesla Employees Describe a Culture of Racism*, L.A. TIMES (Mar. 25, 2022), https://www.latimes.com/business/story/2022-03-25/black-tesla-employees-fremont-plant-racism-california-lawsuit; Dana Hull & Bloomberg, *Tesla Sued By More Women Alleging Sexual Harassment at Plant*, FORTUNE (Dec. 14, 2021), https://fortune.com/2021/12/14/tesla-sued-sexual-harassment-fremont-plant/.

[190] @elonmusk, Twitter (May 18, 2022, 9:09 AM), https://twitter.com/elonmusk/status/1526958110023245829.

[191] *Id.*

[192] Laurence Fletcher & Joshua Oliver, *Green Investing: The Risk of a New Mis-Selling Scandal*, FIN. TIMES (Feb. 19, 2022, https://www.ft.com/content/ae78c05a-0481-4774-8f9b-d3f02e4f2c6f.

[193] Kenneth P. Pucker, *Overselling Sustainability Reporting*, HARV. BUS. REV. (May-June 2021), https://hbr.org/2021/05/overselling-sustainability-reporting.

[194] Kishan & Bloomberg, *supra* note 112.

[195] Hans Taparia, *One of the Hottest Trends in the World of Investing Is a Sham*, N.Y. TIMES (Sept. 29, 2022), https://www.nytimes.com/2022/09/29/opinion/esg-investing-responsibility.html; *see also* Andrew Winston, *What's Lost When We Talk 'ESG' and Not 'Sustainability'*, MIT SLOAN MGMT. REV. (May 5, 2022), https://sloanreview.mit.edu/article/whats-lost-when-we-talk-esg-and-not-sustainability/ (expressing concern with "investor-led language" like ESG because "the quest for shareholder maximization is largely how we got into this mess in the first place" and "it seems unwise to let finance lead the journey to a humane, more just, less greed-filled form of capitalism").

[196] Pucker, *supra* note 193; *see also* David F. Larcker, Lukasz Pomorski, Brian Tayan & Edward M. Watts, *ESG Ratings: A Compass Without Direction*, Rock Center for Corporate Governance Working Paper (Aug. 2, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4179647 (providing description of ESG ratings industry and discussing challenges with completeness of data, standardization, and consistency as well as conflicts of interest).



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information that decision-makers receive from ESG rating agencies is relatively noisy."[197] Furthermore, as companies can choose to use different metrics and standards for reporting, as well as change their methodology from year to year, it is "nearly impossible" to compare companies on the basis of ESG performance.[198]

In addition, ratings firms might compute ESG ratings by measuring the degree to which a company's economic value is at risk due to ESG factors, or based on its management of issues such as pollutive behavior or regulatory risk, rather than its positive environmental and social impacts.[199] Conflicts of interest or other concerns might also be at play. One study showed that one of the leading vendors of ESG ratings gave higher scores to firms connected to it through institutional ownership than to other firms.[200] Another research paper has documented "widespread and repeated changes to the historical ESG scores" of one of the key ratings providers—suggesting there might be "data rewriting" that "plausibly originates from the rating vendor's incentive to retroactively strengthen the link between ESG scores and returns."[201] Unsurprisingly given this state of affairs, 26% of investment professionals surveyed by Amir Amel-Zadeh and George Serafeim indicate concerns with the reliability of ESG ratings, though 82% use ESG data in the investment process.[202] As Virginia Harper Ho has observed, "[t]he limitations of ESG ratings and data have led many asset managers to expend their own resources to analyze ESG information at added cost, which also has fiduciary implications."[203]

Furthermore, the challenge is not simply that there may be misimpressions of what ESG means or widely varying performances between the components of E, S, and G that can give rise to questionable ratings. Without an integrated approach to ESG

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[197] Florian Berg, Julian F. Kölbel & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533 (forthcoming REV. FIN.); *see also* Rajna Gibson, Philipp Krueger & Peter Steffen Schmidt, *ESG Rating Disagreement and Stock Returns*, ECGI Fin. Working Paper No. 651/2020 (Aug. 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3433728 (studying the relationship between ESG rating disagreement and stock returns).

[198] *Id.*; *see also* Andrea Cardoni, Evgeniia Kiseleva & Simone Terzani, *Evaluating the Intra-Industry Comparability of Sustainability Reports: The Case of the Oil and Gas Industry*, 11 SUSTAINABILITY 1093 (2019).

[199] Hans Taparia, *The World May Be Better Off Without ESG Investing*, STAN. SOC. INNOV. REV. (July 14, 2021), https://ssir.org/articles/entry/the_world_may_be_better_off_without_esg_investing (providing the example of Pepsi and Coca Cola which get high ESG scores from the biggest ratings firms because they rank highly on corporate governance and greenhouse gas emissions, "[h]owever, their core businesses involve the manufacturing and marketing of addictive products that are a major cause of diabetes, obesity, and early mortality").

[200] Dragon Yongjun Tang, Jiali Yan & Chelsea Yaqiong Yao, *The Determinants of ESG Ratings: Rater Ownership Matters*, Proceedings of Paris Dec. 2021 Finance Meeting EUROFIDAI – ESSEC (June 6, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3889395.

[201] Florian Berg, Kornelia Fabisik & Zacharias Sautner, *Is History Repeating Itself?: The (Un)predictable Past of ESG Ratings*, ECGI Finance Working Paper No. 708/2020 (Aug. 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3722087.

[202] Amir Amel-Zadeh & George Serafeim, *Why and How Investors Use ESG Information: Evidence from a Global Survey*, 74 FIN. ANALYSTS J. 87 (2018).

[203] Harper Ho, *Sustainable Investment & Asset Management*, *supra* note 128. Relying on private initiatives to standardize ESG investment practices and report "has also created costly fragmentation and slowed the development of a level playing field for all investors." *Id.*



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factors, "sustainability arbitrage" is possible for both companies and investors.[204] Good performance on one issue, such as low-carbon product development, could be strategically used to mask another, such as poor labor practices.[205]

In some instances, the challenge is not even a problematic rating or sustainability arbitrage, but instead inherent tensions between E and S that can arise due to business model or industry.[206] For example, "[a]dverse employment impacts are to be expected in companies in certain sectors such as energy and some regions that will have to execute an extensive transformation to reduce their GHG emissions and to ultimately stay on a path consistent with the net zero ambitions."[207] Environmental concerns and labor interests "are not always reconcilable" and divesting or decommissioning brown assets or transforming a business to new technology can lead to workers losing relevant skills, having lower wages, or getting laid off.[208] If labor has countervailing power it might be able to get concessions, but "it is also possible that balancing of different interests is too difficult and the process of net transition comes often to deadlock" or the company will not give due consideration to social impacts, which could deepen inequality.[209] The potential for stakeholder conflicts arising from this clash between E and S has led to arguments for a "just transition" that promotes swift climate action at the same time as mitigating adverse effects for workers such as with Coasean bargaining or reorganization and re-training programs.[210] To the extent that ESG investors fail to take up the just transition issue, it can add to doubts about whether these investors "walk the talk."[211]

Discourse on the just transition issue connects to an even deeper point – use of ESG factors for investment analysis and decision-making purposes alone may only achieve value alignment for investors with their portfolios, not social value creation. As scholars have highlighted, "[i]t is virtually impossible for a socially-motivated investor to affect the outputs or behavior of companies whose securities trade in public markets through buying and selling their shares in the secondary market."[212] By contrast, "impact investing" is a subset of socially-motivated investing that aims to influence a company's

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[204] Alperen A. Gözlügöl, *The Clash of 'E' and 'S' of ESG: Just Transition on the Path to Net Zero and the Implications for Sustainable Corporate Governance and Finance*, SAFE Working Paper No. 325 (Feb. 6, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3962238.

[205] Nick Robins, Vanda Brunstig & David Wood, *Climate Change and the Just Transition: A Guide for Investor Action* (Dec. 2018), p. 18, https://cpl.hks.harvard.edu/files/cpl/files/jtguidanceforinvestors-1.pdf?m=1569856838; *see also* Hester Peirce, U.S. Securities and Exchange Commission Speech, *Chocolate-Covered Cicadas* (July 20, 2021), https://www.sec.gov/news/speech/peirce-chocolate-covered-cicadas-072021?utm_medium=email&utm_source=govdelivery (arguing that ESG encompasses "a great and growing number of unrelated (and incommensurable) items" that leads to a lack of "clear boundaries and internal cohesion").

[206] Gözlügöl, *supra* note 204.

[207] *Id.* at 4.

[208] *Id.* at 4, 9.

[209] *Id.* at 17, 19-20.

[210] *Id.* at 1; Robins et al., *supra* note 205.

[211] Gözlügöl, *supra* note 204, at 27. Sometimes employees are vocal advocates for companies to reduce their environmental impact. *See* Karen Weise, *Over 4,200 Amazon Workers Push for Climate Change Action, Including Cutting Some Ties to Big Oil*, N.Y. TIMES (Apr. 10, 2019), https://www.nytimes.com/2019/04/10/technology/amazon-climate-change-letter.html

[212] Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (And Can't) Create Social Value*, 44 J. CORP. L. 205, 228 (2019).



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performance or activity.[213] Such outcome might be achieved by lowering the cost of capital to the company, thereby allowing it to engage in more socially valuable practices, or engaging in stewardship or activism of a sort that goes beyond simply considering ESG factors for investment purposes such as socially-screened ESG mutual funds.[214] At some point, tradeoffs with financial returns may come into play.[215]

Existing usage of the term ESG investing includes a wide variety of strategies – some of which aim at impact whereas others are more likely to only attain values alignment at best. Commentators have observed, for example, that analysts typically group ESG investment strategies into five categories: "impact (seeking environmental or social outcomes and most often undertaken by private investors), thematic (focusing on a theme such as water scarcity or energy transition), engagement (direct communications between investors and companies), negative screen (excluding certain industries), or integration (considering ESG-related risks and opportunities)."[216]

Further, scholars and other legal observers have highlighted potential tensions or tradeoffs between focusing on ESG issues at the firm level versus at the portfolio or market-level. Institutional investors that hold a broadly diversified portfolio across the market may be motivated to reduce systematic risk and internalize intra-portfolio negative externalities.[217] Considering ESG factors or risk management for one company may point in a different direction than for the overall portfolio. Moreover, the label "ESG" does not itself convey a theory of how to aggregate company-level ESG characteristics to construct a portfolio-level ESG score.[218] For example, it is not clear whether an investor who values board diversity would prefer a portfolio that maximizes companies with at least one or

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[213] *Id.* at 228.

[214] *Id.* at 228-31; *see also* Lubos Pastor, Robert F. Stambaugh & Lucian A. Taylor, *Dissecting Green Returns*, Univ. of Chicago, Becker Friedman Inst. for Econ. Working Paper No. 2021-70 (June 15, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3869822 ("[O]ur findings imply that greener firms have lower costs of capital than their recent stock performance might suggest. This is good news for ESG investors, because one way they exert social impact is by decreasing green firms' cost of capital.").

[215] *See, e.g.*, Pastor et al., *supra* note 214, at 1, 31 (observing that "green stocks typically outperform brown when climate concerns increase" and noting "[g]reen assets delivered high returns in recent years" because of "unexpectedly strong increases in environmental concerns, not high expected returns" and predicting that future years will see "lower expected returns for green stocks than for broan, consistent with theory"); Pucker, *supra* note 193 (noting some impact investors are explicit about their willingness to tradeoff financial returns).

[216] King & Pucker, *supra* note 6. The SEC's proposed enhanced disclosures for ESG funds uses three categories: "integration, ESG-Focused, and impact investing." SEC, Proposed Rule, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (May 25, 2022), https://www.sec.gov/rules/proposed/2022/ia-6034.pdf.

[217] Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 5 (2020); Frederick Alexander, *An Honorable Harvest: It Is Time for Universal Owners to Take Responsibility for Their Portfolios*, THE SHAREHOLDER COMMONS (Aug. 7, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3433845; Jeffrey N. Gordon, *Systematic Stewardship*, J. CORP. L. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782814; John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*, ECGI Law Working Paper No. 541/2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3678197.

[218] Adriana Z. Robertson & Sarath Sanga, *Aggregating Values*, U. CHI. L. REV. ONLINE (forthcoming) (manuscript on file with author).



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two women on the board or instead maximizes total representation of women directors across the portfolio.[219]

None of these issues are necessarily fatal to the success of the ESG movement, but they can be understood at least in part as stemming from the choice to combine issues in one term that may be in tension with each other or lead to tradeoffs that were not addressed in the initial framing. Although the initiative participants espoused the view that the "entire range" of ESG issues relevant to a business should be considered by companies and integrated into investment analysis,[220] and suggested that this approach was aligned with long-term shareholder value,[221] they did not explain how to do so or what to do when an individual component or activity may not enhance value for shareholders. Quite understandably, much was left to be figured out after the initial coining of the term ESG and championing consideration of a broad set of issues. In hindsight, however, it can be appreciated that the choice of the ESG term came with consequences, such as that priorities were not set in advance as would have been the case had initiative participants instead focused their firepower on a particular issue such as climate change. Additionally, the very flexibility and broad approach embodied by the ESG acronym that contributed to its meteoric rise has also led to challenges that gave fodder to critics.

The critiques of ESG are wide-ranging, from assertions of confusion, unrealistic expectations, and greenwashing to notions that it is crowding out other solutions or inhibiting accountability.[222] As George Serafeim, a leading scholar of ESG has succinctly observed, "ESG has rapidly become a household name leading to both confusion about what it means and creating unrealistic expectations about its effects."[223]

Commentary and changing positions from regulators can contribute to these impressions of problems with the term ESG. For example, some U.S. securities regulators have noted that ESG "encompasses a wide variety of investments and strategies" and "it can be very difficult to understand what some funds mean when they say they're an ESG fund" and some may mislead investors by "overstating their ESG focus."[224] On the other hand, some regulators warn that having the Securities and Exchange Commission (SEC) "standardize" the definition of ESG would limit investor choice and put the SEC in the position of being the arbiter of what constitutes an acceptable ESG strategy.[225] As one

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[219] *Id.*
[220] *See supra* note 59.
[221] *See supra* notes 57 & 58.
[222] *See, e.g.*, King & Pucker, *supra* note 6 ("Managers of ESG investments create false hope, oversell outperformance, and contribute to the delay of long-past-due regulatory action.").
[223] Serafeim, *supra* note 1, at 1.
[224] Gary Gensler, Statement on ESG Disclosure Practices, U.S. Sec. & Exch. Comm'n (May 25, 2022), https://www.sec.gov/news/statement/gensler-statement-esg-disclosures-proposal-052522; *cf.* Roisman, *supra* note 113 (expressing concern that the vagueness of the ESG term and "amorphous" issues it encompasses can give investors misimpressions).
[225] Commissioner Hester M. Peirce, Lucy's Human: Remarks at Virtual Roundtable on The Role of Asset Management in ESG Investing (Sept. 17, 2020), https://www.sec.gov/news/speech/peirce-lucys-human-091720.



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SEC commissioner observed, "One person's ecofriendly windmill is another person's bird killer."[226]

To take another example, in 2020, the U.S. Department of Labor (DOL) issued a rule that removed all references to ESG and required that ERISA plan fiduciaries focus only on pecuniary factors in investment decisions for beneficiaries. It explained that "by conflating unrelated environmental, social, and corporate governance factors into a single term, ESG invites a less than appropriately rigorous analytical approach" for corporate officers and directors to manage as part of the company's "business plan" and for qualified investment professionals to "treat as economic considerations" in evaluating investment.[227] After a change in presidential administration, however, the DOL reversed course and announced a proposed rule that would remove barriers to consideration of ESG factors in selecting investments and exercising shareholder rights.[228] The DOL's disparagement of combining E, S, and G, and varied positions with changing political administrations, ultimately contribute to perceptions that it is not clear whether consideration of ESG issues comes at the expense of financial returns and, moreover, that ESG is ideologically or politically tinged.

Such connotations and understandings could in turn fuel challenges to rulemaking that might otherwise help to address some of the existing problems, such as First Amendment challenges to the climate risk disclosure rules proposed by the SEC.[229] In spring 2022, the agency proposed rule changes that aim to provide investors with "consistent, comparable, and decision-useful information" regarding the climate-related risks and greenhouse gas emissions of public companies.[230] The proposed rules are based in part on the voluntary framework published by the Task Force on Climate-related Financial Disclosures (TCFD) of the Financial Stability Board, an international body that makes recommendations for the global financial system.[231] The TCFD framework is being incorporated in varying degrees into legislation or securities exchange requirements around the world, including in Canada, Hong Kong, Japan, New Zealand, Singapore, Switzerland, and the United Kingdom.[232]

Despite alignment with the TCFD's framework and over 4,000 investment firms managing over $120 trillion in assets supporting the PRI's commitment to seeking ESG

[226] *Id.*

[227] Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72,846 (Nov. 13. 2020) (codified at 28 C.F.R. § 2550.404a-1 (2020)), at 72,857.

[228] US Department of Labor Proposes Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Management (Oct. 13, 2021), https://www.dol.gov/newsroom/releases/ebsa/ebsa20211013.

[229] *See* Elizabeth Pollman, *The Supreme Court and the Pro-Business Paradox*, 135 HARV. L. REV. 220, 251-54 (2021) (discussing potential First Amendment challenges to ESG-related disclosure rules).

[230] U.S. Securities and Exchange Commission, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46.

[231] Michael Littenberg et al., *Ten Thoughts on the SEC's Proposed Climate Disclosure Rules*, HARV. L. SCH. FORUM ON CORP. GOV. (Apr. 30, 2022), https://corpgov.law.harvard.edu/2022/04/30/ten-thoughts-on-the-secs-proposed-climate-disclosure-rules/.

[232] *Id.*



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disclosures from portfolio companies,[233] the SEC's proposed rules have faced pushback in the United States. The SEC has received thousands of letters of public comment from companies, investors, auditors, academics, and trade groups—much of the response has positive, but a vocal group of critics has also emerged.[234] Most notably, critics of the proposed rules, ranging from a group of U.S. senators to an SEC Commissioner who issued an extensive dissenting statement, have argued that the SEC lacks authority for its actions, the cost-benefit analyses in the proposed rules do not meet the requirements of the Administrative Procedure Act, and the proposed rules violate First Amendment restrictions against compelled speech.[235] These arguments will likely end up in court battles and, through an unfortunate twist, the various commentary and changing positions of regulators on ESG-related issues that have been pushing towards progress may be harnessed in attacks against the final rules.[236] Without mandatory climate risk disclosures in the United States, global efforts to standardize and incorporate such information into investment analysis and decision-making are significantly weakened.

Another obstacle for the ESG movement is that limited progress on E and S can lead observers to dismiss the movement as largely ineffectual or raise concerns about "greenwashing."[237] Investigations into greenwashing have indeed become salient with global behemoths such as Goldman Sachs and Deutsche Bank coming under scrutiny.[238] The SEC's enforcement efforts have already yielded a settlement with asset manager BNY Mellon for allegedly misleading investors about ESG claims.[239] Further, greenwashing claims are not limited to concerns about investors, but also encompass consumer protection issues. For example, several environmental organizations have filed a complaint with the Federal Trade Commission, which is charged with enforcing false advertising law, that contends that Chevron has overstated and misrepresented its efforts

[233] Sara Dewey, *What to Know about the SEC's Proposed Climate Risk Disclosure Rule*, HLS ENVT'L & ENERGY L. PROG. (Apr. 27, 2022), https://eelp.law.harvard.edu/2022/04/what-to-know-about-the-sec-proposed-climate-risk-disclosure-rule/.
[234] Mark Maurer, *Companies Skewer SEC's Climate-Disclosures Plan in Comment Letters*, WALL ST. J. (June 21, 2022), https://www.wsj.com/articles/companies-skewer-secs-climate-disclosures-plan-in-comment-letters-11655834912.
[235] Littenberg et al., *supra* note 231.
[236] *See, e.g.*, Sean J. Griffith, *What's "Controversial" About ESG? A Theory of Compelled Commercial Speech under the First Amendment* (May 24, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4118755 (arguing that "the proposed climate rules create controversy by imposing a political viewpoint, by advancing an interest group agenda at the expense of investors generally, and by redefining concepts at the core of securities regulation" and are thus subject to heightened scrutiny and "will likely be invalidated").
[237] *See, e.g.*, Tim Quinson, *Greenwashing Is Increasingly Making ESG Moot*, BLOOMBERG (Mar. 16, 2022), https://www.bloomberg.com/news/articles/2022-03-16/greenwashing-is-increasingly-making-esg-investing-moot-green-insight. On "greenwashing" as a term referring to "misleading environmental communication," see Amanda Shanor & Sarah E. Light, *Greenwashing & The First Amendment*, COLUM. L. REV. (forthcoming 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4178318. The alternative term "bluewashing" is sometimes used to refer to deceptive or misleading social claims. Sarah Dadush, *Identity Harm*, 89 U. COLO. L. REV. 863, 877 (2018).
[238] *See* Patrick Temple-West & Joshua Franklin, *SEC Investigating Goldman Sachs for ESG Claims*, FIN. TIMES (June 10, 2022), https://www.ft.com/content/5812ab1f-c2d4-4681-a6be-45f0befd92df; William Langley & Joe Miller, *DWS Chief Resigns After Police Raid Over Greenwashing Claims*, FIN. TIMES (June 1, 2022), https://www.ft.com/content/50f5c4a1-5ebe-40cc-a89f-2952f58ba324; Patrick Temple-West & Stefania Palma, *SEC Prepares to Crack Down on Misleading ESG Investment Claims*, FIN. TIMES (May 23, 2022), https://www.ft.com/content/6fefdb2c-f72e-4e52-b95b-c0727aeb1a94.
[239] *Id.*



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to reduce greenhouse gas emissions and increase investments in renewable energy.[240] A slew of claims and ESG-related litigation are on the horizon as corporate statements and pledges about environmental and social issues have seen "exponential growth."[241]

More generally, attacks on ESG as an ineffective movement due for a reckoning are on the rise.[242] Tariq Fancy, the former chief investment officer for sustainable investing at BlackRock attracted global attention with his claim that ESG is "marketing gobbledygook" that "is actively misleading people" and creating a "dangerous distraction" from regulation that would fit the scale of problems such as climate change.[243] Corporate finance expert Aswath Damodaran has memorably called the ESG movement a "gravy train" and asserted that investment funds, accounting firms, consulting firms, and ESG measurement services are its real beneficiaries rather than stakeholders.[244] In his view, CEOs have encouraged this gravy train to keep rolling because of "the power it gives them to bypass shareholders and evade accountability."

Many of these challenges and critiques are "hyperboles"[245] or at least can be partially sorted out with time. For example, although there is some cause for concern

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[240] Myles McCormick, *Chevron Accused of 'Greenwashing' in Complaint Lodged with FTC*, FIN. TIMES (Mar. 16, 2021), https://www.ft.com/content/2985e18a-fdcb-4cd2-aee3-d5a0fe4cdab2.

[241] *See* Shanor & Light, *supra* note 237 (discussing "exponential growth in environmental marketing claims"); Adam B. Badawi & Frank Partnoy, *Social Good and Litigation Risk*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4221476 (forthcoming HARV. BUS. L. REV.) (examining the relationship between ESG metrics and securities litigation); Aisha I. Saad & Diane Strauss, *The New "Reasonable Investor" and Changing Frontiers of Materiality: Increasing Investor Reliance on ESG Disclosures and Implications for Securities Litigation*, 17 BERKELEY BUS. L.J. 397 (2020) (examining securities litigation trends related to ESG disclosures); Emily Strauss, *Climate Change and Shareholder Lawsuits*, Duke L. Sch. Public Law & Legal Theory Series No. 2022-41 (Aug. 3, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4174681 (examining climate-related shareholder suits and arguing that "climate disclosures may not be enforced in a socially optimal way" under the current regime for shareholder litigation); Veronica Root Martinez & Gina-Gail Fletcher, *Equality Metrics*, 130 YALE L.J. FORUM 869 (2021) (discussing how "many of the statements issued by corporations in support of the Black Lives Matter movement look more like marketing campaigns than like blueprints for the implementation of specific strategies"); John Rice, *Rainbow-Washing*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4193059 (forthcoming NE. U. L. REV.) (examining how shareholder litigation could address corporate "rainbow-washing" claims in support of the LGBTQIA+ community).

[242] *See, e.g.*, Michael O'Leary & Warren Valdmanis, *An ESG Reckoning Is Coming*, HARV. BUS. REV. (Mar. 4, 2021), https://hbr.org/2021/03/an-esg-reckoning-is-coming (expressing concern that "[a] movement meant to benefit the public good risks becoming a buzzword coopted to keep maximizing short-term profits").

[243] Robert Armstrong, *The ESG Investing Industry Is Dangerous*, FIN. TIMES (Aug. 23, 2021), https://www.ft.com/content/ec02fd5d-e8bd-45bd-b015-a5799ae820cf (quoting essay by Tariq Fancy); *see also* King & Pucker, *supra* note 6 (noting that "every former asset manager professional" interviewed in their study expressed "skepticism" and "were doubtful about ESG investing"). On the false dichotomy between internal and external reforms for corporate governance and regulation, see Aneil Kovvali, *Stark Choices for Corporate Reform*, COLUM. L. REV. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4067505.

[244] Damodaran, *supra* note 155.

[245] Serafeim, *supra* note 1, at 19; *see also* Judy Samuelson, *ESG: Not woke capitalism or greenwashing—but an opportunity for employee voice*, QUARTZ (July 20, 2022), https://qz.com/2185351/esg-not-woke-capitalism-or-greenwashing-but-an-employee-arena/ (arguing that ESG has become "a political issue" but it is "neither woke capitalism nor cynical greenwashing," rather an "imperfect, ever-evolving effort to assess the risk



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about the opacity to investors of relying on the ESG label,[246] there is also evidence that ESG funds are offering their investors increased ESG exposure without increasing costs or reducing returns.[247] To the extent consideration of ESG issues adds value to the investment decision-making process, it is likely asset managers will persist in doing so.[248] New taxonomies could also be created to help investors make informed investment decisions.[249] Regulatory rulemaking could increase transparency about investment company names.[250] Cracking down on greenwashing or other misleading claims could aid in long-term efforts to ensure the credibility of ESG-related statements and disclosures.

Yet some aspect underlying the challenges and critiques stem from the construction itself of combining E, S, and G without definition into a singular term and with the stated intention of relevant issues varying by geography and company. Further, as the alignment between shareholder value creation and ESG performance was asserted from the outset but never fully proven or reconciled, a variety of meanings will likely continue to be ascribed to the ESG term. Understood in this light we can see that the challenges and critiques of ESG will not likely be resolved definitively because they are intertwined with the term and its origins. Appreciating the existing limits and uncertainties of ESG might, however, help identify areas in which investors, corporations, and regulators can take a more thoughtful approach.

### C. Proposals for the Future of ESG

Finally, as debate about ESG continues and memories of its origins fade, new proposals arise to change or define the term. Each of these proposals reveals a critical perspective with the aim of improving the term or related efforts, but none provide a silver bullet against ESG critiques.

The first set of proposals suggest a friendly amendment by adding or subtracting words from the acronym. Such proposals might add emphasis to certain existing components, which is generally the authors' aims, but would not likely alter the fundamental tension that exists between the term's flexibility and big tent approach and the corresponding challenges and critiques it engenders.

For example, Leo Strine, the former Chief Justice of the Delaware Supreme Court, has proposed that another E be added to ESG to increase the salience of

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companies face if they fall short in the race to contain the Earth's temperature rise and make capitalism work for more people").

[246] *See, e.g.*, Brakman Reiser & Tucker, *supra* note 179, at 1921 (providing data from 2018-2019 showing great variation among ESG funds that is "largely opaque to consumers—who rely on the ESG acronym at their peril").

[247] Curtis et al., *supra* note 149, at 393.

[248] *See* Lieber, *supra* note 122 (noting that Vanguard, Fidelity, and TIAA have ESG products "because it adds value to the investment decision-making process" and so "[i]t's here to stay").

[249] *See, e.g.*, Eric C. Chaffee, *Index Funds and ESG Hypocrisy*, 71 CASE W. RES. L. REV. 1295, 1317-20 (2021) (proposing a taxonomy for ESG fund names).

[250] The SEC has stated it plans to consider whether to propose amendments to the Investment Company Act provision that addresses investment company names that are likely to mislead investors. U.S. Securities & Exch. Comm'n, Sunshine Act Notice (May 18, 2022), https://www.sec.gov/os/sunshine-act-notices/sunshine-act-notice-open-052522.



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employees in ESG discussions and analyses.[251] Although such construction might laudably keep the treatment of workers in the mix of ESG issues commonly addressed, the S in ESG already included such a possibility and labor-related issues have been a key example since the *Who Cares Wins* initiative, building on one of the core principles of the Global Compact. Further, adding a component does not change the difficulty of empirical measurement and the potential for tensions and tradeoffs.[252]

Another proposal, advanced by David Larcker and Brian Tayan, is to take the G out of ESG.[253] As a reflection of how the history of the term ESG has been lost, they observe that "[a] perplexing question is why governance—the 'G' in ESG—is included as a third factor."[254] In their view, "[g]overnance is unlike E and S" and "an ineffective measure of how socially responsible a company is" and so "[a] more honest assessment of a company's commitment to stakeholders would leave governance variables out of the rating."[255] Yet Larcker and Tayan seem to simply conceive of governance differently from the institutions that originally coined the term ESG. Instead of integrating consideration of governance mechanisms that are interlinked with E and S, and that execute on such policies, Larcker and Tayan characterize "governance [a]s an *overlay*" and "environmental and social components of ESG a[s] *outcomes*."[256] Such an approach might appeal to some ESG proponents, but likely only a fraction as the endorsing institutions of the *Who Cares Wins* initiative included some of the world's largest banks and they viewed G as crucially interlinked to fulfilling the promise of better environmental and social performance. Traders at asset management funds also find the G in ESG to be critical, especially in vendor and counterparty relationships as it can help to avoid government scrutiny by providing a window into compliance with ethical standards, internal controls, and codes of conduct.[257] Moreover, even if a component of ESG was removed, there would still be two, each with a multiplicity of possible sub-issues that could vary widely by context and over time, and thus not solving the difficulty of empirical measurement or the potential for tensions and tradeoffs.

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[251] *See* Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism* 6 (Roosevelt Inst., Working Paper No. 202008, 2020), https://rooseveltinstitute.org/publications/toward-fair-and-sustainable-capitalism/.

[252] Another proposal championed adding an H for health to ESG. Michell A. Williams & Patricia Geli, *ESG Is Not Enough. It's Time to Add an H*, FORTUNE (Mar. 14, 2022), https://fortune.com/2022/03/14/esg-is-not-enough-time-to-add-health-wellbeing-csr-workers-pandemic-leadership-geli-williams/.

[253] *See* Larcker et al., *supra* note 11, at 3 (arguing that it is a "myth" of ESG that it should include governance because "[t]he need for governance quality is universal among organizations"); David F. Larcker & Brian Tayan, *The Case for Taking the 'G' Out of ESG*, WALL ST. J. (Apr. 28, 2022), https://www.wsj.com/articles/esg-the-case-for-taking-out-the-g-11651004068.

[254] Larcker & Tayan, *supra* note 253; *cf.* Jonathan R. Macey, *ESG Investing: Why Here? Why Now?*, Yale L. & Econ. Res. Paper (Mar. 10, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3942903 (arguing that "ESG investing and governance can be explained, at least in part, as a response to the failure of government" to address broad social problems and "[t]his explains the 'E' and the 'S' in ESG [b]ut it does not explain the 'G' or governance component").

[255] Larcker & Tayan, *supra* note 253.

[256] *Id.*

[257] Tim Quinson, *Traders Are Big Fans of the 'G' in ESG*, BLOOMBERG (Aug. 3, 2022), https://www.bloomberg.com/news/articles/2022-08-03/traders-are-really-big-fans-of-the-g-in-esg-green-insight.



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Interestingly, it is often the S instead of G that is "single[d] out . . . as a different kind of category from its peers."[258] As David Wood explained, "The E invokes issues as such carbon intensity or energy and resource consumption that are easily quantifiable and with comparable units of measure; The G invokes industry standards of board structure, shareholder rights, or standards of business ethics on which there is relatively widespread agreement in principle; but the S invokes issues which are often hard to quantify, not so clearly linked to the risk/reward analysis in investment decision-making, and may touch on culturally specific norms that do not so easily translate into guidance for (often globally focused) investment decision-makers."[259] The S might be seen as "softer" or "mushier" than E and G, as well as "more likely to invoke ethical issues that lie beyond the scope of proper investment strategy or to require cultural judgments about potential consumer, reputational, or political risks that are particularly difficult to gauge."[260] In any event, whether it is the S or the G that is more unlike the others, such proposals and analyses of the divergence between ESG components only underscore that the term will likely continue to be the site of contestation even as its embrace has gone mainstream.

And, by contrast to those who wish to add or subtract a letter from ESG, some scholars have pushed for deconstructing the term altogether. Tracing the history of ESG's origins indeed raises the counterfactual question of what might have occurred if instead of lumping E, S, and G together, the underlying issues had been pursued separately. Swasti Gupta-Mukherjee has proposed disentangling climate change from ESG as "our era's defining issue" and because it is a macro risk factor that impacts physical assets and produces direct costs.[261] According to this view, combining ESG mandates "could inadvertently dilute the awareness, understanding, and action pertaining to climate risk in particular."[262] For some this argument carries great weight, and the market has already launched some novel financial instruments focused specifically on environmental responsibility such as green bonds.[263] But for others, climate change is correlated or intertwined with other important socio-economic concerns, or linked to other environmental issues such as biodiversity loss, and trying to distance climate change from ESG would not be palatable or perhaps even feasible as the term ESG would still exist as an umbrella term for a great number of efforts and investments.

A different set of proposals aims to narrow the meaning of ESG or create a larger set of more precise terms. Fixing a narrower definition of ESG could help protect against misunderstandings and greenwashing, but it might also lose the benefits of flexibility and adaptability that has allowed ESG to evolve over time and vary by geographic region and company. Narrowing ESG would also likely mean that some of the proponents of ESG would no longer embrace it as a concept that serves their goals or interests – some of the existing proponents would no longer fit under the big tent.

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[258] Wood, *supra* note 124, at 554-55 ("There have been dozens, if not hundreds, of conference panels, blog posts, listserve chats, and other discussions that pose the S in ESG as a problem to be solved.").
[259] *Id.*
[260] *Id.* at 555.
[261] Gupta-Mukherjee, *supra* note 16; *see also* ECONOMIST, *supra* note 8 (arguing that E, S, and G should be unbundled and "[i]t is better to simply focus on E" and that E should stand "for emissions alone").
[262] *Id.*
[263] *See, e.g.*, Dorothy S. Lund, *Corporate Finance for Social Good*, 121 COLUM. L. REV. 1617 (2021) (discussing impact bonds, green bonds, carbon offsets, and related financial instruments).



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Creating a sufficiently clear and narrow definition is also a considerable challenge as attempts at drafting legal terms often give way to more interpretational disputes than clarity. For example, the European Union Commission has notably aimed to take major steps forward in defining various ESG and sustainability-related obligations with the proposed Corporate Sustainability Due Diligence Directive,[264] but such efforts have in turn led to a new batch of interpretational issues to be worked through and critiques about loopholes and other concerns.[265]

Another idea would be to create a taxonomy of different, more precise terms for concepts related to ESG.[266] This could provide for greater market differentiation of investment products and accountability. A key potential area for greater clarity and precision could be distinguishing between ESG as "inputs" into an investment process and ESG as "outputs" or goals to be maximized, with the latter carrying an understanding that it may involve trade-offs with financial returns and the need for further specification of the type of goals being pursued.[267] The SEC's proposal to enhance disclosures by investment advisers about ESG practices, and the use of the ESG label on funds, moves in this direction.[268] The European Union's taxonomy on sustainability aims to provide definitions for which economic activities can be considered environmentally sustainable.[269] A taxonomy of different ESG terms or labels might, however, multiply terminology that might be confusing or unwieldy, and global variation would amplify this dynamic.

Some critics and proponents have begun to advocate for the death of ESG – scrapping the term altogether.[270] A special report in *The Economist* concluded, "As an amalgam of three words, environmental, social and governance, which sound more like a

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[264] European Commission, Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and Amending Directive (EU) 2019/1937 (Feb. 23, 2022), https://eur-lex.europa.eu/resource.html?uri=cellar:bc4dcea4-9584-11ec-b4e4-01aa75ed71a1.0001.02/DOC_1&format=PDF.

[265] *See, e.g.*, Sarah Ellington, *Ten Areas of Continued Uncertainty in the EU Commission Proposal for a Corporate Sustainability Due Diligence Directive*, WATSON FARLEY & WILLIAMS (July 6, 2022), https://www.wfw.com/articles/ten-areas-of-continued-uncertainty-in-the-eu-commission-proposal-for-a-corporate-sustainability-due-diligence-directive/; *EU: Disappointing Draft on Corporate Due Diligence*, HUMAN RIGHTS WATCH (Feb. 28, 2022), https://www.hrw.org/news/2022/02/28/eu-disappointing-draft-corporate-due-diligence.

[266] *See, e.g.*, Chaffee, *supra* note 249.

[267] *See* Kirk, *supra* note 123 (arguing to split the meaning of ESG between inputs and outputs).

[268] U.S. Sec. & Exch. Comm'n, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices (May 25, 2022), https://www.sec.gov/news/press-release/2022-92. On navigating First Amendment issues related to regulating greenwashing, see Shanor & Light, *supra* note 237.

[269] European Commission, EU Taxonomy for Sustainable Activities, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en. The EU has also made efforts at comprehensive sustainability disclosure requirements under the umbrella of Sustainable Finance Disclosure Regulation (SFDR). Eurosif, SFDR, https://www.eurosif.org/policies/sfdr/.

[270] *See* THE ECONOMIST, *Measure Less, But Better* (July 21, 2022), https://www.economist.com/special-report/2022/07/21/measure-less-but-better ("Ideally, the term ESG should be scrapped.").



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pious mantra than a force for change, its reputation is now tarnished."[271] Similarly, the former head of sustainability at CalPERS, one of the world's largest pension funds, remarked, "I think it's time for RIP ESG."[272] A different perspective arguing for "the end of ESG" asserts that it is "no better or worse than other factors that drive long-term value" and thus it should not be politicized, treated as special, or "put on a pedestal."[273] Such views do not necessarily reflect a belief that all efforts at investing based on environmental or social issues should be abandoned, but that a major rethinking is due or a shift in discourse.[274]

In all, these various proposals for improving the term ESG or creating new definitions or taxonomies, or even jettisoning it from usage, highlight the underlying tension at the heart of ESG and its origins that this Article has explored. The big tent of ESG, and its ambiguity about whether it is a tool for financial and risk analysis or a vehicle to creating social good, are closely connected to its challenges and critiques. The path forward is uncertain. The profit-making motive within the ESG industry, which to date has pushed towards making ESG ever bigger, could eventually hasten its collapse if credibility concerns continue. Efforts to fight greenwashing and establish some measure of accountability are important to avoid such a fate,[275] but are unlikely to save the term from continued battle, particularly as politicians have attempted to cast it as a lightning rod in the culture wars of a polarized citizenry.[276]

A better understanding of the history, usages, and consequences of ESG might help chart the course forward in these possible futures. Critical analysis of combining E, S, and G reveals the tradeoffs at stake. Amid challenges and backlash to ESG, efforts to create an altogether new term might also arise again, restarting a journey that other terms such as CSR and sustainability have also traveled.

## CONCLUSION

Within just a couple decades the term ESG has gone from closed-door sessions of financial industry executives and other institutional leaders gathered by the United Nations to the everyday lingo of investors, asset managers, corporate officers and

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[271] *Id.*
[272] Tett, *supra* note 134.
[273] Edmans, *supra* note 122, at 10-11.
[274] *Id.* (noting the former CalPERS sustainability head argued for rethinking what ESG means and devising "a broader, human centered approach"); ECONOMIST, *supra* note 270 (arguing for the demise of ESG and "a suitable new name" such as "natural-capital investing" that would blend climate and capitalism).
[275] *See, e.g.*, *id.* (observing that the ESG backlash "is a sign that the market is maturing and evolving, in the face of more scrutiny" and asserting that challenges might make the concept more durable as other financial innovations in history have similarly followed a pattern of pendulum swings between fast uptake and inevitable reaction and regulation); Kishan & Bloomberg, *supra* note 112 (discussing the view that the ESG "shakeout" will lead to more "honesty in markets").
[276] *See* Jeff Green & Saijel Kishan, *America's Political Right Has a New Enemy No. 1: ESG Investors*, BLOOMBERG (May 20, 2022), https://www.bloomberg.com/news/articles/2022-05-20/why-esg-investing-is-under-republican-attack#xj4y7vzkg; Pitchbook, 2022 Sustainable Investment Survey, at 10, https://pitchbook.com/news/reports/2022-sustainable-investment-survey (observing that investment managers must thread the needle by "ensuring they have a robust ESG approach for the majority of investors…but they must also avoid saying anything too strongly or publicly about their ESG practices to avoid being blacklisted by groups who have negatively politicized ESG").



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directors, employees, consumers, and regulators around the world. This Article has provided an in-depth examination of the term and its implications, starting from its history and evolution in usage to the promise and perils of its construction.

This exploration reveals that ESG has a specific origin, but is not a fixed concept beyond the combination of three categories of issues that comprise the acronym. Just as the opaque features of legal standards can create a salutary "fog" that allows for moral deliberation,[277] the flexibility and big tent approach of the term ESG, and its facilitation of claims of alignment between value and values, are at once part of the success story in diffusing ESG widely and forming a diverse movement of proponents. The ambiguity of ESG and varying usages that developed over time have facilitated buy-in from a great variety of market actors. However, these very features that have fostered a global dialogue, attracted trillions of investment dollars, and fueled regulatory reform, are also the source of challenges and critiques that have emerged and will continue into the foreseeable future.

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[277] Seana Valentine Shiffrin, *Inducing Moral Deliberation: On the Occasional Virtues of Fog*, 123 HARV. L. REV. 1214 (2010).



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Harvard Law School Forum on Corporate Governance

# Fiduciary Duties of Public Pension Systems and Registered Investment Advisors

*Posted by Jed Rubenfeld, Strive Asset Management, on Wednesday, March 1, 2023*

**Tags: dei, ESG, ESG Investment, Fiduciary duties, regulation, Sustainability**
**More from: Jed Rubenfeld, Strive Asset Management**

**Editor's Note:** Jed Rubenfeld is Robert R. Slaughter Professor of Law at Yale Law School and an advisor to Strive Asset Management. This post is based on his Strive memorandum. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** (discussed on the Forum **here**) by Lucian A. Bebchuk and Roberto Tallarita; **How Much Do Investors Care about Social Responsibility?** (discussed on the Forum **here**) by Scott Hirst, Kobi Kastiel, and Tamar Kricheli-Katz; **Does Enlightened Shareholder Value add Value** (discussed on the Forum **here**) by Lucian Bebchuk, Kobi Kastiel, Roberto Tallarita; **Companies Should Maximize Shareholder Welfare Not Market Value** (discussed on the Forum **here**) by Oliver D. Hart and Luigi Zingales; and **Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee** (discussed on the Forum **here**) by Max M. Schanzenbach and Robert H. Sitkoff.

So-called Environmental, Social, and Governance ("ESG") investment practices have come under increasing legal scrutiny. Areas of legal concerns include potential breaches of fiduciary duty, conflicts of interest, violations of antitrust law, and violations of federal securities law.

This white paper addresses three questions:

1. Does state law prohibit public pension trustees from choosing investments, adopting investment strategies, or exercising appurtenant voting rights based on ESG considerations?

2. Does state law prohibit public pension trustees from allocating capital to funds, including index funds, owned by asset management firms that engage with portfolio companies, and/or exercise appurtenant voting rights, to promote ESG objectives?

3. Does state or federal law prohibit a registered investment advisor ("RIA") from investing client capital, or advising a client to invest capital, in funds, including index funds, owned by asset management firms that engage with portfolio companies and/or exercise appurtenant voting rights to promote ESG objectives, without expressly informing the client of these ESG-promoting practices and obtaining the client's express advance consent?

## BRIEF ANSWERS

In our opinion, the answer to all three questions is yes.

Under well-established law, public pension trustees and RIAs are fiduciaries, charged with the highest legal duties of loyalty and prudence, and specifically with the duty to act solely and exclusively in the interests of their beneficiaries/clients. In the case of state pension trustees, these fiduciary duties require that state assets be invested solely to maximize *financial* return. By contrast, registered investment advisors (RIAs) are permitted to invest client capital in the service of non-pecuniary objectives, but only if the client gives his express, informed, advance consent thereto.

In our opinion, courts are likely to conclude that ESG investment practices are motivated, either primarily or at least in part, by social and political objectives, not solely by considerations of maximizing financial return. Thus ***state pension trustees may neither engage in ESG investment practices nor allocate capital to asset management firms who engage in such practices***. RIAs, however, may invest client capital with an asset management firm that engages in ESG-promotion, ***but only if they have first obtained informed, express client consent thereto***.

# BACKGROUND

## *What is ESG?*

ESG refers to a set of loosely-defined but highly influential non-pecuniary criteria that purport to assess the extent to which companies are achieving certain social and political objectives with which many citizens disagree.

Prominent among these ESG objectives are what ESG proponents call: (1) "DEI," an acronym for Diversity, Equity, and Inclusion; and (2) "Sustainability." DEI is a euphemism for measures such as affirmative action, "racial audits," and mandatory "anti-racism" sessions, said to be necessary to fight "structural racism," "systemic gender bias," or "white supremacy." Sustainability refers to goals pursued by the environmentalist movement, such as "net-zero" and the lowering or outright banning of fossil fuel production/consumption.

The ESG movement grew out of the Socially Responsible Investing (SRI) movement of the 1970s and 1980s and has been called by respected commentators a "rebranded" version thereof. **[1]** The goal of SRI was to encourage institutional investors to promote through their investment decisions global outcomes considered socially responsible. The movement was propelled into worldwide prominence by a United Nations initiative launched in 1999 by then-Secretary-General Kofi Annan at the World Economic Forum in Davos, calling on private firms to accept a "Global Compact" "to embrace, support and enact a set of core values in the areas of human rights, labour standards, and environmental practices." **[2]**

An important and current statement of ESG principles can be found in the "United Nations Principles of Responsible Investing," which has been signed by over 3,000 asset managers pledging to further "environmental, social, and corporate governance (ESG)" goals in order to "better align investors with broader objectives of society." **[3]**

ESG is also very closely aligned with the "Stakeholder Capitalism" movement, which holds that companies should look beyond "profits and a high share price," **[4]** instead "meeting the needs of all [their] stakeholders: customers, employees, partners, the community, and society as a whole." **[5]** According to BlackRock CEO Larry Fink, a leading proponent of both the Stakeholder Capitalism and ESG movements, Stakeholder Capitalism is a "driving force behind ESG." **[6]**

ESG investing is frequently claimed by its proponents to increase long-term value and profitability. Financially demonstrable proof of this claim, however, is at present entirely lacking. Instead, as discussed below, recent evidence suggests that ESG investing in fact produces inferior financial outcomes. **[7]** At a minimum, ESG investment practices appear plainly to be motivated, either primarily or at least in part, by social and political objectives rather than the sole objective of maximizing financial return.

***ESG Promotion by Asset Managers***.

In recent years the ESG movement has catapulted into a dominant position throughout the asset management industry. Globally, ESG-themed investments totaled an estimated $37.8 trillion in assets under management for year-end 2021. **[8]** As stated above, the UN PRI principles have garnered thousands of asset manager signatories. Signatories to the "Climate Action 100+," an "investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change," include hundreds of asset managers "responsible for more than $68 trillion in assets under management across 33 markets," including the so-called Big Three (BlackRock, Vanguard Asset Management, and State Street Global Advisors). **[9]**

The Big Three, which collectively control roughly $20 trillion in assets, rivaling the entire U.S. GDP, are also members of the "Net Zero Asset Managers Initiative," a partnership dedicated to transforming the global economy to reach net-zero carbon emissions. Before joining the initiative, each member must commit to implementing a "stewardship and

engagement policy"—*i.e.*, a policy of proxy share voting and engaging with corporate executives—consistent with "achieving global net zero emissions by 2050." The Net Zero Asset Managers Initiative requires its members to prescribe specific emissions targets for industry sectors. One internationally prominent net-zero emissions target calls for eliminating fossil fuels from electricity generation by 2050, which would require every American utility and most major American energy companies to radically alter their business operations and policies. **[10]**

The Big Three asset managers have not only publicly committed themselves to promoting the ESG agenda, but have also made "***firmwide commitments***" to do so. *See, e.g.*, *BlackRock 2020 Sustainability Disclosure*, at 6, https://perma.cc/4HE5-6DXH (disclosing BlackRock's "***firmwide commitment to integrate ESG information into investment processes across . . . all of [its] investment divisions and investments teams***"). Significantly, such "firmwide" ESG commitments extend not merely to offering ESG-themed products to interested investors, but also to advancing the ESG agenda throughout ***all*** investment platforms and portfolios, including their so-called "passive" index funds.

In the case of index funds, asset management firms like the Big Three pursue ESG-promotion through two primary mechanisms: (1) shareholder proxy voting and (2) corporate "engagement," defined by Vanguard as "[d]irect contact with companies to discourage undesirable corporate behavior." **[11]** These "direct contacts"—for example, high-level in-person conversations or phone calls with corporate officers—often take place behind closed doors, and the specifics of these communications are typically undisclosed to outsiders. Corporate engagement is less visible and to many less well-known than proxy voting, but is known to be highly influential because of the tens of trillions of dollars in potential investment capital wielded by firms like BlackRock, Vanguard, and State Street.

Through both mechanisms, ESG-promoting asset managers use their power as "shareholders in an attempt to . . . promote what they consider to be the right public policy. This takes place through dialogue with officers and proxy voting." **[12]** Again, asset managers who engage in these ESG-promoting practices—including BlackRock, Vanguard, and State Street—admit that they do so throughout all their investment portfolios, ***including their nominally "passive" index funds***.**[13]** SEC Commissioner Mark Uyeda recently described how the major American asset management firms use both shareholder voting and corporate "engagement" to push the ESG agenda on corporate America:

In reviewing any large asset manager's stewardship website, mentions of ESG seem ubiquitous, from voting guidelines to engagements statistics. The information on these websites often document how an asset manager (1) establishes its expectations for ESG matters, (2) engages with companies that aren't meeting its expectations, and (3) may vote against one or more incumbent directors if those companies do not continue to meet expectations. For example, an asset manager publicly disclosed a case study where, following multi-year engagements, it voted against a director of a public company, who also chaired the board committee overseeing ESG matters, because the company had failed to disclose its forward-looking GHG reduction targets. This is one of many instances in which an asset manager did not support the election of a director on the basis of climate-related issues. **[14]**

With their $20 trillion in assets under management, the Big Three control a staggering sum of investment capital—the "equivalent of more than half of the combined value of all shares for companies in the S&P 500." **[15]** They are also, collectively, the owners of some 20-25% of the voting shares of most major U.S. companies and thus able in many cases to control the election of directors. Due to this extraordinary economic and shareholding power, ESG-promotion by firms like BlackRock, Vanguard, and State Street can and does have a profound impact on company management and policy all across America, often at odds with the best financial interests of the company and its shareholders.

For example, in 2021, an environmental activist group holding a minuscule number of shares of Exxon nominated at that company's annual shareholder meeting a slate of new directors committed to reducing oil production. Whether one agrees or disagrees with this initiative as a matter of social policy, it is hard to see how reducing oil production is in the best financial interests of an oil company. Nevertheless, the Big Three asset management firms voted their proxies in favor of the activist slate of directors, and as a result the activist directors won, causing Exxon subsequently to cut oil production, thereby reducing the company's revenues and contributing to a nationwide increase in gas prices.

This result is disturbing not only because it is a prime example of ESG-promotion by BlackRock and other major asset management serving to further social or political goals at the expense of investors. It is also concerning because oil projects abandoned by Exxon can be picked up by rival companies like PetroChina, the Chinese national energy company —one of whose largest private shareholders happens to be BlackRock. [16] There is no record evidence that BlackRock notified any of its investor-clients of this serious potential conflict of interest—*i.e.*, that Exxon's loss could be BlackRock's gain.

In other examples of ESG initiatives seemingly at odds with the best interests of shareholders and other investors, the Big Three voted their proxies in 2021 to cause Chevron to adopt Scope 3 emissions cuts and in 2022 to cause Apple to engage in a company-wide "racial equity audit." However strongly some may support such measures, they are not primarily motivated by the interests of shareholders, but rather, as their proponents freely acknowledge, by a putative desire to advance the interests of certain social groups, society at large, or a company's other "stakeholders." For example, the proponents of Apple's racial equity audit shareholder proposal **claimed** that such an audit was required to determine "how [Apple] contributes to social and economic inequality" and to force Apple to "identify, remedy, and avoid adverse impacts on its stakeholders." Color of Change—one of the activist groups **pushing** for a racial equity audit at Apple—explains that its **mission** is "to hold companies accountable for the ways they perpetuate white supremacy." Some may view "hold[ing] companies accountable" for "white supremacy" as a noble goal, but it is a goal quite different from maximizing return to those companies' shareholders.

## *Growing Concern Over the Legality of ESG Investment Practices*

In recent months, there has been growing, serious concern over the legality of ESG investment practices, particularly in connection with state public pension systems. Of particular relevance are the following actions taken by state Attorneys General:

- On May 26, 2022, the Attorney General of Kentucky concluded in a formal legal **opinion** that under the law of Kentucky, "'***environmental, social, and governance' investment practices that introduce mixed motivations to investment decisions" violate the "fiduciary duties owed by investment management firms to [state] public pension plans.***"
- On August 4, 2022, nineteen state Attorneys General wrote a **letter** to BlackRock CEO Laurence D. Fink, expressing concern that BlackRock's ESG promotion "***may violate multiple state laws . . . requiring a sole focus on financial return.***"
- On August 30, 2022, the Attorney General of Louisiana issued a formal legal **guidance** letter warning of a "trend among some investment management firms, such as BlackRock, ***to use money from public and state employee pension plans to push their own political agendas and force social change through use of ESG criteria***." The guidance went on to state: "The Big Three have all violated their fiduciary duty by, among other things, pledging together as part of Climate Action 100+, and, thus, have placed their interest in the ESG agenda above the interest of their investor-clients. In dereliction of their fiduciary duties, they have supplanted their client's best monetary interest with their own agenda on climate change, politics, and other self-interests. ***They appear to have weaponized their client's money to force changes in corporate structures and hierarchy, to change corporate policies, and to force companies to follow the ESG agenda all without their client's best monetary interest at the forefront.***"
- On September 1, 2022, the Attorney General of Indiana issued a formal legal **opinion** concluding that public pension fund fiduciaries act unlawfully ***if they allocate capital to asset management firms that "engage with portfolio companies, or exercise voting rights appurtenant to investments based on ESG considerations."***

# LAW AND ANALYSIS

## *The Sole Interest Rule*

Throughout the United States, pension plan managers and investment staff are trustees as well as fiduciaries, required to comply with "***the sole interest rule***," according to which "a plan fiduciary "shall discharge his duties with respect to a plan ***solely in the interest of the participants and beneficiaries and . . . for the exclusive purpose of providing benefits to participants and their beneficiaries***." *Cent. States, Southeast & Southwest Areas Pension Fund v. Cent. Transp., Inc.*, 472 U.S. 559, 570-71 **(**1985) (emphasis added) (citation omitted).

Across America, the sole interest rule is codified in state constitutions, state statutory law, and case law. "All fifty states authorize the assets of public retirement systems to be held in trust. . . . The obligations imposed on the board and third party managers include duties of undivided loyalty and reasonable care that are at the core of fiduciary law." T. Leigh Anenson, *Public Pensions and Fiduciary Law: A View From Equity*, 50 Mich. J.L. Ref. 251, 258 (2016); *see, e.g.*, 3 Restatement (Third) Of Trusts § 78(1) (trustees must act solely in the interest of beneficiaries); Uniform Prudent Investor Act § 5 (1994). As the United States Court of Appeals for the Second Circuit has stated, the "fiduciary obligations of the trustees to the participants and beneficiaries of [a pension] plan are those of trustees of an express trust—the *highest known to the law*." **[18]**

Because fiduciaries must be solely motivated by considerations of financial return, ***"mixed-motive" investing is unlawful***. Opinion of the Attorney General of Kentucky, OAG 22-05 at 5 (May 26, 2022) ("mixed-motive" investing violates pension trustees' fiduciary duty); Opinion of the Attorney General of Indiana, No. 2022-3, at 11 (Ind. Sept. 1, 2022) ("A fiduciary breaches this duty merely by having a mixed motive."); *see, e.g.*, *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2nd Cir. 1982) (pension fund fiduciary must "*act for the exclusive purpose*" of providing financial benefits to plan beneficiaries) (emphasis added); Schanzenbach & Sitkoff, *supra*, at 401 ("***Acting with mixed motives triggers 'an irrebuttable presumption of wrongdoing,' full stop***.") (emphasis added).

## *Social Investing Prohibited*

For the same reasons, "social investing"—*i.e.*, the investing of plan assets motivated by social or political considerations rather than solely motivated by considerations of financial return—is prohibited in state pension systems. As stated in the comments to the Uniform Prudent Investor Act:

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries … in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.

Uniform Prudent Investor Act, § 5, cmt. (1994) (emphasis added).

## *Registered Investment Advisors*

Investment advisers are fiduciaries under both state and federal law. *See, e.g.*, *Securities & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (advisors are fiduciaries under federal and common law); SEC Guidance, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*," **https://www.sec.gov/rules/interp/2019/ia-5248.pdf** ("Under federal law, an investment adviser is a fiduciary."). As the SEC has stated, investment advisors must make a reasonable inquiry into their clients' objectives and must "adopt the [client's] goals, objectives, or ends." *Id*.

Accordingly, in contrast to pension fund fiduciaries, investment advisors may lawfully invest client capital to pursue non-pecuniary objectives, including social investing. Individual investors are free to use their investment capital however they wish, including to pursue social or political objectives, rather than solely to maximize financial return. And investment advisors are legally bound to "adopt" and execute such objectives, if the client has chosen them.

The corollary, however, is that investment advisors may ***not*** place client capital in investments promoting social, political, or other non-pecuniary objectives ***unless the client is aware this is being done and has consented to it***. Under well-

established law, investment advisers have a fiduciary duty to disclose to clients all material information. “As a general matter, an investment adviser, as a fiduciary, ***has a duty to disclose to clients all material facts*** . . . Information is ‘material if there is a substantial likelihood that a reasonable [client] would consider it important.’ This duty is enforceable under Section 206 of the Advisers Act.” **[19]** The fact that an investor’s money and shares will be used to promote a non-pecuniary social or political agenda would seem plainly material; some investors may welcome it, but others could reasonably choose to avoid placing their money with an asset manager who intends to vote their shares (or pursue “corporate engagement”) to advance an agenda with which the investor does not agree. Thus, before placing client capital in an investment promoting non-pecuniary objectives, investment advisors must disclose that information to their clients and secure their advance consent.

## *ESG Investing Barred in Public Pension Systems*

Under the foregoing principles, it is clear that public pension trustees may not engage in ESG investing.

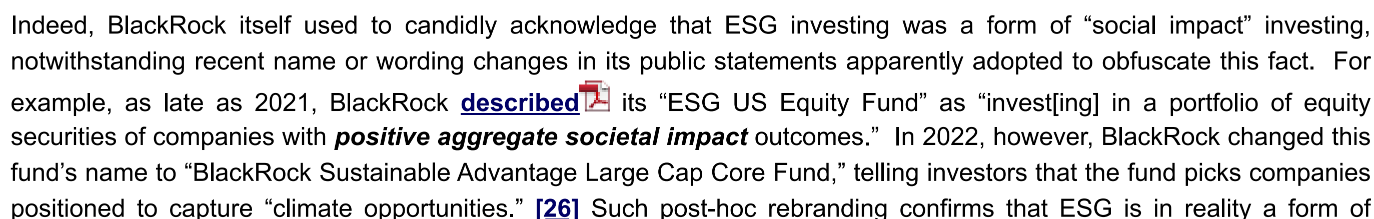
ESG calls for investment decisions to be made to advance certain social and/or political objectives, such as “diversity, equity and inclusion” or “sustainability.” ESG is therefore a form of “social investing” or, at an absolute minimum, an example of “mixed-motive investing.” It is not motivated solely and exclusively to maximize financial return, as the law requires of pension fiduciaries. Citizens may agree or disagree with the ESG agenda, but under well-established law, state pension trustees are not permitted to use employees’ retirement assets to advance it.

ESG advocates sometimes claim that ESG investing is not intended to advance social or political objectives, but rather is solely motivated by financial considerations. Such claims have become more common in recent months as legal scrutiny of ESG has intensified. These claims, however, are not credible, and in our opinion courts are likely to reject them.

ESG is a rebranded version of the earlier Socially Responsible Investing movement. Its proponents believe that corporations and investors should not consider only their own profits, but should rather, as the UN “Global Compact” and “Principles for Responsible Investing” declare, “embrace, support and enact a set of core values in the areas of human rights, labour standards, and environmental practices” **[20]** in order to “better align investors with broader objectives of society.” **[21]**

Candid descriptions of ESG acknowledge that its goal is to advance “socially responsible,” “socially conscious,” or “social impact” outcomes, even at the expense of “profit margin.” The following represent just a few examples:

- “The goal of the [ESG] movement is to ensure that companies take into account *not only their profit margin but also the impact they have on society and the world*.” **[22]**
- “Environmental, social, and governance (ESG) criteria are a set of standards for a company’s behavior used by *socially conscious investors* to screen potential investments . . . to encourage companies to act *responsibly*” and to allow investors to “*put[] their money where their values are*.” **[23]**
- “The corporate social responsibility (CSR) movement wants companies to consider the societal impact of their operations. A recent outgrowth of CSR has been to speak in terms of environmental, social, and governance (ESG) impact of a company’s operations. . . . ESG reflects a way to measure the societal impact by providing metrics [to] investors and investment analysts.” **[24]**
- “The PRI defines *responsible investment* as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.” **[25]**



Indeed, BlackRock itself used to candidly acknowledge that ESG investing was a form of “social impact” investing, notwithstanding recent name or wording changes in its public statements apparently adopted to obfuscate this fact. For example, as late as 2021, BlackRock **described** its “ESG US Equity Fund” as “invest[ing] in a portfolio of equity securities of companies with ***positive aggregate societal impact*** outcomes.” In 2022, however, BlackRock changed this fund’s name to “BlackRock Sustainable Advantage Large Cap Core Fund,” telling investors that the fund picks companies positioned to capture “climate opportunities.” **[26]** Such post-hoc rebranding confirms that ESG is in reality a form of

"social impact" investing and undermines recent attempts to redescribe ESG in terms of capitalizing on market "opportunities."

As to the claim that ESG actually increases investment returns, courts cannot and will not simply defer on this issue to the say-so of ESG-promoting asset management firms or other ESG proponents. Rather, the burden of proof falls on those investment fiduciaries who seek to engage in ESG investment practices. "[U]nder the common law, a fiduciary who allegedly breached his or her fiduciary duty must justify his or her conduct. *See, e.g.*, *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921)." *Green v. Fund Asset Mgmt., L.P.*, 245 F.3d 214, 227 n.14 (3d Cir. 2001). Where "it is possible to question fiduciaries' loyalty," "intensive and scrupulous" inquiry is appropriate, and substantial, objective and "independent" evidence must support the fiduciaries' claims. *Howard v. Shay,* 100 F.3d 1484, 1488-89 (9th Cir. 1996) (quoting *Leigh v. Engle*, 727 F.2d 113, 125-26 (7th Cir. 1984)).

At present, proof that ESG increases investor return is wholly lacking. On the contrary, significant evidence suggests that ESG investing in fact produces *inferior* financial returns. As stated in a March 2022 report issued by the Harvard Business Review:

***ESG funds certainly perform poorly in financial terms***. In a recent Journal of Finance paper, University of Chicago researchers analyzed the Morningstar sustainability ratings of more than 20,000 mutual funds representing over $8 trillion of investor savings. Although the highest rated funds in terms of sustainability certainly attracted more capital than the lowest rated funds, ***none of the high sustainability funds outperformed any of the lowest rated funds.*** **[27]**

Industry studies purporting to show an ESG "alpha"—a higher rate of return—have been called into question by academic research. *See, e.g.*, Financial Times, *ESG outperformance narrative 'is flawed', new research shows*, May 3, 2021, https://www.ft.com/content/be140b1b-2249-4dd9-859c-3f8f12ce6036. "'There is no ESG alpha,' said Felix Goltz, research director at Scientific Beta . . . . 'The claims of positive alpha in popular industry publications are not valid because the analysis underlying these claims is flawed,' with analytical errors 'enabling the documenting of outperformance where in reality there is none.'" *Id*.

According to data from Morningstar, out of 170 U.S.-centered funds with ESG mandates, only 49 (less than a third) outperformed the S&P 500 index in 2021, and as of mid-February, fewer than a quarter of those funds had done so in 2022. **[28]** A recent study of a "comprehensive sample of self-labeled ESG mutual funds" found that "ESG funds appear to underperform financially relative to other funds within the same asset manager and year." **[29]** A leading rating agency's study of data from 2010 through 2017 in a large U.S. equities index concluded that ESG-based "[s]tock selection (asset selection) ***accounted for an annual drag on returns of -1.45 percentage points***. . . . [S]electing companies with high ESG ratings ***led to under-performance***." **[30]** Many industry observers now agree that earlier assertions of an ESG alpha were based on faulty correlations and, in addition, predict that recent global economic shocks will produce an "extended period" of continued "underperformance" for ESG investments going forward. **[31]**

The absence of demonstrable, empirical proof of the financial superiority of ESG investing—together with significant evidence of underperformance—fatally undermines claims by ESG-promoting firms such as BlackRock that their ESG policies are motivated solely and exclusively to increase financial returns. Rather, the empirical evidence confirms that ESG is motivated, either primarily or at least in part, to advance social and political objectives.

Accordingly, public pension system fiduciaries are prohibited from choosing investments, adopting investment strategies, or exercising appurtenant voting rights based on ESG considerations. A public pension trustee must not invest pension assets for any purpose other than paying benefits to plan participants. ESG investment practices are not consistent with this obligation.

Similarly, pension plan fiduciaries are prohibited from allocating capital to investment funds, including index funds, owned or controlled by asset management firms that engage with portfolio companies, or exercise appurtenant voting rights, to promote ESG objectives. Again, this would permit the use of public pension assets for purposes other than paying benefits to plan participants. The corporate engagement and proxy voting practices engaged in by BlackRock and other ESG-promoting firms are not motivated solely to maximize financial return. They are motivated at least in part to achieve "social impact" objectives—objectives with which many disagree. Such practices are highly influential, imposing costs and

policies on American companies that ESG proponents may favor but that are not provably in the best interests of those companies, shareholders or investors.

### *ESG Investment Permitted for RIAs, but Only with Client Consent*

With respect to RIAs, the foregoing analysis shows that RIAs, unlike pension plan trustees, may base their investment advice on ESG considerations and may place client capital in ESG-promoting investments, including index funds owned or controlled by asset management firms that engage with portfolio companies, or exercise appurtenant voting rights, to promote ESG objectives. However, they may do so ***if and only if they have first informed their clients of these facts and obtained advance client consent thereto***.

As stated earlier, "an investment adviser, as a fiduciary, has a duty to disclose to clients all material facts," and information is "material if there is a substantial likelihood that a reasonable [client] would consider it important." **[32]** An investment adviser's "[f]ailure to disclose material facts ***must be deemed fraud***," the Supreme Court has held, and this is so ***regardless of the presence or absence of any intent to deceive***. *Capital Gains Research Bur.*,375 U.S. at 200; *Chiarella v. United States*, 445 U.S. 222, 228 (1980); *SEC v. Wash. Investment Network*, 475 F.3d 392, 404 (D.C. Cir. 2007).

How a client's shares will be voted is undoubtedly material information that investors have a right to know. Specifically, the fact that a client's shares will be voted to advance the ESG agenda is information that many investors will reasonably view as important, especially investors who may not support that agenda. The fact that a client's investment capital will be used by an asset manager for "corporate engagement" with company executives to promote the ESG agenda—rather than solely to produce maximal financial return—is also significant, material information that investors have a right to know.

At present, it appears that RIAs frequently place client capital in funds owned by ESG-promoting asset management firms —or even in ESG investment vehicles—without so informing their clients. A year-end 2021 report by Bloomberg is illustrative:

Almost two years have passed since Larry Fink, the chief executive officer of BlackRock Inc., declared that a fundamental reshaping of global capitalism was underway and that his firm would help lead it by making it easier to invest in companies with favorable environmental and social practices. Lately, he's been taking a victory lap.

"Our flows continue to grow and dominate," Fink said Oct. 13 of so-called ESG, or environmental, social and governance funds, and similar investments. On the same conference call with analysts, he added: "BlackRock is a leader in this, and we are seeing the flows, and I continue to see this big shift in investor portfolios."

What Fink did not say is that BlackRock drove a significant part of that shift by inserting its primary ESG fund into popular and influential model portfolios offered to investment advisers, who use them with clients across North America. The huge flows from such models mean ***many investors got into an ESG vehicle without necessarily choosing one as a specific investment strategy, or even knowing that their money has gone into one.*** **[33]**

Under well-established law, placing client capital into an "ESG vehicle," or even in a passive index fund owned by an asset manager that uses proxy voting and/or corporate engagement to promote ESG objectives, is an act of fraud on the part of an investment adviser if the adviser has not informed the client of this information. Therefore RIAs must make such disclosure to their clients, and obtain advance consent, before placing client capital in ESG-themed investments or with ESG-promoting asset management firms.

## Conclusion

For the foregoing reasons, it is our opinion that ***state pension trustees may neither engage in ESG investment practices nor allocate capital to asset management firms that engage in such practices***, and that RIAs may invest client capital (or recommend the investment of a client's capital) with an asset management firm that engages in ESG-promotion ***only if they have first obtained informed, express client consent thereto***.

## Endnotes

[1] *See* Schanzenbach & Sitkoff, *supra* note 1, at 388 ("[i]n the late 1990s and early 2000s, . . . proponents of SRI rebranded the concept as ESG").
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[2] United Nations Secretary-General, *Secretary-General Proposes Global Compact on Human Rights, Labour, Environment, in Address to the World Economic Forum in Davos* (Feb. 1., 1999),

https://www.un.org/press/en/1999/19990201.sgsm6881.html.; *see* Elizabeth Pollman, *The Origins and Consequences of the ESG Moniker*, U. Penn. L. Research Paper No. 22-23, https://ecgi.global/sites/default/files/Paper%3A%20Elizabeth%20Pollman.pdf.
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[3] U.N. PRI, https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment.
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[4] McKinsey & Co., *Putting stakeholder capitalism into practice*, Jan. 2, 2022, https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/putting-stakeholder-capitalism-into-practice.
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[5] Steve Denning, *Why Stakeholder Capitalism Will Fail*, Forbes, Jan. 5, 2020, https://www.forbes.com/sites/stevedenning/2020/01/05/why-stakeholder-capitalism-will-fail/?sh=74017d25785a.
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[6] ConService ESG, *Stakeholder capitalism is a driving force behind ESG, says Larry Fink*, Jan. 20, 2022, https://www.gobyinc.com/larry-fink-stakeholder-capitalism-driving-force-behind-esg.
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[7] *See infra* pp. 10-11.
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[8] Bloomberg Intelligence, *ESG assets may hit $53 trillion by 2025, a third of global AUM*, Feb. 23, 2021, https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum.
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[9] Climate Action 100+, https://www.climateaction100.org and https://www.climateaction100.org/whos-involved/investors.
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[10] *See* Will Hild, *End Vanguard's ESG Meddling With Utilities*, Wall St. J., Dec. 1, 2022, https://www.wsj.com/articles/end-vanguards-esg-meddling-with-utilities-11669938471?mod=opinion_lead_pos8**.**
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[11] Vanguard, *ESG, SRI, and Impact Investing: A Primer for Decision-Making*, Aug. 2018, at 4, https://perma.cc/42T2-K35T.
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[12] Javier Al-Hage, *Fixing ESG: Are Mandatory ESG Disclosures The Solution To Misleading ESG Ratings?*, 26 Fordham J. Corp. & Fin. L. 359, 366 (2021).
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[13] *See, e.g.*,BlackRock, *BlackRock ESG Integration Statement*, May 19, 2022, at 2, https://www.blackrock.com/corporate/literature/publication/blk-esg-investment-statement-web.pdf ("In index portfolios

where the objective is to replicate a predetermined market benchmark, we engage with investee companies on ESG issues").
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[14] U.S. Securities & Exchange Comm., Nov. 17, 2022, https://www.sec.gov/news/speech/uyeda-remarks-cato-summit-financial-regulation-111722 (remarks of Comm. Uyeda at Cato Summit on Financial Regulation).
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[15] Farhad Manjoo, *What BlackRock, Vanguard and State Street Are Doing to the Economy*, New York Times (May 12, 2022), https://www.nytimes.com/2022/05/12/opinion/vanguard-power-blackrock-state-street.html.
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[16] *See* Fintel, *BlackRock Inc. ownership in PTR / PetroChina Co., Ltd.,* Feb. 3, 2022 (reporting that BlackRock owns over 1 trillion shares—or 5.7%—of PetroChina).
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[17] *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982) (citing Restatement (Second) of Trusts § 2, comment b (1959) (emphasis added)).
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[18] New administrative rules recently adopted by the Biden Administration's Department of Labor (DOL) governing ERISA pension plans reaffirm that the "focus of . . . plan fiduciaries on . . . financial returns and risk to beneficiaries must be paramount" and that plan fiduciaries "may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals," but nevertheless permit ERISA pension fund managers to promote the ESG agenda as a "tie-breaker" when competing investments "equally serve" the plan's financial interests. DOL, Employee Benefits Sec. Admin., *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 87 Fed. Reg. 73822, 73823, 73835 (published Dec. 1, 2022). Whether courts will uphold the new DOL rules, given ERISA's statutory mandate that plan fiduciaries must act solely to maximize "financial benefits," *Dudenhoeffer*, 573 U.S. at 421, remains to be seen. We note here only that ERISA does not apply to state public pension plans, which are governed instead by state law, and a "tie-breaker" policy like the DOL's would appear to be illegal in states with express prohibitions forbidding public pension plan assets from being used to further any purpose other than providing financial benefits to plan participants. *See, e.g.*, South Carolina Const., Art. X, sec. 16 ("[a]ssets and funds established, created and accruing for the purpose of paying obligations to members of the several retirement systems of the State and political subdivisions ***shall not be diverted or used for any other purpose***") (emphasis added).
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[19] 1 Investment Advisers: Law & Compliance § 8.02 (2022) (emphasis added) (citing *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976), *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), and *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963)).
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[20] United Nations Secretary-General, *Secretary-General Proposes Global Compact on Human Rights, Labour, Environment, in Address to the World Economic Forum in Davos* (Feb. 1., 1999),

https://www.un.org/press/en/1999/19990201.sgsm6881.html.; *see* Elizabeth Pollman, *The Origins and Consequences of the ESG Moniker*, U. Penn. L. Research Paper No. 22-23, https://ecgi.global/sites/default/files/Paper%3A%20Elizabeth%20Pollman.pdf.
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[24] Thomas Lee Hazen, *Corporate and Securities Law Impact on Social Responsibility and Corporate Purpose*, 62 B.C.L. Rev. 851, 852 (2021).
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[25] United Nations, *What is responsible investment?*, https://www.unpri.org/an-introduction-to-responsible-investment/what-is-responsible-investment/4780.article.
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[26] *See* Bloomberg Law, *One Fund, Three Names and Lots of Questions for 'ESG'*, Aug. 25, 2022, https://news.bloomberglaw.com/esg/one-fund-three-names-and-lots-of-questions-for-esg.
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[27] Harvard Business Review, *An Inconvenient Truth About ESG Investing*, Mar. 31, 2022, https://hbr.org/2022/03/an-inconvenient-truth-about-esg-investing.
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[28] Barron's, *Sustainable Funds Are Off to a Rough Start to the Year*, Feb. 14, 2022, https://www.barrons.com/articles/esg-sustainable-funds-performance-51644844397.
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[29] Aneesh Raghunandan & Shiva Rajgopal, *Do ESG funds make stakeholder-friendly investments?*, Rev. of Acct. Stud., June 2022, at 1, https://link.springer.com/article/10.1007/s11142-022-09693-1.
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[30] MSCI, *Performance and Risk Analysis of Index-Based ESG Portfolios*, J. Index Investing, Spring 2019, https://www.msci.com/documents/10199/b07d04e1-2cce-9f35-5400-0e5cf4a0c76a (emphasis added).
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[31] *See, e.g.*, Trustnet, *ESG investors face extended period of underperformance*, Mar. 24, 2022,

[ref no=32]1 Investment Advisers: Law & Compliance § 8.02 (2022).
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[33] Bloomberg, *How BlackRock Made ESG the Hottest Ticket on Wall Street: Stampede into sustainable funds got push from model portfolios; Main result is 'giving them more fees,' says former executive*, Dec. 31, 2021, https://www.bloomberg.com/news/articles/2021-12-31/how-blackrock-s-invisible-hand-helped-make-esg-a-hot-ticket.
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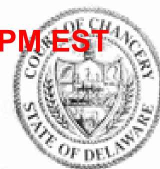

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

| | | |
|---|---|---|
| JAMES MCRITCHIE<br><br>Plaintiff,<br><br>v.<br><br>MARK ZUCKERBERG, SHERYL K. SANDBERG, ROBERT M. KIMMITT, PEGGY ALFORD, MARC L. ANDREESSEN, ANDREW W. HOUSTON, NANCY KILLEFER, TRACY T. TRAVIS, TONY XU, and META PLATFORMS, INC.,<br><br>Defendants. | : | C.A. No. 2022-0890-JTL |

**VERIFIED AMENDED COMPLAINT**

Plaintiff James McRitchie ("Plaintiff"), brings this Verified Complaint against Meta Platforms, Inc. ("Meta" or the "Company") and Mark Zuckerberg ("Zuckerberg"), Sheryl K. Sandberg ("Sandberg"), Robert M. Kimmitt ("Kimmitt"), Peggy Alford ("Alford"), Marc L. Andreessen ("Andreessen"), Andrew W. Houston ("Houston"), Nancy Killefer ("Killefer"), Tracy T. Travis ("Travis"), Tony Xu ("Xu"), and Meta Platforms, Inc. ("Meta") (collectively, "Defendants").

Plaintiff's allegations are based upon his own knowledge as to those facts concerning himself and otherwise upon information and belief as to allegations developed through the investigation conducted by his undersigned attorneys, news reports, documents filed with the SEC, and other public information.

## NATURE OF THE ACTION

1. This is an action to remedy breaches of fiduciary duty by Meta's directors and officers and controlling stockholder.

2. Meta is the largest social media network company in the world, with 3.5 billion users—43% of humanity. Its business decisions inevitably create financial impact well beyond its own cash flows and enterprise value and have significant impacts on the global economy. While defendants have a duty to operate the Company as a business for the financial benefit of its stockholders, those stockholders are often diversified investors with portfolio interests beyond Meta's own financial success. If the decisions that maximize the Company's long-term cash flows also imperil the rule of law or public health, the portfolios of its diversified stockholders are likely to be financially harmed by those decisions. As fiduciaries at a corporation with a business model that depends upon maintenance of a powerful global network, the directors and officers of the Company cannot willfully blind themselves to this reality: where there is great power there is great responsibility.[1]

3. For a corporation whose impact is so widespread, the well-established doctrine of stockholder primacy cannot be rationally applied on behalf of investors without recognizing the impact of portfolio theory, which inextricably links common

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[1] Sir Winston Churchill, Parliamentary Debates (Hansard), House of Commons (Feb. 28, 1906).

stock ownership to broad portfolio diversification. The economic benefits from—indeed the viability of— a system of corporate law rooted in maximizing financial value for stockholders would vanish if it forced directors to make decisions that increased corporate value but depressed portfolio values for most of its stockholders. But this is precisely how the Company has operated: Defendants have ignored the interests of all of its diversified stockholders, making decisions as if the costs that Meta imposes on such portfolios were not meaningful to stockholders.

4. This circumstance is particularly troubling because it favors the Company's CEO, Chairman and controlling stockholder, who possesses absolute control of the Company through high-voting common stock that comprises a majority of his $50 billion fortune, and who operates unilaterally and without board guidance on numerous critical issues affecting the interests of the Company's diversified stockholders without ever considering those interests.

5. Moreover, the Company's compensation programs for directors and officers provide them with Company shares that entice them to favor the controller's interests over the much broader economic interests of the Company's typically diversified shareholders. This practice encourages these fiduciaries to prioritize the value of the Company even when doing so means undermining the global economy, regardless of the real world impact such choices have on the wealth of a typically diversified stockholder. This conflict is exacerbated by Company policies that

require all directors and high-ranking officers to own Company stock, as well as the granting of initial and annual awards of stock to all directors. These compensation and ownership policies have no guardrails to ensure that they do not motivate these fiduciaries to manufacture share "value" by extractive practices that threaten the value of the systems that a diversified portfolio depends upon. As detailed below, these fiduciaries have chosen to maximize the value that matters to only to investors with heavy concentrations of Company stock, rather than the financial values that matter to the Company's diversified stockholder base. The interests of such concentrated holders are directly at odds with those of the diversified stockholders, who can only own only a minority voting stake due to the Company's dual class capital structure.

6. The Defendants have disregarded a core constituency— the Company's diversified stockholders— in favor of a blinkered (and outdated) approach to financial success. Through multiple high-visibility media reports in and around the Fall of 2021, the Board learned (but not for the first time) of the extremely high costs that Meta imposes on society and the economy; these costs imperil the holdings of Meta's diversified stockholders.

7. Every year, the Board elects to spend tens of billions of dollars on stock repurchases, while ignoring the costs it visits on diversified portfolios. In 2021, it used this tool to pay more than $44 billion to stockholders. The media reports make

it clear that there are opportunities for the Company to improve its economic impact (and thus the financial position of its diversified stockholders) by investing some of its cash flows in greater security or by changing certain practices in a manner that would reduce those cash flows. The decision to pay out these large sums— which favors directors and officers whose fortunes are concentrated at the Company— without any consideration of how some of those billions might be used to protect diversified stockholder interests shows utter disregard for the interests of diversified stockholders that cannot meet the requirement of good faith and avoidance of grossly negligent decision making incumbent upon fiduciaries.

8. These press reports were followed by multiple stockholder proposals to the investigate the types of risk articulated in the press reports. The Board rejected each proposal without giving any consideration to the benefits that limiting external costs would provide to the diversified stockholders to whom it owed duties of care, loyalty and good faith. In prior years, the Board has rejected similar proposals without considering the interests of diversified stockholders that diverge from the interest of the insiders whose portfolios are concentrated in Company stock.

9. Defendants have lost sight of the fact that their obligation to increase the value of the Company is to be undertaken for the benefit of all of the providers of its equity capital, not just stockholders with concentrated positions in Meta shares,

such as the controlling stockholder and the directors and officers who are incentivized by required investment in and equity awards of Meta stock.

10. Framing these events, the Company's corporate governance structure (which was adopted by the Board and can be changed by the Board at any time) specifically focuses the Board only on risk to the Company itself. Thus, the Board has expressly chosen to only consider risks to its users to the extent those risks impact the Company's enterprise value over the long-term. They have intentionally established a governance structure that does not permit them to separately consider the impact their activities might have on the diversified value of its stockholders' portfolios. By consciously ignoring these impacts, including in connection with affirmative decisions the Defendants have breached the duties of care and loyalty they owe directly to stockholders as directors of the Company.

11. Defendants Zuckerberg and Sandberg also owe duties directly to the stockholders of the Company as officers, and Zuckerberg further owes such duties as the Company's controlling stockholder, and they have made multiple decisions without board input and without accounting for the impact of those decisions on typically diversified stockholders, and have instead focused solely on increasing the Company's enterprise value, regardless of the costs that increase imposes on diversified portfolios. This conduct breaches the duties of care and loyalty they owe directly to stockholders as officers and controlling stockholder of the Company.

12. The Company's stock ownership and voting structure exacerbate the conflict between maximizing value of the Company without accounting for any costs the Company externalizes and the maximizing the financial values that matter to typically diversified stockholders, who re-internalize such costs. Chairman and CEO Mark Zuckerberg owns more than 350,000,000 shares of high vote common stock, giving him a majority voting interest in the Company (54%) and a $67.6 billion fortune dependent almost entirely on the enterprise value of Meta. In addition, the Company's stock ownership guidelines for directors and officers are designed to create distance, not alignment, between the interests of other insiders and typically diversified Meta stockholders. As a result of the guidelines, Meta's short-term profitability and annual distributions are of greater relative significance to Defendants than to diversified stockholders.

13. Modern stockholders have modern financial interests in the equity capital that they own, and the Defendants must account for those interests to uphold its duties to Meta's owners. It has not.

## PARTIES

14. Plaintiff McRitchie has continuously held shares of Meta stock since August 2012. Plaintiff is a diversified stockholder of Meta, meaning that he has invested a sufficient portion of his portfolio in additional equity securities to ensure that he receives the higher market returns that accompany the risks of residual equity

securities without incurring the idiosyncratic risk associated with concentrated investments in such securities.

15. Nominal Defendant Meta is a Delaware corporation with its headquarters located at 1 Hacker Way, Menlo Park, California 94025. Prior to October 2021, Meta was known as Facebook, Inc. Meta trades on NASDAQ under the ticker symbol META.

16. Defendant Zuckerberg is the founder, CEO, Chairman of the Board and controlling stockholder of Meta.

17. Defendant Sandberg is a director of the Board and has served in that role since 2008. Her fourteen-year tenure as COO of the Company ended in 2022.

18. Defendant Kimmitt is the lead independent director of the Board and has served in that role since 2020. He currently serves on the Company's Privacy Committee.

19. Defendant Alford is a director of the Board and has served in that role since 2019. She currently serves on the Company's Audit & Risk Oversight and Privacy Committees. Previously, Ms. Alford served as the chief financial officer of the Chan Zuckerberg Initiative, the philanthropic organization of Zuckerberg and his wife, Priscilla Chan, an entity that, like Zuckerberg himself, is highly dependent on the performance of Meta stock. A recent filing with the Securities and Exchange Commission shows that the initiative holds over 2,500,000 shares of

Company common stock.

https://www.sec.gov/Archives/edgar/data/1326801/000132680122000128/a2022in formationstatement-.htm

20. Defendant Andreessen is a director of the Board and has served in that role since 2008. He currently serves on the Company's Compensation, Nominating & Governance Committee.

21. Defendant Houston is a director of the Board and has served in that role since 2020. He is a "long-time friend and occasional Ping-Pong partner" of Zuckerberg. He currently serves on the Company's Compensation, Nominating & Governance Committee.

22. Defendant Killefer is a director of the Board and has served in that role since 2020. She currently serves on the Company's Audit & Risk Oversight Committee and is the chair of the Privacy Committee.

23. Defendant Travis is a director of the Board and has served in that role since 2020. She currently serves as the chair of the Company's Audit & Risk Oversight Committee.

24. Defendant Xu is a director of the Board and has served in that role since May 2022. He currently serves on the Company's Compensation, Nominating & Governance Committee.

25. Ms. Alford was added to the board in 2019 in connection with a board shake-up that stripped "Facebook of two of its longest-serving directors without historical investment stakes or close ties to the company's leadership."[2] Those two departures were part of a larger series of exits in 2019 and 2020: "former White House chief of staff Erskine Bowles, Netflix Inc. CEO Reed Hastings, former Genentech executive Susan Desmond-Hellmann, former American Express chief executive Kenneth Chenault and now Mr. Zients—[which were followed by replacements] in some instances with people who have pre-existing social or business relationships with Mr. Zuckerberg."[3] These departures have allowed Mr. Zuckerberg, who has full control over the election of directors, to select board members who will act in a manner consistent with his interests as a highly concentrated owner.

## JURISDICTION

26. This Court has subject matter jurisdiction over this action pursuant to 10 *Del. C.* § 341.

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[2] https://www.wsj.com/articles/facebook-shakes-up-board-erskine-bowles-reed-hastings-to-step-down-11555105224

[3] https://www.wsj.com/articles/facebook-names-former-deputy-secretary-of-the-treasury-to-its-board-11585256495

27. Pursuant to 10 *Del. C.* § 3114, this Court has personal jurisdiction over Defendants Zuckerberg, Sandberg, Kimmitt, Alford, Andreessen, Houston, Killefer, Travis and Xu because they have consented to jurisdiction in this Court when agreeing to serve as directors and/or officers of Meta. Moreover, jurisdiction exists over Defendant Zuckerberg pursuant to 10 *Del. C.* § 3104 in his capacity as controlling stockholder of Meta.

28. Pursuant to 8 *Del. C.* § 321, this Court has personal jurisdiction over Meta because it is a Delaware corporation.

## FACTUAL ALLEGATIONS

### A. The Company's Business Model

29. Facebook was founded in 2004 by Zuckerberg and quickly became the number one online social media platform in the world, with four critical platforms: Facebook, Instagram, Messenger and WhatsApp (the "Platforms.") The Platforms are used by 3.59 billion people every month and 2.82 billion people every day, with 140 billion messages sent daily.[4] The Company directly touches the lives of 35% of the earth's human population every day--no institution has greater global influence.

[4] https://about.facebook.com/company-info/.

30. Meta's ubiquity has driven its top and bottom lines spectacularly. Its 2021 revenues were $118 billion, a 66% increase from just two years earlier.[5] In that same time period, its profits more than doubled, growing to $39.3 billion. In 2021, the Company distributed an extraordinary $44.81 billion to stockholders through share repurchases, and as of the end of that year the Board had authorized an additional $38.79 billion for repurchases. On or around the date of filing, Meta has a market capitalization of $494.73 billion, making it one of the top five companies in market capitalization in the world. Its share price closed opened on February 6, 2022, at $186.63.

31. The extent and breadth of Meta's economic impact was acknowledged in the Federal Trade Commission's $5 billion penalty against Facebook in July 2019.[6] This penalty represented the largest civil penalty ever levied against any company and was justified by the fact that Facebook generated $55.8 billion in revenues in 2018.

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5 https://www.sec.gov/ix?doc=/Archives/edgar/data/1326801/000132680122000018/fb-20211231.htm#i0e2f35c4e2f2407493e331b6cc85a047_88.

6 https://www.ftc.gov/news-events/news/press-releases/2019/07/ftc-imposes-5-billion-penalty-sweeping-new-privacy-restrictions-facebook. The FTC case was a joint investigation with the US Department of Justice to address consumer privacy violations.

32. Meta discloses that it "generate[s] substantially all of our revenues from advertising."[7] In order to generate those advertising revenues, the Company must maintain its high user base, and keep those users engaged. That is why the first risk factor that the Company lists in its Annual Report filed with the SEC is the loss of users and engagement.: "***If we fail to retain existing users or add new users, or if our users decrease their level of engagement with our products, our revenue, financial results, and business may be significantly harmed.***"[8]

B. **Corporate Governance at the Company**

33. The Company has adopted Corporate Governance Guidelines, through the Board, "with a view to enhancing long-term value for Meta shareholders."[9] That policy sets forth the composition, committees and qualifications for members of the Board. Nothing in the guidelines indicates any regard for the effect that the Company's global impact has on the diversified portfolios of its stockholders. Upon

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[7] Meta Platforms, Inc. Form 10-K at 15 (Jan. 28, 2022), https://www.sec.gov/ix?doc=/Archives/edgar/data/1326801/000132680121000014/fb-20201231.htm.

[8] https://www.sec.gov/ix?doc=/Archives/edgar/data/0001326801/000132680122000018/fb-20211231.htm#i0e2f35c4e2f2407493e331b6cc85a047_22 (emphasis added).

[9] Corporate Governance Guidelines (amended Apr. 3, 2022), https://investor.fb.com/leadership-and-governance/corporate-governance-guidelines/default.aspx.

information and belief, the Board and management interpret "long-term value for Meta shareholders" solely in terms of the financial value of Meta itself.

34. The Company has also published the Stock Ownership Guidelines that require that officers and directors of Meta own a minimum number of shares in the Company.[10] The levels of "Target Ownership" required of officers is the equivalent of $4 million in shares and a requirement of $750,000 for directors. The shares must be owned directly by or on behalf of the individual or immediate family members; shares held through index funds, mutual funds or any other pooled investment vehicles do not count, even though these are the types of diversified investments that would align the interests of directors and officers with those of more typically diversified stockholders. These ownership requirements give directors and senior executives a personal interest in maximizing Company enterprise value, even if doing so threatens diversified portfolio value for most of the Company's stockholders. In this respect, the Stock Ownership Guidelines also create an inherent conflict of interests for Defendants. The Board recommendations detailed in this Complaint, which demonstrate a focus on the Company's social impact solely from the perspective of the Company's financial performance and the absence of any

[10] Meta Platforms, Inc. Stock Ownership Guidelines (updated May 27, 2020), https://s21.q4cdn.com/399680738/files/doc_downloads/governance_documents/2021/11/Meta-Stock-Ownership-Guidelines-(5.27.2020).pdf.

consideration of the Company's significant impact on the portfolios of its highly diversified stockholders, demonstrate that each of the Defendant directors lack the independence to prioritize the interests of the overwhelming majority of its stockholders who, unlike directors, are not required to hold substantial positions in Company stock. Zuckerberg and Sandberg have especially significant interests in the performance of Meta stock. Zuckerberg owns over 350,000,000 shares, with a market value of $67.6 billion as of a recent date, and is the controlling stockholder of Meta. Sandberg has been compensated with stock over a 14-year period; in just 2021, she received $93 million in value upon the vesting and settlement of RSUs, while retaining $115 million in unvested shares or share equivalents with a value greater than $115 million.[11]

35. The Company has designed a risk management strategy that focuses on risks from environmental and social issues such as community safety and human rights, but only to the extent these issues ultimately pose risks *to the Company itself.* It has reserved oversight of those matters to the full Board, but also delegated oversight to the Audit & Risk Oversight Committee (the "Audit Committee"):

> The full board of directors has primary responsibility for evaluating ***strategic and operational risk management*** . . . . Our audit & risk

11 https://www.sec.gov/Archives/edgar/data/1326801/000132680122000128/a2022informationstatement-.htm

> oversight committee has responsibility for overseeing certain of ***our major risk exposures***, including in the areas of financial and enterprise risk, legal and regulatory compliance, environmental sustainability, ***social responsibility (including content governance, community safety and security, human rights, and civil rights)***, and cybersecurity, as well as risks in other areas as our audit & risk oversight committee deems necessary or appropriate from time to time. . . . Our board of directors also may exercise direct oversight with respect to these areas or delegate such oversight to committees in its discretion.[12]

The Company describes the Audit Committee's oversight role as follows:

> Overseeing ***our major risk exposures*** (including in the areas of financial and enterprise risk, legal and regulatory compliance, environmental sustainability**,** ***social responsibility (including content governance, community safety and security, human rights, and civil rights), and cybersecurity)*** and the steps management has taken to monitor and control such exposures, and assisting our board of directors in overseeing the risk management of our company.[13]

36. The highlighted language shows that the Board has determined that the Company should monitor risks that human rights, community safety and other social issues pose to the Company, its operations and strategies, but there is no independent mandate to monitor or mitigate the risks the Company's operations and strategies pose to human rights and community safety; no value is accorded to the risks these issues pose to the global economy or diversified stockholders, unless they also pose

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[12] Meta Platforms, Inc., Schedule 14A Proxy Statement at 72 (Apr. 8, 2022), https://www.sec.gov/Archives/edgar/data/1326801/000132680122000043/meta2022definitiveproxysta.htm (the "2022 Proxy Statement") (emphasis added).

[13] *Id.* (emphasis added).

risks to Company enterprise value; and there are no parameters for balancing these risks that may be viewed as minor to the Company but material to Meta's diversified stockholders and the broader economy. The failure to address whether a focus on share value at a corporation that touches the lives of 35% of humanity on a daily basis could negatively impact typical diversified portfolios is grossly negligent conduct and constitutes a conscious decision to ignore information critical to making decisions that are in the best interests of all stockholders.

37. The Compensation, Nominating & Governance Committee (the "Compensation Committee") "is responsible for overseeing all aspects of [the Company's] executive compensation program." The Company's 2022 Proxy Statement includes a report (the "Compensation Report")[14] of the Compensation Committee that demonstrates that the members of the Compensation Committee and Board have affirmatively chosen to incentivize Company executives to focus solely on Company financial performance, even if such focus has a negative impact on the broader economy and, consequently, the portfolios of its diversified stockholders. The Compensation Report states that the Company's compensation program "continues to be heavily weighted towards equity compensation," which the Company believes to be "the best vehicle to focus our executive officers on our

[14] *Id.* at 40.

mission and the successful pursuit of company priorities, and to align their interests with the long-term interests of our shareholders."[15] Read in context, the reference to "shareholders" excludes diversified stockholders, since the equity program does not reflect any variation in compensation due to financial market impact. In assessing the risk of the compensation program (including its heavy reliance on Company equity) the Compensation Committee relied on a report that assessed the risk of the compensation program to the Company only; the Compensation Report stated that "The objective of the assessment was to identify any compensation plans, practices, or policies that may encourage employees to take unnecessary risks ***that could threaten the company***."[16] In other words, Board affirmatively decided not to investigate whether its compensation program, by awarding millions of dollars in equity to its executives, might be incentivizing them to damage the economy, and thus the portfolios of an average diversified stockholder.

38. For all its Guidelines and Committees, Defendants fail (and have thus far refused) to understand and take into consideration a key stockholder interest: portfolio impact. Not a single Guideline or Committee mandate is designed to consider the diversified interests of the stockholders, but instead are structured to keep the Company's operations laser focused on short-term profitability. This

[15] *Id*.

[16] *Id.* at 50 (emphasis added).

lacuna could be filled by the Board at any time, but change is unlikely while the Board is operating under the inherent conflicts those same Guidelines create, or while Zuckerberg is exercising absolute control over who sits on the Company's board of directors.

39. Through his ownership of high-vote stock, Zuckerberg has complete control over membership of the board of directors. In the recent past, he has exercised this control to ensure that the board is comprised of members less likely to disagree with him. Between 2019 and 2020, five of nine board members were replaced:

> *As a result, just four of the directors on Facebook's board at the start of 2019 — Zuckerberg, Andreessen, COO Sheryl Sandberg, and investor Peter Thiel — will remain pending the company's annual shareholder meeting in May. The moves were part of a campaign by Zuckerberg to further consolidate control over the company, sources told The Wall Street Journal.*[17]

40. The directors had been trying to properly oversee Zuckerberg. Erskine Bowles, for example, who had previously served as White House Chief of Staff, left in 2019, "privately criticized Facebook leadership for failing to take his advice on

[17] https://www.businessinsider.com/mark-zuckerberg-marc-andreessen-feuded-over-facebook-ftc-deal-report-2020-4?op=1

politics, his area of expertise."[18] In October of the same year, Susan Desmond-Hellman, the Board's lead independent director announced she was leaving. According to the Wall Street Journal, "Ms. Desmond-Hellmann conveyed to some people that she left Facebook in part because she didn't think the board was operating properly, and that Facebook management wasn't considering board feedback, a person familiar with the matter said."[19] In March of 2020, only 25 months he joined, the departure from the Board of Kenneth Chenault, the former American Express Co. CEO, was announced. According to a press report:

> *But Mr. Chenault had grown disillusioned. Soon after joining, he tried to create an outside advisory group that would study Facebook's problems and deliver reports to the board directly, circumventing Mr. Zuckerberg, according to people familiar with the matter.* [20]

Two weeks later, the Company announced the departure of yet another unhappy director, Jeffrey Zients, former director of the National Economic Council:

> *Messrs. Chenault and Zients were both unhappy for months with executive management and how the company handled misinformation, people familiar with the matter said.*[21]

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[18] https://www.wsj.com/articles/mark-zuckerberg-asserts-control-of-facebook-pushing-aside-dissenters-11588106984

[19] *Id*.

[20] *Id*.

[21] *Id*.

### C. Portfolio Diversification

41. As of March 30, 2022, the top five institutional holders of the Company's stock were the well-known asset managers BlackRock, Vanguard, Fidelity, State Street and T Rowe Price, collectively owning 27.84% of the Company's outstanding stock.[22] These companies manage assets for mutual funds and institutional and other clients, who typically diversify their portfolios to optimize the balance of risk and return.

42. Portfolio diversification is crucial to optimize risk and return because it allows investors to obtain the increased returns available from risky securities while reducing their overall risk. This is the critical insight of Modern Portfolio Theory.[23] In other words, for most investors, diversification enables the ownership of common stock.[24] A pension fund with the obligation to meet liabilities far into the future (or a worker saving for retirement on her own) could not afford to "bet it all" (or even a large portion of it) on Meta stock without talking untenable risks—the privilege to

[22] https://finance.yahoo.com/quote/META/holders?p=META.

[23] *See generally*, Burton G. Malkiel, A Random Walk Down Wall Street (2015).

[24] In many cases, the laws that govern institutional investors require such diversification. 29 U.S.C. § 404(a) (1) (C) (requiring fiduciaries of federally regulated retirement plans to "diversify[] the investments of the plan").

do so is in the province of wealthy individuals like Zuckerberg and Sandberg and others for whom the downside risk of high concentration is financially acceptable.

43. Once a portfolio is diversified, the most important factor determining an investor's return will not be how the companies in her portfolio perform relative to other companies ("alpha"), but rather how the market performs as a whole ("beta"): "According to widely accepted research, alpha is about one-tenth as important as beta. Beta drives some 91 percent of the average portfolio's return."[25]

44. A recent report from the international law firm Freshfields Bruckhaus Deringer explains how the reality of externalized costs reverberates in the fiduciary duties of investment trustees across jurisdictions:

> In recent years investors have increasingly focused on what must be done to protect the value of their portfolios from system-wide risks created by the declining sustainability of various aspects of the natural or social environment. System-wide risks are the sort of risks that cannot be mitigated simply by diversifying the investments in a portfolio. They threaten the functioning of the economic, financial, and wider systems on which investment performance relies. If risks of this sort materialized, they would therefore damage the performance of a portfolio as a whole and all portfolios exposed to those systems.[26]

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[25] Steven Davis, Jon Lukmonik and David Pitt-Watson, *What They Do with Your Money* (2016).

[26] *A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making* (2021). The report, which ran to 558 pages, studied the law of jurisdictions significant to global capital markets, including the United States.

45. The value of diversified portfolios rise and fall with Gross Domestic Product (GDP), an indicator of the economy's intrinsic value. Negative externalities (indirect costs to an uninvolved party that arise as an effect of another party's activity) created by a company pursuing only its bottom line can and do have wide reaching impacts on GDP.

46. Such externalities have increased in relevance and importance over the last several years. The asset manager Schroder's has developed a methodology to measure externalities by "quantifying the positive contributions and negative impacts companies have on society."[27] In 2019, the Head of Sustainable Research for Schroder's published the following stark statistic: "The US $4.1 trillion earnings listed companies generate for shareholders [globally] would fall by 55% to US $1.9 trillion if all of the social and environmental impacts our research identifies crystallised as financial costs. One third of companies would become loss-making."[28]

47. Whether or not Meta's externalities impact its enterprise value, they reduce the value of the economy upon which its diversified stockholders depend.

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[27] Andrew Howard, *Sustainex* at 3 (April 2019), https://prod.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf.

[28] *Id.* at 6.

48. Meta directors fail to meet their fiduciary duties when they ignore these negative impacts on their own diversified stockholders by focusing only on the Company's bottom line or share price, which is only one aspect of the impact that Board decisions have on the investment returns of the Company's stockholders who are not among the limited class of stockholders able to accept the risks of highly concentrated ownership.

## D. Press Reports: Putting Financial Returns Above All Else

49. On September 13, 2021, *The Wall Street Journal* began to publish "The Facebook Files," a series of articles that relied on internal Company documents obtained from Frances Haugen, a former Meta employee, that show that Meta knows its Platforms are riddled with flaws that cause harm to users and threaten the rule of law, but decided not to address them, because doing so would reduce cash flow. On information and belief, such decisions were made without any consideration of the costs such decisions imposed on diversified stockholders' investment portfolios.

### *i. XCheck: Giving VIPs a Free Pass*

50. The first article reported that Meta built a system, known as "cross-check" or "XCheck," that "whitelisted" millions of high-profile users, exempting them from some or all of its rules that otherwise were designed to limit harmful traffic over its Platforms, leading to the very type of social costs its rules were

designed to limit.[29] On information and belief, no consideration was given to the impact of such practices on overall market returns for diversified stockholders.

51. The article noted:

> In 2019, it allowed international soccer star Neymar to show nude photos of a woman, who had accused him of rape, to tens of millions of his fans before the content was removed by Facebook. Whitelisted accounts shared inflammatory claims that Facebook's fact checkers deemed false, including that vaccines are deadly, that Hillary Clinton had covered up "pedophile rings," and that then-President Donald Trump had called all refugees seeking asylum "animals," according to the documents.[30]

52. Zuckerberg and Sandberg had and exercised direct authority over whether whitelisted accounts were given special treatment:

> At times, pulling content from a VIP's account requires approval from senior executives on the Communications and public-policy teams, or even from Mr. Zuckerberg or Chief Operating Officer Sheryl Sandberg, according to people familiar with the matter.[31]

For example, the question whether to leave up a controversial post from the President of the United States was left to Zuckerberg.

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[29] Jeff Horwitz, "Facebook Says Its Rules Apply to All. Company Documents Reveal a Secret Elite That's Exempt", *The Wall Street Journal* (Sept. 13, 2021), https://www.wsj.com/articles/facebook-files-xcheck-zuckerberg-elite-rules-11631541353?mod=article_inline.

[30] *Id.*

[31] *Id.*

53. According to the article, an internal review conducted by Meta employees in 2019 found the Company's favoritism to high-profile users to be widespread and that "[u]nlike the rest of our community, these people can violate our standards without any consequences."[32] Internal documents show that XCheck grew to include at least 5.8 million users in 2020, but Facebook "review[s] less than 10% of XChecked content."[33]

54. When internal Company personnel raised concerns about the harm being caused by XCheck, the product manager replied that such concerns had to be balanced with the need to avoid risks to the Company's business: "The fairness concerns were real and XCheck had been mismanaged, the product manager wrote, but 'we have to balance that with business risk.'"[34] It is clear that the policy established by Zuckerberg was to sometimes permit harm to users in order to maximize Company returns. Such a cost benefit analysis is evidenced in an internal memo detailing that the Company had not put the presumably costly systems in place

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[32] *Id.*

[33] *Id.*

[34] *Id.*

necessary to derisk XCheck: "We do not have systems built out to do that extra diligence for all integrity actions that can occur for a VIP."[35]

55. On information and belief, the impact of such trade-offs on diversified stockholders was never accounted for in the decisions made by Zuckerberg and Sandberg or the Board's risk analysis when it evaluated XCheck's whitelisting.

56. The article concluded that this was a broad pattern that the Company continued, along with other harmful practices, because it did not want to hurt its business:

> Time and again, the documents show, in the U.S. and overseas, Facebook's own researchers have identified the platform's ill effects, in areas including teen mental health, political discourse and human trafficking. Time and again, despite congressional hearings, its own pledges and numerous media exposés, the company didn't fix them.
>
> Sometimes the company held back for fear of hurting its business.[36]

*ii. Mental Health Issues: Instagram and the Perfect Storm*

57. On September 14, 2021, the second article in the series reported that the Company's own internal analyses show that the use of Instagram among teenage girls led to significant mental health issues, and that many users linked suicidal

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35 *Id.*

36 *Id.*

thoughts and eating disorders to their experiences on the app.[37] Even though mental health issues impose tremendous social costs, the Company did not account for the risk Instagram's mental health impacts posed to economic growth and thus the diversified portfolios of its stockholders. Internal documents made it clear that the Company was aware of the problem:

> For the past three years, Facebook has been conducting studies into how its photo-sharing app affects its millions of young users. Repeatedly, the company's researchers found that Instagram is harmful for a sizable percentage of them, most notably teenage girls.
>
> "We make body image issues worse for one in three teen girls," said one slide from 2019, summarizing research about teen girls who experience the issues.
>
> "Teens blame Instagram for increases in the rate of anxiety and depression," said another slide. "This reaction was unprompted and consistent across all groups."[38]

58. The one-third figure evinces a very significant impact, as more than 40% of the platform's users are 22 years old or younger, and 22 million teenagers log on every day. The article concluded that the Company was focusing on maximizing revenue without regard to the societal harm caused: "Expanding its

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[37] Georgia Wells, Jeff Horwitz and Deepa Seetharaman, "Facebook Knows Instagram Is Toxic for Teen Girls, Company Documents Show", *The Wall Street Journal* (Sept. 14, 2021), https://www.wsj.com/articles/facebook-knows-instagram-is-toxic-for-teen-girls-company-documents-show-11631620739?mod=article_inline.

[38] *Id.*

base of young users is vital to the company's more than $100 billion in annual revenue, and it doesn't want to jeopardize their engagement with the platform."[39]

59. The article reported that the Company executives, including Zuckerberg, were aware of the problem but chose to ignore it, and certainly did not undertake to determine whether the problem would undermine the portfolios of typical investors:

> In five presentations over 18 months to this spring, the researchers conducted what they called a "teen mental health deep dive" and follow-up studies.
>
> They came to the conclusion that some of the problems were specific to Instagram, and not social media more broadly. That is especially true concerning so-called social comparison, which is when people assess their own value in relation to the attractiveness, wealth and success of others.
>
> . . . .
>
> The features that Instagram identifies as most harmful to teens appear to be at the platform's core.
>
> . . . It warns that the Explore page, which serves users photos and videos curated by an algorithm, can send users deep into content that can be harmful.
>
> "Aspects of Instagram exacerbate each other to create a perfect storm," the research states.
>
> The research has been reviewed by top Facebook executives, and was cited in a 2020 presentation given to Mr. Zuckerberg, according to the documents.[40]

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[39] *Id.*

[40] *Id.*

60. But the Company hid this research because it wanted to grow its base of young users. As the article reported:

> "Instagram is well positioned to resonate and win with young people," said a researcher's slide posted internally. Another post said: "There is a path to growth if Instagram can continue their trajectory."
>
> In public, Facebook has consistently played down the app's negative effects on teens, and hasn't made its research public or available to academics or lawmakers who have asked for it.
>
> "The research that we've seen is that using social apps to connect with other people can have positive mental-health benefits," CEO Mark Zuckerberg said at a congressional hearing in March 2021 when asked about children and mental health.[41]

61. Even when requested by a bipartisan pair of United States Senators to be transparent about its impact on children's mental health, the Company refused:

> In August, Sens. Richard Blumenthal and Marsha Blackburn in a letter to Mr. Zuckerberg called on him to release Facebook's internal research on the impact of its platforms on youth mental health.
>
> In response, Facebook sent the senators a six-page letter that didn't include the company's own studies. Instead, Facebook said there are many challenges with conducting research in this space, saying, "We are not aware of a consensus among studies or experts about how much screen time is 'too much,'" according to a copy of the letter reviewed by the Journal.[42]

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[41] *Id.*

[42] *Id.*

62. Between 2011 and 2020, the total economic output loss associated with mental disorders will be an estimated $16.3 trillion, comparable to that of cardiovascular diseases or to that of cancer, chronic respiratory disease and diabetes combined.[43] Angela Guarda, director for the eating-disorders program at Johns Hopkins Hospital and an associate professor of psychiatry in the Johns Hopkins School of Medicine told *The Wall Street Journal* that Instagram and other social media platforms play a role in the disorders of about half of her patients.

*iii. Meaningful Social Interactions: Turning Up the Algorithmic Heat*

63. The next article in the series, published on September 15, 2021, showed how a change in the Facebook algorithm to emphasize "meaningful social interactions" ("MSI") drove more negative posting with harmful societal effects, but that Meta chose to preserve its business rather than protect its diversified stockholders from those effects, favoring concentrated insider stockholders over its large, diversified stockholder base:[44]

> The 2018 algorithm change affected Facebook's central feature, the News Feed . . . . It accounts for the majority of time Facebook's

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[43] https://healthmed.org/economic-burden-of-depression-and-anxiety-disorders/.

[44] Keach Hagey and Jeff Horwitz, "Facebook Tried to Make Its Platform a Healthier Place. It Got Angrier Instead", *The Wall Street Journal* (Sept. 15, 2021), https://www.wsj.com/articles/facebook-algorithm-change-zuckerberg-11631654215.

> nearly three billion users spend on the platform. The company sells that user attention to advertisers, both on Facebook and its sister platform Instagram, accounting for nearly all of its $86 billion in revenue last year.
>
> A proprietary algorithm controls what appears in each user's News Feed. It takes into account who users are friends with, what kind of groups they have joined, what pages they have liked, which advertisers have paid to target them and what types of stories are popular or driving conversation.
>
> Significant changes to the algorithm can have major implications for the company, advertisers and publishers. Facebook has made many algorithm tweaks over the years. The shift to emphasize MSI was one of the biggest.[45]

64. The article made it clear that the Company's decision-making process was dominated by Zuckerberg: "Mr. Zuckerberg announced he was changing Facebook product managers' goal from helping people find relevant content to helping them interact more with friends and family."[46] Another investigative report attributed the MSI metric directly to Zuckerberg:

> *In 2018, Zuckerberg defined a new metric that became his "north star," according to a former executive. That metric was MSI — "meaningful social interactions" — named because the company wanted to emphasize the idea that engagement was more valuable than time spent passively scrolling through videos or other content. For example, the company's algorithm would now weight posts that got a large number of comments as more "meaningful" than likes, and would use that information to inject the comment-filled posts into the news feeds of many more people who were not friends with the original poster, the documents said.*

45 *Id.*

46 *Id.*

> *Even as the company has grown into a large conglomerate, Zuckerberg has maintained a reputation as a hands-on manager who goes deep on product and policy decisions, particularly when they involve critical trade-offs between preserving speech and protecting users from harm — or between safety and growth.*[47]

The same article reported that Zuckerberg was individually responsible for everything the Company does:

> *"The specter of Zuckerberg looms in everything the company does," said Brian Boland, a former vice president of partnerships and marketing who left in 2020 after coming to believe that the platform was polarizing society. "It is entirely driven by him."*[48]

65. It is also clear that that the relevant decisions by Zuckerberg prioritized the Company's financial returns over safety, regardless of the risks that Company practice posed to stable societies around the globe, or the impact such risks might have on the diversified portfolios of Meta's stockholders. The article explained that while the change was explained as a positive for users, it was actually designed to address a drop in user interaction, and that it degraded the Platform's content and interactions:

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[47] https://www.washingtonpost.com/technology/2021/10/25/mark-zuckerberg-facebook-whistleblower/

[48] *Id.*

> Facebook's chief executive, Mark Zuckerberg, said the aim of the algorithm change was to strengthen bonds between users and to improve their well-being. . . .
>
> Within the company, though, staffers warned the change was having the opposite effect, the documents show. It was making Facebook's platform an angrier place.
>
> Company researchers discovered that publishers and political parties were reorienting their posts toward outrage and sensationalism. That tactic produced high levels of comments and reactions that translated into success on Facebook.
>
> ***"Our approach has had unhealthy side effects on important slices of public content, such as politics and news," wrote a team of data scientists, . . . . "This is an increasing liability***," one of them wrote in a later memo.
>
> ***They concluded that the new algorithm's heavy weighting of reshared material in its News Feed made the angry voices louder***. "Misinformation, toxicity, and violent content are inordinately prevalent among reshares," researchers noted in internal memos.
>
> . . . .
>
> Facebook employees also discussed the company's other, less publicized motive for making the change: Users had begun to interact less with the platform, a worrisome trend, the documents show.[49]

66. But the Company rejected fixes that would have led to a healthier dialogue because doing so would have reduced user traffic, and thus revenue. Zuckerberg, with final control over every decision, would not permit the Company to "tradeoff" traffic in order to improve the Platform's social and economic impact, even if doing so would have benefitted its diversified stockholders:

[49] *Id.* (emphasis added).

> Data scientists on that integrity team—whose job is to improve the quality and trustworthiness of content on the platform—worked on a number of potential changes to curb the tendency of the overhauled algorithm to reward outrage and lies. ***Mr. Zuckerberg resisted some of the proposed fixes, the documents show, because he was worried they might hurt the company's other objective—making users engage more with Facebook***.
>
> Anna Stepanov, who led a team addressing those issues, presented Mr. Zuckerberg with several proposed changes meant to address the proliferation of false and divisive content on the platform, according to an April 2020 internal memo she wrote about the briefing. One such change would have taken away a boost the algorithm gave to content most likely to be reshared by long chains of users.
>
> "Mark doesn't think we could go broad" with the change, she wrote to colleagues after the meeting. Mr. Zuckerberg said he was open to testing the approach, she said, but "***We wouldn't launch if there was a material tradeoff with MSI impact***."[50]

67. The article further detailed how the change to the algorithm led to harsher discourse:

> In Poland, the changes made political debate on the platform nastier…
>
> "One party's social media management team estimates that they have shifted the proportion of their posts from 50/50 positive/negative to 80% negative, explicitly as a function of the change to the algorithm," wrote two Facebook researchers in an April 2019 internal report.
>
> [Political parties in Central and eastern Europe] now have an incentive, [a political scientist] said, to create posts that rack up

[50] *Id.* (emphasis added).

> comments and shares—often by tapping into anger—to get exposure in users' feeds.[51]

68. The issue extends to Western Europe and Asia as well:

> The Facebook researchers wrote in their report that in Spain, political parties run sophisticated operations to make Facebook posts travel as far and fast as possible.
>
> "They have learnt that harsh attacks on their opponents net the highest engagement," they wrote." …
>
> Facebook researchers wrote in their internal report that they heard similar complaints from parties in Taiwan and India.[52]

69. ***Critically, the article details the fact that the Company was consciously choosing traffic, revenue, and Company financial performance over global impacts***. When employees figured out how to tweak the algorithm to address the negative impacts, Zuckerberg vetoed the change because it would reduce traffic, the Company's stock in trade:

> Early tests showed how reducing [an] aspect of the algorithm for civic and health information helped reduce the proliferation of false content. Facebook made the change for those categories in the spring of 2020.
>
> When Ms. Stepanov presented Mr. Zuckerberg with the integrity team's proposal to expand that change beyond civic and health content—and a few countries such as Ethiopia and Myanmar where changes were already being made—***Mr. Zuckerberg said he didn't***

[51] *Id.*

[52] *Id.*

> ***want to pursue it if it reduced user engagement, according to the documents***.[53]

70. In other words, the change in the algorithm forced Zuckerberg to decide between Meta's increasing profits or having a positive impact on discourse around the world, and he chose the former. The Board members were not innocent bystanders either: even though internal reports, press coverage, and, as detailed below, shareholder proposals expressly addressed by the Board called attention to the negative externalities created by incentivizing politicians around the world to use "harsh attacks" on their opponents and other tactics that succeed at "tapping into anger," they consciously chose not to consider whether Zuckerberg's choices from the perspective of Meta's diversified stockholders.

*iv. Sex Work, Cartels, Violence and Dictators: The Real Cost of Internet Clicks*

71. While the first three articles in the series demonstrated the Company's traffic-at-any-cost mentality, the fourth article, published on September 16, 2021, showed that not only were social and economic costs ignored to boost revenue, but that cost-saving also was prioritized over addressing such costs. The article reported on Meta's weak and ineffective responses to drug cartels and human traffickers that

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[53] *Id.*

use the Company's platforms to facilitate their illegal activities.[54] The article made it very clear that the Company prioritized its business and cash flow over any concern over the social and economic impact of the role it plays in degrading the rule of law outside of wealthy countries or the impact of that degradation on its diversified stockholders. The article made it clear that the Company simply was not spending enough money to police dangerous use cases of the platforms around the world:

> In some countries where Facebook operates, it has few or no people who speak the dialects needed to identify dangerous or criminal uses of the platform, the documents show.
>
> . . . .
>
> Facebook has focused its safety efforts on wealthier markets with powerful governments and media institutions, he said, even as it has turned to poorer countries for user growth.
>
> "There is very rarely a significant, concerted effort to invest in fixing those areas," he [a former Facebook vice president] said.[55]

72. The article explained that the Company must focus on these developing markets to grow its business:

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[54] Justin Scheck, Newley Purnell and Jeff Horwitz, "Facebook Employees Flag Drug Cartels and Human Traffickers. The Company's Response is Weak, Documents Show", *The Wall Street Journal* (Sept. 16, 2021), https://www.wsj.com/articles/facebook-drug-cartels-human-traffickers-response-is-weak-documents-11631812953?mod=article_inline.

[55] *Id.*

> The developing world already has hundreds of millions more Facebook users than the U.S.—more than 90% of monthly users are now outside the U.S. and Canada. With growth largely stalled there and in Europe, nearly all of Facebook's new users are coming from developing countries, where Facebook is the main online communication channel and source of news. Facebook is rapidly expanding into such countries, planning for technology such as satellite internet and expanded Wi-Fi to bring users online including in poor areas of Indonesia one document described as "slums."[56]

73. While Facebook responded to individual complaints, it would not fix the system:

> Employees flagged that human traffickers in the Middle East used the site to lure women into abusive employment situations in which they were treated like slaves or forced to perform sex work. They warned that armed groups in Ethiopia used the site to incite violence against ethnic minorities. They sent alerts to their bosses on organ selling, pornography and government action against political dissent, according to the documents. …
>
> When problems have surfaced publicly, Facebook has said it addressed them by taking down offending posts. But it hasn't fixed the systems that allowed offenders to repeat the bad behavior. ***Instead, priority is given to retaining users, helping business partners and at times placating authoritarian governments, whose support Facebook sometimes needs to operate within their borders, the documents show***.
>
> ***Facebook treats harm in developing countries as "simply the cost of doing business"*** in those places, said Brian Boland, a former Facebook vice president who oversaw partnerships with internet providers in Africa and Asia before resigning at the end of last year.[57]

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[56] *Id.*

[57] *Id*. (emphasis added).

74. A separate investigative report published by the *Washington Post* detailed global failures of the Company to address posts that led to ethnic violence:

> *Despite Facebook's assurances it would increase moderation efforts, when riots broke out in Delhi last year, calls to violence against Muslims remained on the site, despite being flagged, according to the group. Gruesome images, claiming falsely to depict violence perpetrated by Muslims during the riots, were found by The Post. Facebook labeled them with a fact check, but they remained on the site as of Saturday.*
>
> *More than 50 people were killed in the turmoil, the majority of them Muslims.*
>
> *"They were told, told, told and they didn't do one damn thing about it," said a member of the group who attended the meetings. "The anger [from the global south] is so visceral on how disposable they view our lives."*
>
> . . . .
>
> *In late 2019, the Next Billion Network ran a multicountry study, separate from the whistleblower's documents, of Facebook's moderation and alerted the company that large volumes of legitimate complaints, including death threats, were being dismissed in countries throughout the global south, including Pakistan, Myanmar and India, because of technical issues, according to a copy of the report reviewed by The Post.*
>
> *It found that cumbersome reporting flows and a lack of translations were discouraging users from reporting bad content, the only way content is moderated in many of the countries that lack more automated systems. Facebook's community standards, the set of rules that users must abide by, were not translated into Urdu, the national language of Pakistan. Instead, the company flipped the English version so it read from right to left, mirroring the way Urdu is read.*
>
> *In June 2020, a Facebook employee posted an audit of the company's attempts to make its platform safer for users in "at-risk countries,"*

> *a designation given to nations Facebook marks as especially vulnerable to misinformation and hate speech. The audit showed Facebook had massive gaps in coverage. In countries including Myanmar, Pakistan and Ethiopia, Facebook didn't have algorithms that could parse the local language and identify posts about covid-19. In India and Indonesia, it couldn't identify links to misinformation, the audit showed.*
>
> *In Ethiopia, the audit came a month after its government postponed federal elections, a major step in a buildup to a civil war that broke out months later. In addition to being unable to detect misinformation, the audit found Facebook also didn't have algorithms to flag hate speech in the country's two biggest local languages.*[58]

75. When the Company completed a civil rights audit in 2020, the final report made it clear that responsibility over the Company's response to violence by state actors rested with Zuckerberg and Sandberg:

> *Facebook has a long road ahead on its civil rights journey, and [the audit leadership] agreed to continue to consult with the company, but with the audit behind us, we are discussing what the scope of that engagement will look like. Sheryl Sandberg will continue to sponsor the work at the company. Mark Zuckerberg said that he will continue to revisit its voter suppression policies, as well as its policies relating to calls for violence by state actors.*[59]

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[58] https://www.washingtonpost.com/technology/2021/10/24/india-facebook-misinformation-hate-speech/

[59] Facebook Civil Rights Audit, Final Report, July 8, 2020, available at https://muslimadvocates.org/wp-content/uploads/2020/07/Civil-Rights-Audit-Final-Report.pdf

76. While the human rights violations are themselves horrendous, they also sap the global economy of productivity over time, as human potential is wasted and the networks of trust that undergird a healthy economy are compromised.[60] As an example, the article detailed how Meta allowed its Platforms to be used as tools of a drug cartel in Mexico, threatening the rule of law that buttresses a healthy economy in that country:

> The ex-cop and his team untangled the Jalisco New Generation Cartel's online network by examining posts on Facebook and Instagram, as well as private messages on those platforms, according to the documents…
>
> The team identified key individuals, tracked payments they made to hit men and discovered how they were recruiting poor teenagers to attend hit-man training camps…
>
> … The former cop recommended the company improve its follow-through to ensure bans on designated groups are enforced and seek to better understand cartel activity.
>
> Facebook didn't fully remove the cartel from its sites.
>
> The investigation team asked another Facebook unit tasked with coordinating different divisions to look at ways to make sure a ban on the cartel could be enforced. ***That wasn't done effectively either, according to the documents, because the team assigned the job didn't follow up***.
>
> On Jan. 13, nine days after the report was circulated internally, the first post appeared on a new CJNG Instagram account: A video of a person with a gold pistol shooting a young man in the head while

[60] Cristina Bodea & Ibrahim Elbadawi, *Political Violence and Economic Growth* (2008) ("Although [political] violence is itself endogenous to a range of complex factors, once ignited, it can become the direct cause of untold human suffering, loss of life as well as massive economic decline and political instability.")

> blood spurts from his neck. The next post is a photo of a beaten man tied to a chair; the one after that is a trash bag full of severed hands.[61]

77. In the same article, it was reported that the Company's lax attitude extended to ethnic cleansing, as the Company simply did not spend the money necessary to translate posts to determine whether vulnerable populations were being put at risk through its Platforms:

> In Ethiopia, armed groups have used Facebook to incite violence. The company's internal communications show ***it doesn't have enough employees who speak some of the relevant languages to help monitor the situation***. For some languages, Facebook also failed to build automated systems, called classifiers, that could weed out the worst abuses. Artificial-intelligence systems that form the backbone of Facebook's enforcement don't cover most of the languages used on the site. …
>
> In a December planning document, a Facebook team wrote that the risk of bad consequences in Ethiopia was dire, and that "***most of our great integrity work over the last 2 years doesn't work in much of the world***." It said in some high-risk places like Ethiopia, "Our classifiers don't work, and ***we're largely blind to problems on our site***."
>
> Groups associated with the Ethiopian government and state media posted inciting comments on Facebook against the Tigrayan minority, calling them "hyenas" and "a cancer." Posts accusing Tigrayans of crimes such as money laundering were going viral, and some people on the site said the Tigrayans should be wiped out.

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61 *Id.* (emphasis added).

> As violence escalated, Secretary of State Anthony Blinken labeled the violence "ethnic cleansing." [62]

78. The article showed the Company simply did not want to spend the money required to address abusive use in all languages:

> Arabic is spoken by millions of Facebook users across what the company calls a highly sensitive region. Most of Facebook's content reviewers who work in the language speak Moroccan Arabic, and often aren't able to catch abusive or violent content in other dialects or make errors in restricting inoffensive posts, according to a December document. Facebook's enforcement algorithms also weren't capable of handling different dialects.
>
> "It is surely of the highest importance to put more resources to the task of improving Arabic systems," an employee wrote in the document.[63]

79. Meta's lax policies that threaten the rule of law around the world pose risks to economic growth (and thus diversified portfolios). One recent study concluded:

> Economic growth has been a dominant concern for senior global leaders and policy makers for the past century; understandably, the determinants of economic growth has preoccupied economists for the past several decades. We consider 134 countries during the period 1984-2019 and find a significant positive relation between Rule of Law (law and order provided by police and courts, respect

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[62] *Id.* (emphasis added).

[63] Id.

> for private property rights) and GDP per capita. Notably, this positive relation has improved over time.[64]

*v. Vaccine Information*

80. On September 17, 2021, the fifth article in the series was published, showing conclusively that Meta lacked the ability or willingness to manage the content on its Platforms, even with respect to topics on which the Company had committed to advancing a particular message. The article focused on repeated public commitments made by Meta and Zuckerberg regarding the use of the Platforms to communicate health guidance related to the COVID-19 pandemic. According to the internal documents, however, the Company completely failed in its purported efforts to manage such messaging and content. The article included the following quotes from Company personnel in internal documents:

- "We know that COVID vaccine hesitancy has the potential to cause severe societal harm…"
- "Vaccine hesitancy in comments is rampant."
- "Our ability to detect vaccine-hesitant comments is bad in English, and basically non-existent elsewhere."[65]

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[64] https://www.hblr.org/2020/11/economic-growth-income-inequality-rule-of-law/.

[65] Sam Schechner, Jeff Horwitz, and Emily Glazer, "How Facebook Hobbled Mark Zuckerberg's Bid to Get America Vaccinated," *The Wall Street Journal* (Sept. 17, 2021), https://www.wsj.com/articles/facebook-mark-zuckerberg-vaccinated-11631880296?mod=series_facebookfiles.

81. The article noted:

> In August 2020, a report by advocacy group Avaaz concluded that the top 10 producers of what the group called "health misinformation" were garnering almost four times as many estimated views on Facebook as the top 10 sources of authoritative information. Facebook needed to take harsher measures to beat back "prolific" networks of Covid misinformation purveyors, Avaaz warned.
>
> . . . .
>
> A Facebook employee also warned that antivaccine forces might be dominating comments on posts, possibly giving users a false impression that such views were widespread.
>
> "I randomly sampled all English-language comments from the past two weeks containing Covid-19-related and vaccine-related phrases," the researcher wrote early this year, adding that based on his assessment of 110 comments, about two-thirds "were anti-vax." The memo compared that figure to a poll showing the prevalence of antivaccine sentiment in the U.S. to be 40 points lower.
>
> . . . .
>
> A Unicef staffer said in an interview the group noticed its pro-vaccine posts faced "a huge deluge of antivax sentiment" when they reached a wider-than-normal audience, such as when they featured a famous spokesperson. Facebook's main advice to Unicef, the staffer said, was to "keep posting information that we know cuts through and targets our key audience."
>
> "Who knows how much more successful those campaigns might be if they weren't swarmed by anti-vax comments?" the staffer said.[66]

82. One former Vice President of the Company attributed the failures to Zuckerberg's focus on connecting users:

[66] *Id.*

> *He credits Mr. Zuckerberg with getting Facebook to work quickly on health initiatives during the pandemic but said his focus on connecting people created a blind spot for company leaders. "There was not a lot of discussion in our circles of, 'Hey, are people propagating harmful messages on the platform?' " he said.*[67]

The article said the blind spot left the Company "ill-prepared" to address vaccine misinformation:

> *Mr. Zuckerberg has long espoused the belief that Facebook's role connecting people makes it a tool to help solve the world's problems. Former executives say that optimism left him and his company repeatedly ill-prepared when people used the platform in ways it didn't anticipate.*[68]

83. It was Zuckerberg alone who made the final decisions with respect to curbing inaccuracies on the platforms:

> *Facebook has similarly struggled with how to handle the spread of inaccuracies on other issues, from QAnon conspiracy theories and other election falsehoods to hoax cancer cures and Holocaust denial. Mr. Zuckerberg initially permitted such denials on the platform on free speech grounds but last year changed his position, citing rising anti-Semitic violence.*
>
> . . . .
>
> *Mr. Zuckerberg wasn't ready to embrace a more interventionist approach against its users.*[69]

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[67] *Id*.

[68] *Id*.

[69] *Id*.

84. The article called attention to internal divisions at the Company over the need to address the harm implicit in its business model; ultimately the reporters concluded that Meta's business model itself was harmful: "The vaccine documents are part of a collection of internal communications reviewed by the Journal that offer an unparalleled picture of how Facebook is acutely aware that the products and systems central to its business success routinely fail and cause harm."[70]

85. In July of 2021, United States Surgeon General Vivek Murthy warned that social media companies "have enabled misinformation to poison our information environment, with little accountability to their users."[71] The President of the United States specifically called out Meta on this question.

86. It is well-established that slowing down the efforts to fight COVID-19 can have severe effects on the economy. The International Monetary Fund (IMF) has estimated that an inadequate global vaccine supply could lead to global economic losses of up to $9 trillion.[72] The Federal Reserve Bank of St. Louis

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[70] *Id.*

[71] Myah Ward, "Social Media Must Do More to Support Vaccination, Surgeon General Says", *Politico* (July 18, 2021), https://www.politico.com/news/2021/07/18/murthy-covid-vaccine-misinformation-facebook-499973.

[72] Ruchir Agarwal and Gita Gopinath, *A Proposal to End the COVID-19 Pandemic,* IMF Staff Discussion Note (May 2021),

published research showing that the average country's GDP was reduced by 7.3% in 2020 due to the pandemic.[73] [74]

*vi. Zuckerberg Decides to Comply with Hanoi's Demands*

87. In another instance of prioritizing financial returns over broader systemic health, Zuckerberg unilaterally caused the Company to comply with the demands of Vietnam's ruling Communist Party to censor dissidents.

88. A news article captured the nexus between Zuckerberg's desire to maximize revenue and his decision-making power within the organization:

> *But in Vietnam, upholding the free-speech rights of people who question government leaders could have come with a significant cost in a country where the social network earns more than $1 billion in annual revenue, according to a 2018 estimate by Amnesty International.*
>
> *So Zuckerberg personally decided that Facebook would comply with Hanoi's demands, according to three people familiar with the decision, speaking on the condition of anonymity to describe internal company discussions. Ahead of Vietnam's party congress in January,*

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https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2021/05/19/A-Proposal-to-End-the-COVID-19-Pandemic-460263.

[73] Juan Sanchez, *COVID-19's Economic Impact around the World,* ST. Louis Federal Reserve (Aug. 11, 2021), https://www.stlouisfed.org/publications/regional-economist/third-quarter-2021/covid19s-economic-impact-world.

[74] Matt Viser, Rachel Lerman and Tyler Pager, "'They're Kiling People': Biden Aims Blistering Attach at Tech Companies Over Vaccine Falsehoods", *The Washington Post* (July 16, 2021), https://www.washingtonpost.com/politics/biden-vaccine-social-media/2021/07/16/fbc434bc-e666-11eb-8aa5-5662858b696e_story.html.

> *Facebook significantly increased censorship of "anti-state" posts, giving the government near-total control over the platform, according to local activists and free-speech advocates.*
>
> *Zuckerberg's role in the Vietnam decision, which has not been previously reported, exemplifies his relentless determination to ensure Facebook's dominance, sometimes at the expense of his stated values, according to interviews with more than a dozen former employees.*[75]

89. The same article reported that Zuckerberg's unilateral decisions put billions of users at risk:

> *But the former employees who spoke with The Post said his influence goes far beyond what he has stated publicly, and is most felt in countless lesser-known decisions that shaped Facebook's products to match Zuckerberg's values — sometimes, critics say, at the expense of the personal safety of billions of users.*[76]

*vii. The Whistleblower Goes Public*

90. On October 3, 2021, the Meta whistleblower revealed her identity during a televised interview on the CBS News program, *60 Minutes*. During the interview, Frances Haugen, a data scientist and former project manager at Meta, said that "[t]he thing I saw at Facebook over and over again was there were conflicts of interest between what was good for the public and what was good for Facebook.

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[75] https://www.washingtonpost.com/technology/2021/10/25/mark-zuckerberg-facebook-whistleblower/

[76] *Id.*

And Facebook, over and over again, chose to optimize for its own interests, like making more money" and repeatedly "has shown it chooses profit over safety."[77]

91. Ms. Haugen stated that Meta's algorithm optimizes for content that generates engagement, including more content that is angry, divisive, and polarizing because "they'll get more views."[78] Ms. Haugen reported that "Facebook has realized that if they change the algorithm to be safer, people will spend less time on the site, they'll click less ads, [and] they'll make less money."[79] Ms. Haugen, who previously worked at other big technology companies, stated that things were "substantially worse at Facebook."[80] She also asserted that Meta facilitated the January 6, 2021, deadly riot at the United States Capitol, some of which was coordinated through Meta's Platform, because the Company lacked the safety measures and financial incentive to thwart the spread of harmful content.

92. In describing her role as a member of Meta's Civic Integrity Unit, which worked on risks related to the spread of misinformation in connection with

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77 Scott Pelley, "Whistleblower: Facebook is Misleading the Public On Progress Against Hate Speech, Violence, Misinformation", *CBS News, 60 Minutes* (Oct. 4, 2021), https://www.cbsnews.com/news/facebook-whistleblower-frances-haugen-misinformation-public-60-minutes-2021-10-03/.

78 *Id*.

79 *Id.*

80 *Id.*

political elections but which the Company dissolved weeks after the 2020 United States Presidential election, Ms. Haugen stated that "I don't trust that they're willing to actually invest what needs to be invested to keep Facebook from being dangerous."[81]

93. In October 2021, *Time* ran an investigative piece entitled, "How Facebook Forced a Reckoning by Shutting down the Team that Put People ahead of Profits."[82] The story detailed the work of Meta's civic engagement team and its attempts to limit harmful social impact from algorithms used to drive more traffic (and thus more revenue). Among its conclusions:

> *But for many of the Facebook employees who had worked on the team, including a veteran product manager from Iowa named Frances Haugen, the message was clear: Facebook no longer wanted to concentrate power in a team whose priority was to put people ahead of profits…*
>
> *Facebook's focus on increasing user engagement, which ultimately drives ad revenue and staves off competition, [Haugen] argued, may keep users coming back to the site day after day—but also systematically boosts content that is polarizing, misinformative and angry, and which can send users down dark rabbit holes of political*

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81 *Id.*

82 Billy Perrigo, "How Facebook Forced a Reckoning by Shutting down the Team that Put People ahead of Profits," *Time* (Oct. 7, 2021), https://time.com/6104899/facebook-reckoning-frances-haugen/.

> *extremism or, in the case of teen girls, body dysmorphia and eating disorders.*[83]

94. One former member of the team told *Time* that before it was dissolved, "[t]he team prioritized societal good over Facebook good. It was a team that really cared about the ways to address societal problems first and foremost. It was not a team that was dedicated to contributing to Facebook's bottom line."[84]

95. On October 4, 2021, Haugen testified before the United States Congress, explaining:

> The company's leadership knows ways to make Facebook and Instagram safer and won't make the necessary changes because ***they put their immense profits before people***… This is not simply a matter of some social media users being angry or unstable. Facebook became a $1 trillion company by ***paying for its profits with our safety***, including the safety of our children.[85]

96. Haugen also filed complaints with the Securities and Exchange Commission, which highlighted the control Zuckerberg exercised over decisions at the Company:

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[83] *Id.*

[84] *Id.*

[85] U.S. Senate Committee on Commerce, Science and Transportation, Sub-Committee on Consumer Protection, Product Safety, and Data Security, "Statement of Frances Haugen," (Oct. 4, 2021), https://www.commerce.senate.gov/services/files/FC8A558E-824E-4914-BEDB-3A7B1190BD49.

> *Haugen references Zuckerberg's public statements at least 20 times in her SEC complaints, asserting that the CEO's unique degree of control over Facebook forces him to bear ultimate responsibility for a litany of societal harms caused by the company's relentless pursuit of growth.*[86]

97. Despite the press reports detailing the threats the Company's practices posed to the community, the Compensation Committee determined that high ranking executive officers should receive 110% and 100% of their target Company performance-related bonuses for the first and second halves of 2021, respectively, even though one component of the determination is Company prioritization of "making progress on the major social issues facing the internet and [the] Company, including privacy, safety, and security." Such awards make sense only if the sole perspective of the Company is that of Company financial performance.

98. Haugen's testimony laid responsibility with Zuckerberg. One news article characterized him as the "master switch:"

> *Except, as Haugen points out, Zuckerberg's monster has a master switch. As she told Congress on Tuesday, "Mark has built an organization that is very metrics-driven. It is intended to be flat. There is no unilateral responsibility. The metrics make the decision. Unfortunately, that itself is a decision. And in the end, if he is the*

[86] https://www.washingtonpost.com/technology/2021/10/25/what-are-the-facebook-papers/

> *CEO and the chairman of Facebook, he is responsible for those decisions."*[87]

This same article specifically attributed the decision not to roll out protections to Zuckerberg:

> *The company's researchers subsequently recommended some fixes that might counteract this deleterious effect, but Zuckerberg declined to pursue some proposals out of fear that they would adversely affect user engagement. One crucial potential fix was to reduce an aspect of the new algorithm known as "downstream MSI," which promoted posts that were likely to receive likes and comments and proliferate on news feeds through reshares. Research indicated that dialing this back could hamper the spread of misinformation, and the change had already been made in Ethiopia and Myanmar, where Facebook was being blamed for inflaming ethnic violence. Zuckerberg opted not to roll out the change more broadly, however."*[88]

**E. <u>The Stockholder Proposals</u>**

99. As a publicly traded United States company subject to the Securities Exchange Act of 1934, Meta is required to include proposals made by stockholders in the proxy statement for its annual meeting if such proposals meet certain requirements established in Rule 14a-8. To make a proposal that would be voted on at the Company's 2022 annual meeting of stockholders (the "2022 Annual Meeting"), a stockholder had to deliver a notice to the Company by December 10, 2021 (the "Proposal Deadline").

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[87] https://slate.com/technology/2021/10/facebook-scandal-zuckerberg-what-he-knew.html

[88] *Id*.

100. Twelve stockholder proposals were presented at the 2022 Annual Meeting. The 2022 Proxy Statement included the Board's narrative response to each proposal and its voting recommendation. In the case of each of the twelve proposals, the Board recommended a "no" vote.

101. Companies that receive stockholder proposals have several options. They can ask the SEC to allow exclusion of the proposal by arguing that it does not meet the requirements of Rule 14a-8. They can accede to some or all of what the proposal requests to negotiate a withdrawal of the proposal. If the proposal is presented, they can recommend either a "yes" or "no" vote. One source calculated that in the 2021 proxy season, 18% of proposals were excluded in the SEC process, 29% were withdrawn by the proponent and 50% went to a vote.

102. A number of the proposals the Company received for the 2022 Annual Meeting related to the type of broad social harm discussed in the press reports detailed above. In opposing each of these proposals and specifically recommending that stockholders vote against them, the Board never accounted for nor considered the impact on the portfolios of diversified stockholders of the Company's failure to take more actions to guard against the risks raised by the press reports and the proposals. The following four proposals are among those that raised such issues (collectively the "2022 Stockholder Proposals"):

**a. The external costs proposal**

103. Prior to the Proposal Deadline, the Company received a stockholder proposal that specifically requested that the Company report on the external costs created by the Company's prioritization of its financial return over healthy social and environmental systems and how risks created by such prioritization would affect the Company's diversified stockholders (the "External Costs Proposal"). Specifically, the proposal stated:

> **RESOLVED,** shareholders ask that the board commission and disclose a report on (1) risks created by Company business practices that prioritize internal financial return over healthy social and environmental systems and (2) the manner in which such risks threaten the returns of its diversified shareholders who rely on a productive economy to support their investment portfolios.[89]

104. The External Costs Proposal was filed by H.E.S.T. Australia Ltd, Trustee of Health Employees Superannuation Trust Australia ("HESTA").[90] HESTA manages AUS$66 billion (about US$48 billion).

105. The Company did not negotiate a settlement with HESTA, although in the 2021 proxy season, a stockholder proponent had filed a similar proposal with YUM! Brands, another Delaware corporation, and that corporation agreed to prepare

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[89] 2022 Proxy Statement at 72.

[90] *Id.* at 61.

and make public a report addressing the external costs of the use of antibiotics in its supply chain in exchange for the withdrawal of the proposal.

106. Instead, the Company submitted a letter to the SEC, arguing that the External Costs Proposal did not satisfy Rule 14a-8 because (1) it related to "ordinary business" and (2) it was vague and misleading.[91] On April 2, 2022, the SEC staff issued its response, stating it was "unable to concur" in either argument, so that the Company could not exclude the proposal and that, "In our view, the Proposal transcends ordinary business matters."[92]

107. The 2022 Proxy Statement included the Board's response to the External Costs Proposal and its recommendation that stockholders vote "no."[93] The response from the Board included the following statements:

- We believe that protecting our community is more important than maximizing our profits.
- We have also made significant investments in our safety and security efforts, and our actions demonstrate that we do not put profits ahead of safety on our platforms.

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[91] https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/shareholdermeta040222-14a8.pdf.

[92] *Id.*

[93] 2022 Proxy Statement at 73.

- We also spent approximately $5 billion on safety and security in 2021 alone.[94]

108. The Board's statement that community protection is prioritized over financial return flies in the face of multiple internal reports and employee statements cited in the press reports noted above, including testimony before Congress, to the contrary. The statement in support of the External Costs Proposal, which was reproduced in the 2022 Proxy Statement, expressly connected the press reports of social harm cited above to the need to report on external costs in order to protect stockholder interests. The absence of any acknowledgment by the Board in its response to the serious issues raised in the press shows gross negligence and a lack of good faith in the Board's decision not to prepare an external cost report and its recommendation that stockholders vote no on the External Costs Proposal.

109. Nothing in the Board's response reflects any contemplation of the trade-offs being made between Company profits and the external costs of safety lapses, or the broader impact of those trade-offs on the Company's diversified stockholders, despite the clear language in the External Cost Proposal addressed to those specific concerns.

110. The Board's response to the External Costs Proposal did not acknowledge, address, or account for the deliberate choice the Company made to

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[94] *Id.*

use an algorithm that harms public safety, rather than protecting it, or the impact those harms have on the global economy and the portfolios of its diversified stockholders.

**b. The Metaverse Proposal**

111. Prior to the Proposal Deadline, the Company received a stockholder proposal asking it to prepare and report on its "metaverse" project and to then submit the project to an advisory stockholder vote (the "Metaverse Proposal").[95] In particular, the report was to include a third-party assessment of:

- potential psychological and civil and human rights harms to users that may be caused by the use and abuse of the platform, [and]
- whether harms can be mitigated or avoided, or are unavoidable risks inherent in the technology.[96]

112. The Metaverse Proposal was filed by Arjuna Capital, an asset manager that uses sustainable investing strategies on behalf of its clients. The Metaverse Proposal focused on the types of external costs detailed in the press reports and addressed by the External Costs Proposal but was focused on a new company strategy: Zuckerberg had said "I expect people will transition from seeing us

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95 Notice of Exempt Solicitation at 1 (Apr. 27, 2022), https://www.sec.gov/Archives/edgar/data/0001703208/000121465922005924/b427221px14a6g.htm.

96 *Id.*

primarily as a social media company to seeing us primarily as a metaverse company."[97]

113. The statement supporting the Metaverse Proposal expressly called attention to public reports of the damage being done by the Meta business model:

> A *Wall Street Journal* investigation, based on internal documents provided by a whistleblower, concluded: "Facebook...knows, in acute detail, that its platforms are riddled with flaws that cause harm, often in ways only the company fully understands." A third-party civil rights audit expressed concern about "the vexing and heartbreaking decisions Facebook has made that represent significant setbacks for civil rights."[98]

114. The statement detailed how these current concerns will only be multiplied as the metaverse technology grows:

> The same issues Facebook is reckoning with—discrimination, human and civil rights violations, incitement to violence, and privacy violations—may be heightened in the metaverse. . . .
>
> Meta is dedicating significant resources to the metaverse without fully understanding its potential risks and negative impacts. The Company employs over 10,000 people working on metaverse projects and plans to hire at least 10,000 more. It estimates spending

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[97] Facebook Q2 2021 Earning Call at 4 (TRANSCRIPT) (July 28, 2021), https://s21.q4cdn.com/399680738/files/doc_financials/2021/q2/FB-Q2-2021-Earnings-Call-Transcript.pdf.

[98] Notice of Exempt Solicitation at 1 (Apr. 27, 2022), https://www.sec.gov/Archives/edgar/data/0001703208/000121465922005924/b427221px14a6g.htm.

> 10 billion dollars on metaverse investments in 2021, approximately 50 percent of capital expenditures, with additional future spending.[99]

115. The Company tried to exclude the Metaverse Proposal, arguing that it only dealt with "ordinary business."[100] On April 2, 2022, the SEC staff responded that it was unable to concur with the Company's argument, and that, in the view of the staff, the Metaverse Proposal "transcends ordinary business matters."[101]

116. The Metaverse Proposal was included in the 2022 Proxy Statement, which included a Board response and a recommendation of the Board to stockholders to vote "no."[102]

117. The Board response recited a litany of areas where the Company "will work with others to anticipate and address risks" involving the metaverse.[103] It talked about researchers, experts and advocates that it was working with and about a $50 million, two-year investment, which is not clearly earmarked solely for

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[99] *Id.*

[100] https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/arjunameta040222-14a8.pdf.

[101] *Id.*

[102] 2022 Proxy Statement at 77.

[103] *Id.*

safety.[104] But again, nothing in the Board's response addresses the concerns that the Company has a history of sacrificing safety for profit, as well-reported in the press, and as specifically raised by the Metaverse Proposal.

118. The press reports had made it clear that the Company's business model sacrifices users' mental well-being and the human rights of communities around the world impacted by the Platforms in order to boost traffic, revenue, and profits. The requested third-party assessment would have given the Board better tools to determine the extent to which such sacrifices were being made and whether and how they effected the diversified portfolios of the Company's stockholders. But the Board response detailing its decision not to pursue such a report (and to advocate against stockholder support for the report) completely ignores those red flags.

119. The Board response to the Metaverse Proposal did not acknowledge, address, or account for the deliberate choice the Company made to use an algorithm that harms public safety, rather than protecting it, or the impact those harms have on the global economy and the portfolios of its diversified stockholders.

**c. The Community Standards proposal**

120. Prior to the Proposal Deadline, the Company received a proposal seeking a report investigating why the enforcement of the Company's "Community

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[104] *Id.*

Standards" had been ineffective at controlling content on the platform that, among other things, "incites violence and/or harm to public safety or personal safety" (the "Community Standards Proposal").[105] Specifically, the Community Standards Proposal referenced continued harm from the Company's activities by citing the following examples:

- Millions of high-profile users exempted from its rules, permitting continued widespread, incitement of violence and harassment;
- Internal Company research demonstrating that Instagram is toxic for teen girls;
- Mental health crises among outsourced moderators due to viewing child pornography and animal cruelty;
- Lack of cooperation with authorities to prevent and detect child exploitation and abuse;
- Ignored employee red flags about the spread of election misinformation;
- Political advertisements containing deliberate lies and mistruths;
- Hate speech that continues to thrive;
- Anti-immigrant violence around the world.[106]

121. The proponent's statement supporting the Community Standards Proposal and included in the 2022 Proxy Statement suggested including the

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[105] 2022 Proxy Statement at 74.

[106] *Id.*

following items in the report, all of which would inform Company decisions about how to weigh the impacts of the Company's failure to enforce its own standards on diversified stockholders:

- A quantitative and qualitative assessment by an external, independent panel of qualified computer scientists of the effectiveness of Meta's algorithms to locate and eliminate content that violates the Community Standards;
- An assessment of the effectiveness of Meta's staff and contractors in locating and eliminating content that violates the Community Standards;
- An examination of benefits to users and impact to revenue if the Company would voluntarily follow existing legal frameworks established for broadcast networks (e.g. laws forbidding child pornography and rules governing political ads);
- An analysis of the benefits of the Company continuing to conduct technology impact assessments focused on how Meta's platforms affect society.[107]

122. The Community Standards Proposal was submitted by As You Sow ("AYS") on behalf of an individual stockholder. AYS is a non-profit organization that has been advocating for the rights of stockholders since 1992. The Company again sought relief at the SEC but did not even attempt to argue that the Community Standards Proposal addressed ordinary business. Instead, Meta relied on a different objection—that the proposal repeated proposals received in prior years.

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[107] *Id.*

Specifically, the Company asserted that "the Proposal deals with substantially the same subject matter as prior proposals that have been included in the Company's proxy materials and voted on more than three times within the preceding five calendar years."[108]

123. The Company's request to the SEC staff included the following chart to demonstrate the similarity of the previous proposals:[109]

| | | **Proposal** | **2021 Proposal** | **2019 Proposal** | **2018 Proposal** |
|---|---|---|---|---|---|
| **Subject Matter** | **Allegedly harmful content on the Company's platform and its negative impact** | "incitement of violence and harrassment"; "Political advertisements containing deliberate lies and mistruths"; "Hate speech that continues to thrive" | "incited genocide"; "political advertisements that contain deliberate lies and disinformation"; "Hate speech linked to anti- immigrant violence" | "propagating hate speech"; "abuse and misinformation campaigns continue, implicating issues such as democracy, human rights, and freedom of expression" | "dissemination of violence through Facebook Live, broadcasting dozens of murders, suicides, and beatings"; "misuse of its platform to spread lies, propaganda, and hate" |
| | **The Company's efforts to monitor and control the content** | "creation of the "Transparency Center" that displays qualitative and quantitative reports on the elimination of posts that violate the 25 | "Facebook successfully altered algorithms and took other actions to de-prioritize extremist postings and to instead emphasize | "Facebook's recent efforts to increase disclosures and enhance internal compliance and enforcement strategies" | "Facebook worked to block such targeted advertising"; "agree to address vulnerabilities that can be exploited for election interference and to |

[108] https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/asyousowmeta033122-14a8.pdf.

[109] *Id.*

| | | | | | |
|---|---|---|---|---|---|
| | | "Community Standards" | mainstream news content" | | make political ads more transparent" |
| | **The effectiveness of those efforts** | "the enforcement of "Community Standards" as described in the "Transparency Center" has proven ineffective" | "Management and the board have failed to take effective action to stem these abuses" | "concern over the Company's inadequate approach to governing content appearing on its platforms"; "Shareholders are concerned Facebook's approach to content governance has proven ad hoc, ineffectual, and poses continued risk" | "disclosures have been inadequate"; "Content policies appear reactive, not proactive" |
| | **Types of additional reporting each of the proposals seeks** | "analysis of the benefits of the Company continuing to conduct technology impact assessments focused on how Meta's platforms affect society"; "examination of benefits to users and impact to revenue" | "characterize and quantify the benefits or harms of such enhanced actions on…revenue and earnings" | "extent to which they address human rights abuses and threats to democracy and freedom of expression and the reputational, regulatory, and financial risks posed by content governance controversies" | "reviewing the efficacy of its enforcement of its terms of service related to content policies and assessing the risks posed by content management controversies (including election interference, fake news, hate speech, sexual harassment, and violence) to the company's finances, operations and reputation" |

124. While the SEC staff rejected the request to exclude the Community Standards Proposal, the first three rows of the Company-submitted chart amply demonstrate that public knowledge of the economic threats posed by the Company's activities long before the press articles that appeared in the Fall of 2021.

125. The Community Standards Proposal appeared in the 2022 Proxy Statement, which included a Board response and a recommendation to vote "no" on the proposal.[110]

126. The Board's response completely failed to address any consideration of the trade-offs between Company profit and broad economic welfare, or the impact that trade-off might have on diversified stockholders of Meta, despite the fact that the requested report could have provided significant assistance in assessing those trade-offs. Indeed, the Board response reads as if no such trade-offs exist, despite the ample evidence from the press reports and Ms. Haugen's Congressional testimony. In deciding not to pursue the Community Standards Proposal, and to recommend that the stockholders reject the proposal, the Board did not account for this critical aspect of financial concern to the Company's noncontrolling stockholders, despite multiple warnings of its importance.

127. The Board response to the Community Standards Proposal did not acknowledge, address, or account for the deliberate choice the Company made to use a business model that harms public safety, rather than protecting it, or the impact those harms have on the global economy and the portfolios of its diversified stockholders.

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[110] 2022 Proxy Statement at 75.

### F. <u>The Human Rights Proposal</u>

128. Prior to the Proposal Deadline, the Company received a proposal seeking a third-party human rights assessment (the "Human Rights Proposal").[111] The Human Rights Proposal sought an assessment that would address the human rights impacts of the Company's practices:

> **RESOLVED:** Shareholders direct the board of directors of Meta Platforms, Inc. (formerly known as Facebook, Inc) to publish an independent third-party Human Rights Impact Assessment (HRIA), examining the actual and potential human rights impacts of Facebook's targeted advertising policies and practices throughout its business operations . . . .[112]

129. The proponent's statement supporting the Human Rights Proposal linked the Company's revenue model, its algorithms, and the risk to investors of adverse human rights impacts, all of which were made salient in the press reports and Ms. Haugen's testimony:

> Facebook's business model relies on a single source of revenue – advertising. Targeted advertising, given concerns around the fairness, accountability, and transparency of the underlying algorithmic system, has been heavily scrutinized for its adverse

[111] Notice of Exempt Solicitation at 1 (Apr. 13, 2022), https://www.sec.gov/Archives/edgar/data/1326801/000121465922005187/o413223px14a6g.htm.

[112] *Id.*

> impacts on human rights, and is targeted for significant regulation. This is a material risk to investors.[113]

130. The Company sought to exclude the Human Rights Proposal from the 2022 Proxy Statement, arguing to the SEC that it constituted ordinary business and that it dealt with substantially the same subject matter as at least two other proposals submitted to the Company in the previous five years.[114] The Company's petition to the SEC included the following chart, claiming to show that stockholders had raised similar concerns about the Company's human rights violations over the prior two years:[115]

| **Proposal** | **2020 Proposal** | **2019 Proposal** |
|---|---|---|
| RESOLVED: Shareholders direct the board of directors of Meta Platforms, Inc. (formerly known as Facebook, Inc) to publish an independent third-party Human Rights Impact Assessment (HRIA), examining the actual and potential human rights impacts of Facebook's targeted advertising policies and practices throughout its business operations. This HRIA should be conducted at reasonable cost; omit proprietary and confidential information, as well as information relevant to litigation or enforcement actions; and be published on the company's website by June 1, 2023. | RESOLVED: Shareholders urge the Board of Directors to oversee management's preparation of a report on Board-level oversight of civil and human rights risks. In doing so, Facebook might consider reporting on board level expertise in civil and human rights; board level responsibilities for advising on and managing civil and human rights risk; board level expertise pertinent to oversight regarding civil and human rights issues impacting Facebook's community of global users; and the presence of board level infrastructure ensuring ongoing consultation with leading civil and human rights experts. | RESOLVED , The Company publish a report (at reasonable cost, omitting proprietary or legally privileged information) evaluating its strategies and policies on content governance, including the extent to which they address human rights abuses and threats to democracy and freedom of expression, and the reputational, regulatory, and financial risks posed by content governance controversies. |

[113] *Id.*

[114] https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/mercymeta033022-14a8.pdf.

[115] *Id.*

| | | Proposal | 2020 Proposal | 2019 Proposal |
|---|---|---|---|---|
| **Subject Matter** | **Focus on the Company's Platform** | "Targeted advertising given concerns around the fairness, accountability, and transparency of the underlying algorithmic system, has been heavily scrutinized for its adverse impacts on human rights." | "While Facebook recently took steps to limit discriminatory targeting in advertising, concerns have been raised that the algorithm used to determine how ads are delivered to users is itself discriminatory...... " | "Facebook's content governance challenges are complex...... " |
| | **Focus on the Company's Business Model** | "Facebook's business model relies almost entirely on ads, with 98% of Facebook's global revenue in 2020 generated from advertising." | "Accordingly to Investopedia, almost all of Facebook's revenue comes from advertising. . . ." | "News of Cambridge Analytica's misappropriate of millions of Facebook users' data preceded a decline in Facebook's stock market capitalization of over 100 billion dollars in March 2017. Another 100-billion plus decline in market value—a record-setting drop—came in July after Facebook's quarterly earnings report reflected increasing costs and decreasing revenue growth." |
| | **Impact to "Human Rights"** | "Shareholders direct the board of directors . . . to publish an independent third-party Human Rights Impact Assessment examining the actual and potential human rights impacts of Facebook's targeted advertising policies and practices throughout its business operations." | "Shareholders urge the Board of Directors to oversee management's preparation of a report on Board-level oversight of civil and human rights risks." | "The Company publish a report . . . evaluating its strategies and policies on content governance, including the extent to which they address human rights abuses ..... " |
| | **Alleged human rights abuses as a result of the Company's platform** | "exacerbating systemic discrimination and other human rights abuses" | ". . . excluded people from seeing housing, employment and credit ads based on age, gender, race . . ." | "propagating hate speech"; "abuse and misinformation campaigns continue, implicating issues such as democracy, human rights, and freedom of expression" |

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| | **Concerns regarding the effectiveness of the Company's mitigation efforts** | "However, it was discovered that, outside of stated parameters, Facebook is still using the vast amount of data it collects about young people to determine which children are most likely to be vulnerable to a given ad, opening them to allegations of human rights violations. . . • | "Although Facebook has taken steps to limit its civil and human rights risk exposure . . . [w]e are concerned that these efforts have not received adequate attention from leadership." | "Despite Facebook's recent efforts to increase disclosures and enhance internal compliance and enforcement strategies, abuse and misinformation campaigns continue, implicating issues such as democracy, human |
| | | Additionally, Facebook does not publish data on alleged violations of the policies they do have, making it impossible to know if they are effective" | | rights, and freedom of expression." |
| | **Focus on potential financial and legal implications** | "Facebook was fined $5 billion for such privacy violations by the U.S. Federal Trade Commission in 2019." | "In 2019, Facebook paid $5 million to settle civil rights lawsuits claiming Facebook's advertising systems excluded people from seeing housing, employment and credit ads based on age, gender and race . . ." | "News of Cambridge Analytica's misappropriation of millions of Facebook users' data preceded a decline in Facebook's stock market capitalization of over 100 billion dollars in March 2018. Another 100-billion plus decline in market value—a record-setting drop—came in July after Facebook's quarterly earnings report reflected increasing costs and decreasing revenue growth." |
| | **Types of additional reporting each of the proposals want** | "examining the actual and potential human rights impacts" and "information relevant to litigation or enforcement actions. . ." | "reporting on . . . board level responsibilities for advising on and managing civil and human rights risks" | "evaluating [the Company's] strategies and policies on continent governance, including the extent to which they address human rights abuses. . . " |

131. The SEC staff did not concur with the Company's attempt to exclude the Human Rights Proposal.[116] It was included in the 2022 Proxy Statement, which also included the Board response and its recommendation that the stockholders vote

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116 *Id.*

against the proposal.[117] As was the case with each of the other 2022 Stockholder Proposals, the Board's description of its decision to recommend against the Proposal to obtain a third-party assessment starkly ignored all of the information about human rights concerns reflected in the press reports from the Fall of 2021, and the impact of human rights violations on the portfolios of the Company's diversified stockholder base.

132. The Board response to the Human Rights Proposal did not acknowledge, address, or account for the deliberate choice the Company made to use a business model that harms public safety, rather than protecting it, or the impact those harms have on the global economy and the portfolios of its diversified stockholders.

### G. The Future

133. In October 2021, the Company rebranded as Meta, adopted the term "metaverse" as its overarching theme, and assigned itself a mission of providing people with "useful and engaging products that enable people to connect and share with friends and family through mobile devices, personal computers, virtual reality headsets, and in-home devices," seeking to "help people discover and learn about what is going on in the world around them, [and] enable people to share their opinions, ideas, photos, videos, and other activities with audiences" using Meta

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[117] 2022 Proxy Statement at 79.

products including Facebook, Instagram, Messenger, WhatsApp and Facebook Reality Labs.[118] Reality Labs is the Meta group that provides augmented and virtual reality products to "help people feel connected, anytime, anywhere."[119] Combining these products with the Platforms will create the Metaverse.

134. On the Company's earnings call for the second quarter of 2022, held on July 27, 2022, Zuckerberg indicated that the Company's strategy of more engagement for more revenue would be further advanced through the use of artificial intelligence:

> Right now, about 15% of content in a person's Facebook feed and a little more than that of their Instagram feed is recommended by our AI from people, groups, or accounts that you don't follow. We expect these numbers to more than double by the end of next year. As our AI finds additional content that people find interesting, that increases engagement and the quality of our feeds. Since we're already efficient at monetizing most of these formats, this should increase our business opportunity over that period as well.[120]

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[118] Facebook, Inc. Form 10-K at 7 (Jan. 28, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/1326801/000132680121000014/fb-20201231.htm.

[119] *Id.*

[120] Meta Platforms, Inc. Q2 2022 Earning Call at 2 (TRANSCRIPT) (July 27, 2022), https://s21.q4cdn.com/399680738/files/doc_financials/2022/q2/Meta-Q2-2022-Earnings-Call-Transcript.pdf.

135. Based on the Corporate Governance Guidelines, the Company's risk management structure, and the Board's refusal to engage on the question of the massive harms reportedly caused by the Company's pursuit of traffic and revenue, even when confronted with high profile press reports and pointed 2022 Stockholder Proposals, it is reasonable to infer that the Board is shirking its duties of care and loyalty with respect to the adoption of these new technologies, and has not given any consideration to whether they are designed to address the interests of the Company's diversified stockholders.

### H. <u>Meta's Stock Repurchase Program</u>

136. In 2017, the Company commenced its share repurchase program, which provides financial return to investors solely in their capacity as Company residual equity holders. Some portion of these funds could be used to address the social and economic externalities that stockholders have been calling attention to in recent years, including through the 2022 Stockholder Proposals, potentially limiting the risks and costs that Meta poses to capital market returns to the Company's diversified stockholders.

137. "In November 2016, our board of directors authorized a share repurchase program that commenced in January 2017 and does not have an expiration date. We completed repurchases under the original authorization to purchase up to $6.0 billion of our Class A common stock during the second quarter

of 2018. In April 2018, the authorization for the repurchase of our Class A common stock was increased by an additional $9.0 billion, and we completed repurchases under this authorization during the fourth quarter of 2018. In December 2018, our board of directors authorized an additional $9.0 billion of repurchases under this program, all of which remained available for future repurchases as of December 31, 2018."[121]

138. At the end of 2018, the Board had authorized $24 billion of share repurchases. Each year, the Board authorizes more share repurchases.

139. "As of December 31, 2019, $4.90 billion remained available and authorized for repurchases. In January 2020, an additional $10.0 billion of repurchases was authorized under this program."[122] As of 2020, the Board had authorized $34 billion in share repurchases.

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[121] Facebook, Inc. Form 10-K at 31 (Jan. 31, 2019), https://www.sec.gov/Archives/edgar/data/0001326801/000132680119000009/fb-12312018x10k.htm#s679A0518EA9453288D11BEF4861F1DA0.

[122] Facebook, Inc. Form 10-K at 40 (Jan. 30, 2020), https://www.sec.gov/ix?doc=/Archives/edgar/data/0001326801/000132680120000013/fb-12312019x10k.htm#s3A86A459AFFE5228BABF7CE2F79E0540.

140. "In January 2021, an additional $25 billion of repurchases was authorized under this program."[123] As of 2021, the Board had authorized a total of $59 billion be earmarked for share repurchases.

141. For the first time since the share repurchase program was instituted, the Board did not authorize additional funds for share repurchase in 2022. Nevertheless, the fact that the Board has authorized an astounding $59 billion for share repurchases indicates their blinkered focus on the Company's bottom line and share price maximization.

142. For example, in 2021, while the Board highlighted the expenditure of $5 billion on safety in its response to the External Costs Proposal, it did not acknowledge the decision to spend $44.1 billion on share buybacks during the same year, rather than further increasing safety: the Company could have doubled its spending on safety by reducing its spending on buybacks by a mere 11%. The Board has made affirmative decisions through its share repurchase authorizations and rejection of the 2022 Stockholder Proposals that emphasize Meta's laser focus on the Company's profitability, cost savings, and Meta's own cash flows.

[123] Facebook, Inc. Form 10-K at 48 (Jan. 28, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/0001326801/000132680121000014/fb-20201231.htm#i5d2898d61ccf450cbccb20a5c73005f3_40.

143. When analyzed under a lens that accounts for the Stock Ownership Guidelines, the share repurchase program, and the diversified nature of Meta's minority-voting, non-insider stockholders, it is apparent that the Board is laboring under inherent conflicts that only serve to further Meta's blinkered approach to maximizing its bottom line.

## CLASS ACTION ALLEGATIONS

144. Plaintiff brings this action pursuant to Rule 23. Individually and on behalf of the diversified stockholders of Meta, defined as stockholders that have invested a sufficient portion of their portfolios in additional equity securities to ensure that they receive the higher market returns that accompany the risks of residual equity securities without incurring the idiosyncratic risk associated with concentrated investments in such securities, and that have held Meta stock as of October 2019 (the "Class"). The Class specifically excludes Defendants herein, any person, firm, trust, corporation, or other entity related to, or affiliated with, any of Defendants.

145. This action is properly maintained as a direct class action because the interested, blinkered decisions Defendants have made about Meta's business ignore negative and material impacts on the common interests of Meta's diversified stockholders. Diversified stockholders bear the cost of Defendants' decisions not to

address the negative externalities the Company's business practices have on the overall economy and human community.

146. The Class has been and continues to be deprived of their rights as stockholders of Meta to have their interests accounted for, as evidenced by the Board's continued rejection of 2022 Stockholder Proposals, which highlight those negative externalities and could prepare Meta to use less harmful and more beneficial means to manage a profitable Company while also preserving and protecting the portfolios of its diversified stockholders.

147. Instead, the conflicted Defendants elect to continually use the Company's share repurchase program to prioritize cash flows to its stockholders, without regard for the continuing harms their business practices visit on the Company's own diversified stockholder base.

148. Defendants' disregard for the negative externalities of its business has resulted in harm to all of Meta's diversified stockholders whose investments are materially and adversely affected by the Company's failure to take steps to ameliorate those negative externalities.

149. The Class is so numerous that joinder of all members is impracticable. For the quarter ending June 30, 2022, Meta had 2.826 billion shares of stock issued. The Class is immensely numerous.

150. Plaintiff is an adequate representative of the Class, has retained competent counsel experienced in litigation of this nature, and will fairly and adequately protect the interests of the Class.

151. Plaintiff's claims are typical of the claims of the other Class members, and Plaintiff does not have any interests adverse to the Class.

152. The prosecution of separate actions by individual members of the Class would create the risk of inconsistent and varying adjudications without respect to individual members of the Class that would establish incompatible standards of conduct for Defendants, or adjudications with respect to individual members of the Class that would, as a practical matter, be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests.

153. Defendants have acted on grounds generally applicable to the Class with respect to the wrongdoing complained of herein, thereby making appropriate the relief sought herein with respect to the Class as a whole.

## CLAIM FOR RELIEF

### COUNT I
BREACH OF FIDUCIARY DUTY
*(Directly Against all Defendants as Directors)*

154. Plaintiff realleges each allegation pleaded above.

155. By virtue of their conduct and decisions as members of the Board, Defendants have impinged upon the rights of Meta's diversified stockholders to have their interests considered in connection with the Board's business decisions.

156. The deprivation of this right of Meta's diversified stockholders directly damages Plaintiff and similarly situated stockholders.

157. Defendants, as conflicted concentrated stockholders of the Company, have administered Meta in a manner that ignores the interests of the Class of minority diversified stockholders, and make decisions which continue to cause harm to the Company's diversified stockholders while increasing Meta's share price and bottom line.

158. Each member of the Board acted with gross negligence and consciously disregarded the threat posed to the interests of the Company's diversified stockholders as investors created when Company decisions taken to maximize Company returns failed to account for Meta's outsized impact on the global economy. The press reports highlighted many of these risks. In many cases, the 2022 Stockholder Proposals asked for specific action on these risks, reiterating the press reports themselves. In addition, with respect to the Human Rights Proposal and the Community Standards Proposal, the Company itself asserted to the SEC that the proposals were duplicative of proposals received in prior years. Thus, even the Board acknowledges the history of red flags.

159. The factors raised in the press reports and the 2022 Stockholder Proposals that harmed the Class includes:

- Rules meant to limit social risk are waived for high-profile users to drive traffic, revenue and profits;
- The Company promotes products that drive significant mental health issues, including depression, anxiety, eating disorders and suicidal thoughts;
- Changes to the algorithm that drives the central News Feed feature of Facebook drive harsh political discourse around the world,
- Zuckerberg rejected expansive use of an employee recommended "tweak" to the algorithm to address negative impact, because it might have reduced user engagement;
- Company platforms are used to lure women into abusive situations including sex work and modern slavery; while the Company addresses reported issues by removing offending posts, it does not address the systemic issue; it instead gives priority to retaining users, helping business partners and placating authoritarian governments;
- The Company treats harm in developing countries as a cost of doing business;

- Despite warnings, the Company allows drug cartels to use its Platform to recruit teenagers to attend "hit-man training camps." Despite having been alerted to such activity, the Company allowed a video of a man being shot in the head, along with a photo of severed hands;
- The Company does not have enough translators to monitor incitement to ethnic violence, leading an internal team to conclude the Company was "blind" to these problems;
- Posts on Company platforms referred to the Tigrayan minority in Ethiopia as "hyenas" and "a cancer," while the United States Secretary of State described the situation as "ethnic cleansing;"
- The Company's own personnel recognize that vaccine hesitancy is "rampant" on Company Platforms and that it has the "potential to cause severe societal harm," and much of the problem comes from the failure to have adequate translation resources;
- Journalists who have reviewed internal documentation conclude that the Company "is acutely aware that the products and systems central to its business success routinely fail and cause harm;"
- Ms. Haugen stated that "Facebook has realized that if they change the algorithm to be safer, people will spend less time on the site, they'll click less ads, they'll make less money;"

- The Company specifically shut down the Civic Engagement Team, which did prioritize "societal good over Facebook good;" and
- Ms. Haugen told Congress the Company "won't make the necessary changes because they put their immense profits before people" and "Facebook became a $1 trillion company by paying for its profits with our safety, including the safety of our children."

160. Threats of the type detailed in the press reports bear a clear relation to overall economic health and thus diversified portfolio returns, as detailed in the External Costs Proposal, which was rejected by a vote of the Board.

161. The egregious nature of these facts, standing alone, is enough to demonstrate an utter failure by the Board to exercise its duties of care and loyalty. But not only did the Board allow this situation to develop, it also refused, in violation of its duties of care and loyalty, to consider the harm its policies were causing to diversified stockholders when the 2022 Stockholder Proposals requested specific action in response to the harms identified. Indeed, the remedies sought were relatively mild— reports that would have allowed stockholders and the Company itself to better understand these costs. But the Board refused to pursue such reports and recommended against stockholder votes in favor. And each response to the 2022 Stockholder Proposals made it clear that, despite the press reports, and despite the supporting statements, the Board utterly refused to consider the impact on diversified

stockholders of the trade-offs the Company was making, as it pursued more user engagement with business practices that threatened the economy.

162. The Board chose not to obtain a report, as requested by the External Cost Proposal, that would specifically analyze how the many externalities detailed in the press reports will harm the economy and diversified stockholders, even though Yum!, having received a similar proposal, did obtain such a report. The Board's response to that Proposal completely lacks any analysis of the impact the Company's behaviors had on diversified stockholders.

163. The Metaverse Proposal provided an opportunity to obtain a third-party assessment of the types of human rights harms—including ethnic cleansing—detailed in the press reports. Despite the impact such threats to the rule of law likely have on diversified stockholders, the Board response did not evaluate or even acknowledge such impacts.

164. The Community Standards Proposal sought an investigation of why Company policies aimed at promoting safety were failing, citing many of the harms detailed in the press reports. Even though the Company unsuccessfully argued that it should be able to exclude the proposal because it was similar to proposals received in 2018, 2019 and 2021, meaning that the Board (which must recommend for or against proposals) has known of these issues for at least four years, the Board response simply ignores the critical conflict between profits that benefit inside,

concentrated stockholders uniquely and the threats that the Board is permitting to be visited on its diversified stockholders.

165. The Board has also elected to leave an astounding $38.79 billion available for the Company's share repurchase program rather than putting more money towards addressing the types of issues raised by the 2022 Stockholder Proposals, which further indicates the Board's blinkered focus on share price maximization that also inherently increases the value of Defendants' stock options that make up a large portion of their compensation.

166. In reacting to the 2022 Stockholder Proposals and authorizing share repurchases, the Board has continually refused to take up the important consideration of how Meta's activities and policies effect society and the economy at large and thus the portfolios of its diversified stockholders, despite the evidence of the prioritization of profit over important social and economic interests. This is consistent with its Corporate Governance Guidelines and the design of the Company's risk management system, each of which were adopted by the Board and are subject to Board amendment at any time, and which are designed to focus only on enterprise value, even if doing so is harmful to most of the Company's stockholders.

167. On information and belief, the Board has continued to ignore these risks as the Company increases its use of immersive technologies and artificial

intelligence to increase user engagement and drive advertising revenue. These new technologies will exacerbate the risks described in the press reports by deepening users' psychological ties to the Platforms and by further eliminating human contribution to the traffic-driving algorithms. In light of the huge social costs already identified in the press reports, and the threats those costs pose to the vast base of diversified stockholders as demonstrated in the 2022 Stockholder Proposals, the Board's failure to force management to consider such costs as it embarks on the Metaverse journey is grossly negligent and a clear violation of its obligation to act in good faith.

168. Defendants suffer from inherent conflicts of interest as concentrated stockholders of Company stock as compared to the majority of non-insider, diversified stockholders, and due to their domination and control by the Company's controlling stockholder, Zuckerberg, who eliminated all potential voices of dissent in a purge over the past few years and replaced such voices with personal friends and directors less likely to challenge him. Those conflicts infect Defendants' recent decisions to ignore the media reports about the negative externalities of Meta's operations, to reject the 2022 Stockholder Proposals, to extend a governance structure focused solely on enterprise value, and to continually authorize more and more of the Company's funds to repurchase its own shares such that Defendants face a substantial likelihood of liability for those acts and omissions.

169. Plaintiff has been damaged by Defendants' conduct and will continue to be damaged thereby in an amount to be determined at trial.

170. Plaintiff has no adequate remedy at law.

**COUNT II**
BREACH OF FIDUCIARY DUTY
*(Directly Against Zuckerberg and Sandberg as Officers)*

171. Plaintiff realleges each allegation pleaded above.

172. By virtue of their positions as officers of the Company, Zuckerberg and Sandberg owe its stockholders fiduciary duties of care and loyalty.

173. Examples of their breach of such duties include:

- Zuckerberg and Sandberg permitting, in their capacity as officers, white-listed accounts of high-profile users to ignore platform rules, leading to that harms could reverberate throughout the economy and in the diversified portfolios of Company stockholders, including in the case of accounts where enforcing the rules required the consent of either Zuckerberg or Sandberg.
- Decisions weakening company civil rights policies impacting calls for violence by state actors, which work was "sponsored" by Sandberg and "revisited" by Zuckerberg in their capacities as officers, leading to ethnic violence that creates economic disruption that threatens the portfolios of the Company's diversified stockholders.

- Zuckerberg, in his capacity an officer, vetoing any "tradeoff" by the Company of traffic in order to improve the platform's social and economic impact, even if doing so would have benefitted its diversified stockholders.
- Zuckerberg, in his capacity as an officer, imposing a new metric for success, MSI, that prioritized the Company's financial returns over safety, regardless of the risks that Company practice posed to stable societies around the globe, or the impact such risks might have on the diversified portfolios of Meta's stockholders.
- Zuckerberg's decision as an officer not to suppress vaccine disinformation, which created significant risk to the economy, putting the Company's diversified shareholders at risk for financial losses.
- Zuckerberg deciding, in his capacity as an officer, that the Company would comply with the demands of the authoritarian rulers in Vietnam, without consideration of the impact that assisting in government - sponsored suppression of free speech would have on the global economy and diversified shareholders.
- Zuckerberg and Sandberg failing to oversee, in their capacity as officers, Company activity that threatened the value of the diversified portfolios of the Company's stockholders.

174. Zuckerberg has violated his duties of care and loyalty to the Company's diversified stockholders as an officer through his responsibility for each of the harms to diversified stockholders described in this Complaint, in light of his insistence that engagement and traffic metrics guide all decisions. As Haugen stated, "The metrics make the decision. Unfortunately, that itself is a decision. And in the end, if he is the CEO and the chairman of Facebook, he is responsible for those decisions."

175. Plaintiff has no adequate remedy at law.

## COUNT III
BREACH OF FIDUCIARY DUTY
*(Directly Against all Zuckerberg as Controlling Stockholder)*

176. Plaintiff realleges each allegation pleaded above.

177. By virtue of his positions as controlling stockholder of the Company, Zuckerberg owes its stockholders fiduciary duties of care and loyalty.

178. Zuckerberg has violated his duties of care and loyalty to the Company's diversified stockholders as a controlling stockholder through his responsibility for each of the harms to diversified stockholders described in this Complaint, in light of his "unique degree of control over Facebook [,which] forces him to bear ultimate responsibility for a litany of societal harms caused by the company's relentless pursuit of growth" And the fact that the Company "is entirely driven by him."

## PRAYER FOR RELIEF

WHEREFORE, Plaintiff demands judgment in his favor and prays for relief as follows:

A. Certifying this case as a class action, certifying Plaintiff as an adequate Class representative and his counsel as Class counsel;

B. Declaring that the directors and officers named as Defendants herein have breached their fiduciary duties as alleged herein;

C. Enjoining Defendants from continuing to disregard the interests of Meta's diversified stockholders in connection with the Board's business decisions;

D. Requiring Defendants to pay to Plaintiff the amounts by which he has been damaged or will be damaged by reason of the conduct complained of herein;

E. Awarding to Plaintiff the costs and disbursements of the action, including reasonable attorneys', accountants', and experts' fees, costs, and expenses; and

F. Granting such other and further relief as the Court deems just and proper.

HEYMAN ENERIO
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Dated: February 7, 2023

**CERTIFICATE OF SERVICE**

Kurt M. Heyman, Esquire, hereby certifies that on February 7, 2023, a copy of the foregoing Verified Amended Complaint was served electronically upon the following:

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*_/s/ Kurt M. Heyman_*
Kurt M. Heyman (# 3054)

**IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE**

| | | |
|---|---|---|
| JAMES MCRITCHIE,<br><br>Plaintiff,<br><br>v.<br><br>MARK ZUCKERBERG, SHERYL K. SANDBERG, ROBERT M. KIMMITT, PEGGY ALFORD, MARC L. ANDREESSEN, ANDREW W. HOUSTON, NANCY KILLEFER, TRACY T. TRAVIS, TONY XU, and META PLATFORMS, INC.,<br><br>Defendants. | ) | C.A. No. 2022-0890-JTL |

**DEFENDANTS' OPENING BRIEF IN SUPPORT OF**
**<u>THEIR MOTION TO DISMISS PLAINTIFF'S AMENDED COMPLAINT</u>**

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*Standard Gen. L.P. v. Charney*, 2017 WL 6498063 (Del. Ch. Dec. 19, 2017), *aff'd*, 195 A.3d 16 (Del. 2018) .......... 15

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Leo E. Strine, Jr., *Making it Easier for Directors to "Do the Right Thing"?*, 4 Harv. Bus. L. Rev. 235 (2014).....13

William T. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894 (1997) .....11

## PRELIMINARY STATEMENT

Plaintiff's Verified Amended Complaint (the "Amended Complaint or "AC") should be dismissed because its claims are contrary to well-established Delaware corporate law. Plaintiff, a stockholder of Meta Platforms, Inc. ("Meta" or the "Company"), alleges that Defendants breached their fiduciary duties as directors, officers and/or controlling stockholders because they worked to "maximiz[e] Company enterprise value," AC ¶ 34, without considering the potential negative effects that their corporate decisions might have on the value of Plaintiff's investments in *other* companies. But the fiduciaries of Delaware corporations do not owe a duty to oversee, consider, or protect a stockholder's investments in other companies—their duties are to Meta and its stockholders in their capacity as stockholders of that company. Thus, Plaintiff's claims—which are foreclosed by decades of Delaware precedent on fiduciary duties—fail as a matter of law.

Plaintiff's breach of fiduciary duty claims are also not well-pled. Plaintiff asserts that decisions by Meta's directors to maximize the Company's long-term profits were improperly self-interested because—according to Plaintiff—Meta's directors own "concentrated positions" in Meta stock, *id.* ¶ 9, and so they personally benefit from Meta's success while so-called "diversified stockholders" (Meta stockholders who also own stock in other companies) are purportedly harmed as a result. Plaintiff, however, does not allege any facts to support this fiction, and does

not attempt to explain how he, *as a Meta stockholder*, was financially harmed or otherwise damaged by Meta's success. To the contrary, Plaintiff acknowledges that Meta's "top and bottom lines" have grown "spectacularly" under the stewardship of Defendants, *id.* ¶ 30, and that "[o]n or around" the date the Amended Complaint was filed, Meta had a "market capitalization of $494.73 billion, making it one of the top five companies in market capitalization in the world," *id.* And in the six months since Plaintiff first filed this suit, his investment in Meta has grown in value by more than *$50 per share*, or nearly 40%. *See* AC, Exhibit A ("Redline") at 12-13.

Plaintiff previously asserted breach of fiduciary duty claims directly, purportedly on behalf of a class of so-called "diversified" Meta stockholders, and also derivatively, purportedly on behalf of Meta. In his Amended Complaint, Plaintiff purports to assert only direct claims. Yet Plaintiff's claim that Defendants "acted with gross negligence and consciously disregarded" a "history of red flags" relating to Meta's purportedly harmful conduct, *see* AC ¶ 158, is quintessentially derivative in nature, irrespective of how Plaintiff chooses to label it. As such, it must also be dismissed because Plaintiff does not allege that he has derivative standing, or that the Company itself was harmed by the alleged wrongdoing.

At bottom, Plaintiff is not pursuing claims under the law as it exists, but rather using this case to broadcast his theories about how he would like the law to change. Tellingly, Plaintiff never explains how his preferred version of fiduciary duty law

could feasibly be followed—where the decisions of corporate fiduciaries must be guided by not only what is in the best interests of the corporation itself, but also what is in the best interests of every other company, including Meta's competitors, or the "global economy." *E.g., id.*, ¶¶ 2, 5. Regardless, the Amended Complaint does not state a claim under decades-old, black-letter Delaware law. Plaintiff's claims should be dismissed with prejudice.

## BACKGROUND[1]

### A. Meta's Business and Board of Directors

Meta is a Delaware corporation based in Menlo Park, California, that builds technology that helps people connect, find communities, and grow businesses. *See* AC ¶ 15. Its products include Facebook, Instagram, Messenger, and WhatsApp, among others. *Id.* ¶ 29.

Meta has a nine-member Board consisting of Mark Zuckerberg, Robert Kimmitt, Peggy Alford, Marc Andreessen, Andrew Houston, Nancy Killefer, Sheryl Sandberg, Tracy Travis, and Tony Xu (collectively, the "Board" or "Director Defendants"). *Id.* ¶¶ 16-25. Meta's stock ownership guidelines require Board members to own Meta stock. *Id.* ¶ 34. Meta's executive directors must own shares with a value of at least $4 million, and non-employee directors must own shares with

[1] "Ex." citations are to the exhibits attached to the Affidavit of Holly E. Newell, Esq., filed contemporaneously herewith.

a value of at least $750,000. *Id*. These ownership requirements are intended to "further align the interests of [Meta's] executive officers and directors with those of [Meta's] shareholders," Ex. A (Meta's 2022 Proxy Statement) at 50, consistent with long-settled Delaware law.[2]

**B. <u>Meta's Financial Performance and Share Repurchases</u>**

As alleged in the Amended Complaint, Meta's services "are used by 3.59 billion people every month and 2.82 billion people every day, with 140 billion messages sent daily." AC ¶ 29. As Plaintiff acknowledges, "Meta's ubiquity has driven its top and bottom lines spectacularly," and in 2021, Meta generated $118 billion in revenue and $39.3 billion in profit, both significant increases from the years before. *Id.* ¶ 30. "On or around" the date the Amended Complaint was filed, Meta had a "market capitalization of $494.73 billion, making it one of the top five companies in market capitalization in the world." *Id.* As noted, in the six months since Plaintiff first filed this lawsuit, Meta's stock price has increased in value by more than *$50 per share*, or nearly 40%. *See* Redline at 12-13.

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[2] The Court may consider Meta's proxy statement and related public filings as part of this motion because they are incorporated by reference into the Amended Complaint, *see*, *e.g.*, AC ¶¶ 37, 100, 103, 107-08, 116-17, 121-22, 125-26, and are also subject to judicial notice, *see, e.g.*, *Dolan v. Altice USA, Inc.*, 2019 WL 2711280, at *2 (Del. Ch. June 27, 2019) (the Court may consider "documents incorporated by reference or integral to the Complaint and judicially noticeable facts available in public . . . filings").

In November 2016, to return profits to its stockholders, Meta's Board authorized a share repurchase program that commenced in January 2017. AC ¶ 137. Every year since then Meta has repurchased its stock pursuant to that program. *Id.* ¶¶ 138-141. In 2021, for example, Meta distributed over $44 billion to its stockholders through share repurchases and, as of the end of that year, the Board had authorized an additional $38.79 billion for repurchases. *Id.* ¶¶ 30, 142. Plaintiff does not allege that the repurchases were improper transactions, but rather that the Board "could have" spent the money on other things, such as "safety." *Id.* ¶ 142.

### C. Meta's Efforts to Protect Safety and Security

Meta undertakes significant efforts to protect both user and community safety and security. As Plaintiff notes, its executive bonuses depend, in part, on whether Meta is "making progress on the major social issues facing the internet and [the] Company, including privacy, safety, and security," AC ¶ 97, and the Company spent "approximately $5 billion on safety and security in 2021 alone," *id.* ¶ 107.

Further, although not required to resolve this motion, the Company's 2022 Proxy Statement discloses that such efforts have also included: maintaining an independent oversight board that provides recommendations regarding content policies and practices; issuing quarterly Community Standards Enforcement Reports that track Meta's progress in enforcing content policies; maintaining a corporate human rights policy that commits Meta to human rights due diligence in accordance

with the United Nations Guiding Principles on Business and Human Rights; conducting an internal civil rights audit and maintaining a dedicated Civil Rights Team to advance civil rights across Meta's services; maintaining a privacy committee that oversees efforts to enforce user privacy preferences and protect their personal information; and committing to achieving net zero greenhouse emissions by 2030, among many other endeavors. *See* Ex. A at 29–32.

### D. 2022 Stockholder Proposals

Meta's 2022 Proxy Statement disclosed that twelve stockholder proposals had been presented at the Company's 2022 Annual Meeting, and that the Board recommended a "no" vote on each of them. *See* AC ¶ 100. Plaintiff alleges that the Board's opposition to four of those proposals, which purportedly related to the "broad social harm" allegedly caused by Meta's products, demonstrates that "the Board never accounted for nor considered the impact [of those alleged social harms] on the portfolios of diversified stockholders." *Id.* ¶ 102; *see also id.* ¶¶ 103–132.

The Proxy Statement indicated that the Board recommended a "no" vote on those proposals because the proposals were unworkable as a practical business matter,[3] or the work requested by the proposals was already being performed by the

[3] *See, e.g.*, Ex. A at 72–73 (the "external costs" proposal was "both too vague in its definition and too broad in its scope to be feasible or effective").

Company.[4] Notably, Meta stockholders rejected the proposals, including the "external costs" proposal—which, like Plaintiff's lawsuit here, demanded that the Board make decisions based on how they would affect the "returns of its diversified shareholders," AC ¶ 103; *see* Ex. B (Meta's Form 8-K regarding its 2022 Annual Meeting) at 4.

### E. Plaintiff's Amended Complaint And Theory Of Liability

Plaintiff is an individual stockholder activist who runs a website on corporate governance and the how-to's of stockholder activism.[5] On his website, Plaintiff admits that he is using this lawsuit against Meta and its Board to "open[] up a new legal battle," one that "asks that fiduciary duty [law to] recognize the realities of modern portfolio theory" in ways that it currently does not.[6]

Plaintiff's original complaint was filed October 3, 2022, and advanced two causes of action for breach of fiduciary duty—one alleged directly, the other

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[4] *Id.* at 75 ("[g]iven the robust efforts already in place that demonstrate our commitment to our Community Standards and the transparency we provide into our enforcement actions, our board of directors believes" the "proposal is unnecessary"); *id.* at 77 ("[g]iven that we are already working with numerous researchers, experts, and advocates around the globe to better understand potential risks and mitigations . . . our board of directors believes [the metaverse] proposal is unnecessary"); *id.* at 79 ("[g]iven our active approach to addressing human rights, including our regular independent assessments against our commitments, our board of directors believes that the [human rights] proposal is unnecessary.").

[5] https://www.corpgov.net.

[6] https://www.corpgov.net/2022/10/meta-lawsuit-beyond-director-feedbags/.

derivatively. On December 16, 2022, Defendants moved to dismiss the original complaint, arguing that the claims failed as a matter of law and that Plaintiff could not establish derivative standing because he failed to adequately plead that a pre-suit demand on the Board would have been futile.

Rather than oppose Defendants' motion to dismiss, Plaintiff filed the Amended Complaint, which (i) drops the derivative cause of action for breach of fiduciary duty, *see* Redline at 85, 94–95, despite retaining allegations of failed board oversight that sound derivatively, *see* AC ¶ 158; (ii) makes cosmetic changes to Plaintiff's conclusory allegations, *see, e.g.,* Redline at 3–4; and (iii) adds two new direct causes of action for breach of fiduciary duty, *see id.* at 94–97.

Now, Count I for Breach of Fiduciary Duty is averred directly "against all Defendants as directors" for allegedly "administer[ing] Meta in a manner that ignores the interests" of Meta's "diversified" stockholders and "cause[s] harm to [them] while increasing Meta's share price and bottom line." AC ¶ 157. As alleged, Defendants breached their duties as directors because Meta's actions purportedly "imposed [costs] on [the] diversified stockholders' investment portfolios." *Id.* ¶ 49; *see also id.* ¶ 158 (Defendants "acted with gross negligence and consciously disregarded the threat posed to the interests of the Company's diversified stockholders as investors"). In short, Plaintiff asserts that Defendants are directly liable as directors of Meta for supposedly diminishing Plaintiff's investment returns

in the stocks of *other* companies. *See, e.g.*, *id.* ¶ 166 (Defendants allegedly failed to consider "how Meta's activities and policies effect society and the economy at large and thus the portfolios of its diversified stockholders").

Count II for Breach of Fiduciary Duty is premised on the same allegations as Count I, *see id.* ¶ 171, and is averred directly "against Zuckerberg and Sandberg as Officers" for purportedly causing the "Company activity that threatened the value of the diversified portfolios of the Company's stockholders," *id.* ¶ 173.[7] Count III for Breach of Fiduciary Duty is likewise based on the same allegations, *id.* ¶ 176, and is averred directly against Mr. "Zuckerberg as Controlling Stockholder" on the ground that he was allegedly "responsib[le] for each of the harms to diversified stockholders described in th[e] [Amended] Complaint," *id.* ¶ 178.

The Amended Complaint, like the original complaint, does not allege any facts (as opposed to conclusions) to demonstrate that (i) any Defendant has a "highly concentrated" position in Meta stock, (ii) any Defendant's investment portfolio is not diversified, (iii) Plaintiff's investment portfolio is in any way more or less diversified than Defendants' portfolios, (iv) Defendants' and Plaintiff's financial

[7] As Plaintiff acknowledges, however, Ms. Sandberg's tenure at Meta "ended in 2022," AC ¶ 17, and therefore she is no longer an officer of the Company.

interests are in any way "at odds," *see* AC ¶ 5, or (v) Plaintiff's investment portfolio was in any way damaged by Meta's actions.[8]

## ARGUMENT

### A. Plaintiff's Theory Of Liability Is Foreclosed By Delaware Law

Plaintiff is suing Meta as a test case in which he can share his theories on how he thinks corporations *should* operate. *See* AC ¶¶ 2–3, 41–48. He asserts that Defendants breached their fiduciary duties because they made decisions to "maximize the Company's long-term cash flows" without considering how it would affect Plaintiff's investments in other companies. *Id*. ¶ 2. But Defendants have no duty to consider Plaintiff's investments in other companies.

Under well-settled Delaware law, Meta's fiduciaries must govern the corporation so as to maximize long-term value for the corporation, *see Frederick Hsu Living Tr. v. ODN Holding Corp*., 2017 WL 1437308, at *18 n.18 (Del. Ch. Apr. 24, 2017) (citing Leo E. Strine Jr., *Corporate Power Ratchet: The Courts' Ability in Eroding "We the People's" Ability to Constrain Our Corporate Creations*,

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[8] Plaintiff's claim that Meta's actions have "undermin[ed] the global economy," AC ¶ 5, which in turn supposedly harms "diversified stockholders," is likewise unsupported by any facts. Plaintiff calls Gross Domestic Product (GDP) a measure of "the economy's intrinsic value," *id.* ¶ 45, but notably omits any factual allegations that the global GDP has fallen in recent years, let alone specifically due to any of Defendants' decisions. And while Plaintiff claims that a diversified portfolio is properly measured by "how the market performs as a whole," *id.* ¶ 43, he offers no facts to show how the market as a whole has performed, or that any poor performance could possibly be attributed to Defendants.

51 Harv. C.R.–C.L. L. Rev. 423, 440–41 (2016)), and cannot base their decisions on the "idiosyncratic" preferences of particular stockholders, *see, e.g.*, *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 38 (Del. Ch. 2013) ("Stockholders may have idiosyncratic reasons for preferring decisions that misallocate capital. Directors . . . need not cater to stockholder whim.").[9] Simply put, Defendants have an "obligation to maximize the value of the corporation for the benefit of the undifferentiated equity," so "[w]hen exercising their authority, [they] must seek 'to promote the value of [Meta] for the benefit of its stockholders.'" *Allen v. El Paso Pipeline GP Co.*, 113 A.3d 167, 179–80 (Del. Ch. 2014) (citation omitted), *aff'd*, 2015 WL 803053 (Del. Feb. 26, 2015); *see also Prod. Res. Grp. L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 791 (Del. Ch. 2004) (fiduciaries "have the task of attempting to maximize the economic value of the firm"); William T. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894, 896–97 (1997) ("[T]he proper orientation of corporation law is the protection of long-term value of capital committed indefinitely to the firm.").

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[9] Even where there are different groups of stockholders with diverging interests, directors do not breach their fiduciary duties merely by choosing one group over the other. *See In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 618-19 (Del. Ch. 1999) ("Since the two stockholder groups had potentially divergent interests, plaintiffs believe that they state a duty of loyalty claim merely by alleging that the Board treated one group unfairly . . . . In my view, that is not the law."); *see also* Andrew S. Gold, *Dynamic Fiduciary Duties*, 34 Cardozo L. Rev. 491, 501-02 (2012) ("Delaware courts have made it clear that it is up to directors . . . to decide whether to favor shareholders who are *diversified or undiversified*; shareholders who are hedged or unhedged; shareholders who are risk-averse or risk-neutral; shareholders who are affiliated or unaffiliated with the corporation." (emphasis added)).

Even "[i]n a world with many types of stock . . . and many types of stockholders—record and beneficial holders, long-term holders, short-term traders, activists, momentum investors, noise traders, *etc.*," this duty remains the same, which is owed to "the undifferentiated equity as a collective, without regard to any special rights." *Frederick Hsu*, 2017 WL 1437308, at *17.

Here, the interest that Plaintiff seeks to vindicate with this lawsuit—his investments in *other* companies—is unrelated to his rights as a Meta stockholder. Defendants owe fiduciary duties to Meta stockholders only in their capacity as Meta stockholders. *See, e.g.*, *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 37 (Del. 1996) (although fiduciaries owe "duties to minority stockholders *qua* stockholders, those duties are not implicated when the issue involves the rights of the minority stockholder [in a different capacity]"). While the Board can sometimes consider interests beyond those associated with increasing Meta's profits, it may only do so when "giving consideration to them can be justified as benefiting [Meta] stockholders." *Bandera Master Fund LP v. Boardwalk Pipeline Partners, LP*, 2019 WL 4927053, at *14 n.8 (Del. Ch. Oct. 7, 2019) (quoting Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50

Wake Forest L. Rev. 761, 771 (2015)).[10] Meta is not a "public benefit corporation," governed by 8 *Del. C.* § 362, which "vitiate[s] any profit maximization duty," and imposes a "mandatory, enforceable duty on the part of directors to consider the best interests of [all] corporate constituencies and those affected by the corporation's conduct when they make decisions." Leo E. Strine, Jr., *Making it Easier for Directors to "Do the Right Thing"?*, 4 Harv. Bus. L. Rev. 235, 243, 249 (2014).

Beyond economic and voting rights specific to Meta itself, any other rights that Meta stockholders may have must be granted by statute, contract, or common law. *See, e.g.*, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (holding that because "[t]he rights of the [noteholders] were fixed by contract" the noteholders "required no further protection" from Revlon's board). Plaintiff has identified no such law that obligates Defendants to consider the interests of companies in which some Meta stockholders may have also invested. Because Defendants do not have an obligation to monitor, consider, or protect Plaintiff's

[10] Plaintiff's claim that Meta's "core constituency" is "the Company's diversified stockholders," AC ¶ 6, is incorrect under Delaware law—the Company's "core constituency" is *all* Meta stockholders. *See Gilbert v. El Paso Co.*, 575 A.2d 1131, 1147-48 (Del. 1990) (where there are "competing interests of various shareholder groups," directors' "fiduciary duties . . . require[] them . . . to protect and advance the interests of *all* [of a company's] shareholders"). And Meta's directors and officers could not possibly have the unworkable duty to advance every private interest that each Meta stockholder has, however important.

investments in other companies, "[t]his is not a case of breach of fiduciary duty to [Plaintiff] *qua* [Meta] stockholder." *Riblet*, 683 A.2d at 40.

The same analysis applies to the Amended Complaint's new claims for breach of fiduciary duty against Mr. Zuckerberg and Ms. Sandberg as officers of the Company, *see* AC ¶¶ 171–75, and against Mr. Zuckerberg as a controlling stockholder, *id.* ¶¶ 176–78. Because corporate officers owe fiduciary duties that are identical to those owed by corporate directors, *see In re McDonald's Corp. Stockholder Derivative Litigation*, 289 A.3d 343, 362-64 (Del. Ch. 2023), Meta's officers' fiduciary duties are likewise owed to Plaintiff "qua [Meta] stockholder," *Riblet*, 683 A.2d at 40, and do not extend to monitoring, considering, or protecting Plaintiff's personal investments or interests in other companies. And while controlling "stockholders have fiduciary duties to minority stockholders *qua* stockholders, those duties are not implicated when the issue involves the rights of the minority stockholders" outside of the corporation-stockholder relationship. *Id.* at 37.

This fundamental defect dooms Plaintiff's lawsuit at the threshold, and the Court can and should dismiss it without further analysis. But as detailed below, Plaintiff's lawsuit suffers from additional fatal defects that require its dismissal.

### B. Plaintiff Fails To State A Claim For Breach Of Fiduciary Duty

The Amended Complaint's three Breach of Fiduciary Duty claims should be dismissed pursuant to Court of Chancery Rule 12(b)(6) because the Complaint fails to plead any non-conclusory facts that would make it "reasonably conceivable" that Defendants breached any fiduciary duty to Plaintiff and his alleged class of so-called "diversified stockholders."[11]

As discussed above, Defendants owe Plaintiff fiduciary duties "*qua* [Meta] stockholder," *Riblet*, 683 A.2d at 40, and have no duty to monitor, consider, or protect Plaintiff's interests in *other* companies, which is Plaintiff's theory of the case. Put simply, because Plaintiff cannot "demonstrate that the duty [allegedly] breached was owed to [Meta] stockholder[s]," *Brookfield Asset Mgmt., Inc. v. Rosson*, 261 A.3d 1251, 1266 (Del. 2021) (citation omitted), the breach of fiduciary duty claims must be dismissed on that basis alone.[12]

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[11] On a Rule 12(b)(6) motion, the Court must accept all well-pleaded factual allegations in the Amended Complaint as true, but need not accept as true conclusory allegations without specific supporting factual allegations. *See Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Holdings LLC*, 27 A.3d 531, 535 (Del. 2011). The Court draws all reasonable inferences in favor of Plaintiff and denies the motion unless Plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof. *Id.*

[12] To the extent Plaintiff also asserts this claim against Meta itself, it "is well established that corporations themselves do not owe fiduciary duties." *Standard Gen. L.P. v. Charney*, 2017 WL 6498063, *7 n.69 (Del. Ch. Dec. 19, 2017), *aff'd*, 195 A.3d 16 (Del. 2018).

Separately, the business judgment rule protects the actions of Defendants, affording them the presumption that they acted on an informed basis and in the honest belief that they acted in the best interest of the corporation and its stockholders. *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *see also Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594-95 (Del. Ch. 1986) (business judgment rule applies to controlling stockholder actions where the benefits inure to all stockholders equally). To overcome that presumption, Plaintiff must plead facts showing that Defendants failed to act (1) in good faith, (2) in the honest belief that the action taken was in the best interest of the company and its stockholders, or (3) on an informed basis. *Aronson*, 473 A.2d at 812.

Moreover, pursuant to 8 *Del. C.* § 102(b)(7), Meta's certificate of incorporation includes an exculpatory provision[13] that immunizes the Director Defendants in their capacities as directors from liability arising out of any breach of the duty of care. *See In re Cornerstone Therapeutics Inc. S'holder Litig.*, 115 A.3d 1173, 1181 (Del. 2015). Accordingly, Plaintiff must plead facts that raise a "rational inference that" each of the Director Defendants "harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party

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[13] *See* Ex. C (Meta's Amended and Restated Certificate of Incorporation) at Art. VII. The Court "may take judicial notice of the certificate in deciding a motion to dismiss." *McPadden v. Sidhu*, 964 A.2d 1262, 1273 n.28 (Del. Ch. 2008).

from whom they could not be presumed to act independently, or acted in bad faith." *Id.* at 1179–80. Plaintiff utterly fails in this regard.

As Plaintiff would have it, Defendants acted in bad faith and in their own self-interest because they are "concentrated stockholders of the Company," and thus when they took actions designed to "maximize Company returns," they benefitted themselves to the detriment of more "diversified stockholders" like Plaintiff, who invest in other (unnamed) companies that are purportedly harmed by Meta's success. *See* AC ¶¶ 157-60. But the Amended Complaint offers no *facts* to support any part of that conclusory assertion.[14] Moreover, and in any event, Delaware law requires the Defendants' interests to be aligned with the interests of Meta stockholders *qua* Meta stockholders, not *qua* "diversified stockholders," and the more Meta equity a Defendant owns, the more closely his or her interests will align with those of all other Meta stockholders. Indeed, Delaware law has long held precisely the opposite of what Plaintiff asserts here: that when fiduciaries "own 'material' amounts of common stock, it *aligns* their interests with other stockholders." *Chen v. Howard-Anderson*, 87 A.3d 648, 670–71 (Del. Ch. 2014) (emphasis added) (citation omitted);

[14] For example, the Amended Complaint alleges no facts showing that any Defendant has a "concentrated" position in Meta stock or that Plaintiff or any other Meta stockholder has a more diversified investment portfolio than any Defendant. In any event, a large position in Meta stock "does not create a disqualifying 'personal pecuniary interest' to defeat the operation of the business judgment rule." *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 958 (Del. 1985).

*see also In re PLX Tech. Inc. S'holders Litig.*, 2018 WL 5018535, at *41 (Del. Ch. Oct. 16, 2018) (similar), *aff'd*, 211 A.3d 137 (Del. 2019).

In sum, Defendants' stock ownership aligns their interests with all other Meta stockholders. And, more importantly, the Amended Complaint's allegations show that Defendants have acted in compliance with longstanding Delaware law by seeking to maximize Meta's value. Accordingly, Plaintiff cannot, as a matter of law, state a claim that any Defendant acted in a disloyal, self-interested, or bad faith manner. *See, e.g.*, *Ryan v. Buckeye Partners, L.P.*, 2022 WL 389827, at *12 (Del. Ch. Feb. 9, 2022) (concluding that plaintiff's "narrative does not come close to supporting a reasonable inference that the Buckeye Defendants engaged in bad faith," "especially" because "the Individual Buckeye Defendants were themselves unitholders" and therefore had same "incentive" as other unitholders), *aff'd*, 385 A.3d 459 (Del. 2022).

Plaintiff next argues that Defendants violated their duties of care and loyalty when they purportedly ignored warning signs of ongoing harm to Meta's diversified stockholders, *see* AC ¶¶ 159, 173, and, as directors, wrongly "recommended against" the 2022 shareholder proposals that would have purportedly cured those harms, *id* ¶¶ 161-64. But Plaintiff does not allege that Defendants were motivated by anything other than maximizing Meta's value—which is not actionable—and the Board's decision on how to respond to each of the shareholder proposals is a

quintessential business judgment. Alleging, as Plaintiff does here, "that a board incorrectly exercised its business judgment and made a 'wrong' decision in response to red flags . . . is insufficient to plead bad faith." *Melbourne Mun. Firefighters' Pension Tr. Fund v. Jacobs*, 2016 WL 4076369, at *9 (Del. Ch. Aug. 1, 2016), *aff'd*, 158 A.3d 449 (Del. 2017); *see also Pettry ex rel. FedEx Corp. v. Smith*, 2021 WL 2644475, at *8 n.91 (Del. Ch. June 28, 2021) ("Plaintiff's quibbles with [defendants'] approach amount to nothing more than a disagreement about the merits of a deliberate decision . . . and fall well short of supporting an inference of bad faith."), *aff'd*, 273 A.3d 750 (Del. 2022).

Plaintiff also alleges that Defendants exhibited bad faith by apportioning "$38.79 billion available for the Company's share repurchase program rather than putting more money towards addressing the types of issues raised by the 2022 Stockholder Proposals." AC ¶ 165. But it is "well established that, in the absence of evidence of fraud or unfairness, a corporation's repurchase of its capital stock . . . is entitled to the protection of the business judgment rule." *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988). Indeed, "[i]f, when, and how much stock to repurchase are precisely the types of decisions that are subject to the business judgement rule and protected against judicial second-guessing." *Tilden v. Cunningham*, 2018 WL

5307706, at *19 (Del. Ch. Oct. 26, 2018) (emphasis removed).[15] Stock repurchases advance various objectives—including distributing profits to stockholders—that have long been regarded by this Court as proper business purposes. *See, e.g.*, *Frank v. Arnelle*, 1998 WL 668649, at *6 (Del. Ch. Sept. 16, 1998), *aff'd*, 725 A.2d 441 (Del. 1999). In the absence of facts suggesting that the Board was conflicted when it approved the repurchases (there are no such allegations), or that the repurchases were illegal (they were not), it is not for Plaintiff to say how Meta should have spent its cash. That business judgment is reserved to the Board, and there are no facts alleged to overcome the protections of the business judgment rule.

Even ignoring his inability to plead any facts to support his claims for breach of fiduciary duty, if Plaintiff wants to "be awarded a meaningful remedy," he must also establish that a "sufficiently convincing causal linkage exists between the breach of duty and the remedy sought." *Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC*, 2018 WL 3326693, at *23–24 (Del. Ch. July 6, 2018), *aff'd*, 221 A.3d 100 (Del. 2019). But Plaintiff does not—and cannot—do so. The Amended Complaint fails to allege any facts showing that there is a causal link between Defendants' alleged actions and any purported injury to Plaintiff. It includes no facts

[15] Plaintiff also asserts that Mr. Zuckerberg "violated his duties of care and loyalty to the Company's diversified stockholders as a controlling stockholder through his responsibility for each of the harms to diversified stockholders described in this Complaint," AC ¶ 178, but there are no facts alleged to support any part of that claim.

to show that Meta's business harmed any identified company's stock price, let alone the stock price of a company in which Plaintiff is invested. It also contains no facts to indicate that any aspect of Plaintiff's portfolio was harmed at all, let alone harmed due to any decision that Defendants made. Plaintiff speculates that due to Defendants and Meta's actions his investments in other companies are "likely to be financially harmed," AC ¶ 2, but there are no facts to show that Plaintiff's investments in other companies were actually harmed, let alone facts that would show a causal connection between Defendants' actions and that speculative harm.

Finally, even if Plaintiff adequately alleged an injury to his other investments that was causally linked to Defendants actions, and he does not, Plaintiff's claims would still fail because he is not seeking redress "for injuries affecting his or her legal rights as a stockholder" *in Meta*. *See Brookfield*, 261 A.3d at 1263. The Amended Complaint fails to allege any damage to Plaintiff as a Meta stockholder—there is no allegation that his economic interest or voting rights in Meta have been impaired. To the contrary, the Amended Complaint openly acknowledges that Plaintiff, in his capacity as a Meta stockholder, benefited immensely, as Defendants' "decisions" have "increas[ed] Meta's share price and bottom line," AC ¶ 157, "spectacularly," *id.* ¶ 30; *see also* Redline at 12-13 (showing that between the filing of the original complaint and Amended Complaint, Plaintiff's investment in Meta has grown in value by nearly 40%).

### C. Plaintiff's Claims Are Ostensibly Derivative In Nature And Must Be Dismissed For That Additional Reason

In his original complaint, Plaintiff asserted a derivative claim purportedly on behalf of Meta against the Director Defendants for alleged breaches of fiduciary duty arising from the Board supposedly "consciously ignoring red flags" and "prioritiz[ing] [] share price over economic impact." Redline at Count II. After Defendants filed a motion to dismiss that demonstrated that Plaintiff lacks derivative standing, and that the derivative claim failed as a matter of law, Plaintiff abandoned the derivative claim in the Amended Complaint, and now purports to pursue only direct claims against Defendants. *See, e.g.*, Redline at 94.[16]

Yet Plaintiff still avers allegations that sound as derivative claims. "[A] claim is not 'direct' simply because it is pleaded that way . . . . Instead, the court must look to all the facts of the complaint and determine for itself whether a direct claim exists." *Dieterich v. Harrer*, 857 A.2d 1017, 1027 (Del. Ch. 2004). Here, despite eschewing his derivative cause of action, Plaintiff still alleges that Defendants "acted with gross negligence and consciously disregarded" a "history of red flags" relating

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[16] In their motion to dismiss the original complaint, Defendants demonstrated that Plaintiff's derivative claim failed at the outset for lack of harm to the corporation. *See* Defendants' Opening Brief in Support of Their Motion to Dismiss Plaintiff's Verified Complaint (Dkt. 17) ("Defs' First MTD") at 17-19. While this fact precludes a viable derivative claim, "it does not necessarily follow that the complaint states a direct, individual claim. . . [I]n reality, it states no claim at all." *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004).

to Meta's purportedly harmful conduct in order to "maximize Company returns." AC ¶ 158. "On its face, engaging in a 'business plan' to disregard [harmful conduct] is a form of mismanagement, whether or not it is styled as a *Caremark* claim for failing to exercise proper oversight and supervision. The duty implicated is plainly the directors' normal duty to manage the affairs of the corporation, which is owed to the corporation and not separately or independently to the stockholders." *In re Massey Energy Co. Derivative & Class Action Litig.*, 160 A.3d 484, 503 (Del. Ch. 2017) (internal quotations and citation omitted); *see also Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at *13 (Del. Ch. Aug. 26, 2005) ("Essentially, this a claim for mismanagement, a paradigmatic derivative claim.").

Plaintiff's derivative claims in disguise fail as a matter of law for two distinct reasons. First, it is clear from the face of the Amended Complaint that Meta was not actually harmed by the alleged misconduct—indeed, Plaintiff admits that Defendants' decisions have "increas[ed] Meta's share price and bottom line," AC ¶ 157, "spectacularly," *id.* ¶ 30. Without an "injury to the corporate entity[, t]here is no relief that would go the corporation," *Tooley*, 845 A.2d at 1039, and therefore a derivative claim cannot be maintained.

Second, Plaintiff did not make a pre-suit demand on the Board, and the Amended Complaint does not even attempt to allege specific facts to show that a pre-suit demand would have been futile, as required by Court of Chancery Rule 23.1.

*See Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993) (a stockholder's right to sue derivatively "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" as futile).[17] Because Plaintiff "brings [his] derivative claims without first making demand, and demand is not excused, th[e] claims must be dismissed." *Albert*, 2005 WL 2130607, at *13.

**CONCLUSION**

For the foregoing reasons, the Court should dismiss the Amended Complaint with prejudice.

ROSS ARONSTAM & MORITZ

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Words: 5,906

Dated: March 31, 2023

[17] As explained in Defendants' motion to dismiss the original complaint, Plaintiff cannot adequately plead that a pre-suit demand on the Board would have been futile in any event. *See* Defs' First MTD at 19-28.

**IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE**

| | | |
|---|---|---|
| JAMES MCRITCHIE,<br><br>Plaintiff,<br><br>v.<br><br>MARK ZUCKERBERG, SHERYL K. SANDBERG, ROBERT M. KIMMITT, PEGGY ALFORD, MARC L. ANDREESSEN, ANDREW W. HOUSTON, NANCY KILLEFER, TRACY T. TRAVIS, TONY XU, and META PLATFORMS, INC.,<br><br>Defendants. | ) | C.A. No. 2022-0890-JTL |

**DEFENDANTS' MOTION TO DISMISS**
**PLAINTIFF'S AMENDED COMPLAINT**

Defendants Mark Zuckerberg, Robert M. Kimmitt, Peggy Alford, Marc L. Andreessen, Andrew W. Houston, Nancy Killefer, Tracy T. Travis, Sheryl K. Sandberg, Tony Xu, and Meta Platforms, Inc., by and through their undersigned counsel, hereby move this Court for an Order dismissing Plaintiff's Amended Complaint with prejudice, pursuant to Court of Chancery Rules 12(b)(6) and 23.1 in the above-captioned action. The grounds for this Motion are further set forth in the Opening Brief filed contemporaneously herewith.

ROSS ARONSTAM & MORITZ LLP

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## CERTIFICATE OF SERVICE

I, David E. Ross, hereby certify that on March 31, 2023, I caused true and correct copies of (i) *Defendants' Motion to Dismiss Plaintiff's Amended Complaint*, (ii) *Defendants' Opening Brief in Support of Their Motion to Dismiss Plaintiff's Amended Complaint*, and (iii) the *Transmittal Affidavit of Holly E. Newell in Connection with Defendants' Opening Brief in Support of Their Motion to Dismiss Plaintiff's Amended Complaint* to be served through File & Serve*Xpress* upon the following counsel of record:

Kurt M. Heyman
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*/s/ David E. Ross*
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EFiled: Jan 25 2023 09:00AM EST
Transaction ID 68980470
Case No. 2021-0324-JTL

**IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE**

| | | |
|---|---|---|
| IN RE McDONALD'S CORPORATION | ) | |
| STOCKHOLDER DERIVATIVE | ) | C.A. No. 2021-0324-JTL |
| LITIGATION | ) | |

**OPINION**

Date Submitted: December 15, 2022
Date Decided: January 25, 2023

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Daniel C. Herr, LAW OFFICES OF DANIEL C. HERR LLC, Wilmington, Delaware; Shawn P. Naunton, Catherine S. Duval, Leila Bijan, ZUCKERMAN SPAEDER LLP, New York, New York; *Attorneys for Defendant Stephen J. Easterbrook.*

Kathleen M. Miller, Julie M. O'Dell, Jason Z. Miller, SMITH, KATZENSTEIN & JENKINS LLP, Wilmington, Delaware; *Attorneys for Defendant David Fairhurst*.

**LASTER, V.C.**

Defendant David Fairhurst served as Executive Vice President and Global Chief People Officer of McDonald's Corporation ("McDonald's" or the "Company") from 2015 until his termination with cause in 2019. In that position, Fairhurst was the executive officer with day-to-day responsibility for ensuring that one of the largest employers in the world provided its employees with a safe and respectful workplace.

In this action, stockholders of the Company have sued Fairhurst derivatively on the Company's behalf. They allege that during Fairhurst's tenure as the head of human resources, he breached his fiduciary duties by allowing a corporate culture to develop that condoned sexual harassment and misconduct. They assert that Fairhurst's fiduciary duties included a duty of oversight, which required that he make a good faith effort to establish an information system that would generate the information necessary to manage the Company's human resources function. They maintain that Fairhurst had a duty to use the resulting information to do his job and to report on his areas of responsibility to the CEO and the board. Those duties, they say, demanded that he address or report upward about any red flags regarding sexual harassment and misconduct at the Company.

The plaintiffs do not allege that Fairhurst failed to make a good faith effort to establish information systems. They argue instead that Fairhurst breached his duty of oversight by consciously ignoring red flags.

Fairhurst has moved to dismiss the oversight claim under Rule 12(b)(6) for failing to state a claim on which relief can be granted. Fairhurst contends that Delaware law does not impose on officers any obligations comparable to the duty of oversight articulated by

Chancellor Allen in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

This decision clarifies that corporate officers owe a duty of oversight. The same policies that motivated Chancellor Allen to recognize the duty of oversight for directors apply equally, if not to a greater degree, to officers. The Delaware Supreme Court has held that under Delaware law, corporate officers owe the same fiduciary duties as corporate directors, which logically includes a duty of oversight. Academic authorities and federal decisions have concluded that officers have a duty of oversight.

The fact that corporate directors owe a duty of oversight does not foreclose officers from owing a similar duty. Just as a junior manager with supervisory duties can report to a senior manager with supervisory duties, so too can an officer with a duty of oversight report to a board of directors with a duty of oversight. And just as a senior manager with supervisory duties can hold a junior manager accountable for failing to fulfill the junior manager's supervisory duties, so too can a board with a duty of oversight hold an officer accountable for failing to fulfill the officer-level duty.

Although the duty of oversight applies equally to officers, its context-driven application will differ. Some officers, like the CEO, have a company-wide remit. Other officers have particular areas of responsibility, and the officer's duty to make a good faith effort to establish an information system only applies within that area. An officer's duty to address and report upward about red flags also generally applies within the officer's area, although a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain. As with the director's duty of oversight, establishing

a breach of the officer's duty of oversight requires pleading and later proving disloyal conduct that takes the form of bad faith.

Fairhurst thus owed a duty of oversight. He had an obligation to make a good faith effort to put in place reasonable information systems so that he obtained the information necessary to do his job and report to the CEO and the board, and he could not consciously ignore red flags indicating that the corporation was going to suffer harm.

Fairhurst next argues that even if he owed a duty of oversight, the plaintiffs have failed to allege sufficient facts to state a claim against him. The plaintiffs have identified red flags indicating that sexual harassment occurred at the Company. They also have alleged facts supporting a reasonable inference that Fairhurst knew about the red flags. The analysis comes down to whether Fairhurst acted in bad faith by consciously ignoring the red flags.

Delaware law presumes that directors and officers act in good faith, and a complaint must plead facts sufficient to support an inference of bad faith intent. The complaint alleges that in December 2016 and again in November 2018, Fairhurst engaged in acts of sexual harassment. He was also warned about his use of alcohol at Company events. Fairhurst was disciplined for the November 2018 incident, then terminated in November 2019 after he committed another act of sexual harassment. The complaint cites statements from Company employees who asserted that under Fairhurst's watch, the human resources function turned a blind eye to complaints about sexual harassment. During 2018, the Company faced a series of public issues relating to sexual harassment, including coordinated complaints filed by restaurant workers and a ten-city strike.

When a corporate officer himself engages in acts of sexual harassment, it is reasonable to infer that the officer consciously ignored red flags about similar behavior by others. As Global Chief People Officer, Fairhurst was obligated to know about what was going on with the Company's employees, and he had day-to-day responsibility for the department charged with promoting a safe and respectful workplace. It is reasonable to infer that Fairhurst knew about and played a role in creating the Company's problems with sexual harassment and misconduct, which led to the external signs that took the form of employee complaints and a ten-city strike. The plaintiffs have therefore stated a claim against Fairhurst for breach of his oversight duties.

The more difficult question is whether the plaintiffs have stated a claim based on events that post-dated November 2018, when Fairhurst was disciplined for his second incident of sexual harassment. A series of events in 2018, including the incident with Fairhurst, caused the Company's management team and its directors to begin focusing on issues of sexual harassment and misconduct at the Company. There is record evidence that Fairhurst was part of the management team's response. In addition, the human resources function necessarily would have been part of the responsive steps that the management team took.

It is possible that Fairhurst's actions in 2019 could mean that the claim against him cannot extend beyond November 2018, when he was disciplined and seemingly joined in trying to fix the problem that he had helped create. Of course, one year later, he was terminated for another incident of sexual harassment, which supports an inference that either the message did not get through or that it was consciously ignored. Given the

complaint's allegations, it is not possible to determine at this stage when to cut off Fairhurst's exposure. The plaintiffs have pled a claim against Fairhurst, and that is sufficient to survive Fairhurst's motion to dismiss.

The plaintiffs also allege that Fairhurst's acts of sexual harassment constituted a breach of duty in themselves. The duty of good faith requires that a fiduciary subjectively act in the best interests of the entity. When engaging in sexual harassment, the harasser engages in reprehensible conduct for selfish reasons. By doing so, the fiduciary acts in bad faith and breaches the duty of loyalty. The plaintiffs' claim against Fairhurst for his own acts of sexual harassment states a claim on which relief can be granted.

## I. FACTUAL BACKGROUND

The facts are drawn from the operative complaint and the documents it incorporates by reference.[1] At this stage of the proceedings, the complaint's allegations are assumed to be true, and the plaintiffs receive the benefit of all reasonable inferences. Because this decision concerns the claims against Fairhurst, it emphasizes the facts relevant to him.

### A. The Company

The Company is a Delaware corporation with its principal place of business in Chicago, Illinois. When this litigation began, there were more than 36,000 McDonald's-

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[1] Citations in the form "Compl. ¶ —" refer to allegations in the plaintiffs' amended and consolidated complaint. Citations in the form "Ex. — at —" refer to exhibits to the Transmittal Declaration of S. Reiko Rogozen, which the director defendants filed in support of their motion to dismiss and upon which Fairhurst relied. Page citations refer to the internal pagination or, if there is none, then to the last three digits of the control number.

branded restaurants in over 100 countries. The Company both operates corporate-owned restaurants and acts as a franchisor. In the year immediately preceding this litigation, the Company earned approximately $19 billion in revenue. Corporate-owned restaurants accounted for $8 billion while franchised restaurants produced $11 billion.

The Company has over 200,000 employees, and franchises employ another two million, making the Company one of the world's largest employers. Over half (55%) of all Company and franchisee employees are women. At more senior levels, the percentage of women decreases, and just over one-fourth (27%) of the Company's officers are female.

Young people in entry-level positions make up a large portion of the Company's workforce, and the Company prides itself on being "America's best first job." Compl. ¶ 26. The Company's Standards of Business Conduct and its Human Rights Policy call for cultivating "respectful workplaces" and creating a professional environment that "builds trust, protects the integrity of our brand and fuels our success." *Id.* ¶ 28.

**B. Fairhurst Becomes The Company's Global Chief People Officer.**

In 2015, the Company faced its first sales decline in twelve years. To turn the Company around, the board of directors (the "Board") hired Stephen J. Easterbrook as CEO. Easterbrook was a longtime Company employee who served in various positions from 1993 until 2011, including as Senior Vice President for the United Kingdom and Northern Europe. After a brief hiatus, Easterbrook returned to the Company in 2013 as Executive Vice President and Chief Brand Officer.

In March 2015, Easterbrook formally became CEO and started working out of the Company's headquarters in Chicago, Illinois. Easterbrook promptly promoted Fairhurst to

the position of Global Chief People Officer. Fairhurst, another longtime Company employee, previously served as the Company's Vice President and Chief People Officer for Europe. He and Easterbrook became close personal friends while working together in the Company's London office. Fairhurst joined Easterbrook at the Company's Chicago headquarters.

**C. A Party Atmosphere**

Easterbrook and Fairhurst promoted and participated in a "party atmosphere" at the Chicago headquarters. Compl. ¶ 49. The eighth floor of the Chicago office had an open bar where executives hosted weekly happy hours. Easterbrook and Fairhurst frequently attended with their management teams. "Male employees (including senior corporate executives) engaged in inappropriate behavior at these happy hour events, routinely making female employees feel uncomfortable." *Id.* ¶ 6; *see id.* ¶ 50.

Employees also frequently drank alcohol at other Company-affiliated events. Easterbrook, Fairhurst, and other Company executives, including the Senior Vice President of Human Resources, participated in drinking excursions. Easterbrook and Fairhurst developed reputations for flirting with female employees, including their executive assistants.

The Company grew to resemble a boys' club. Recruiters were encouraged to hire "young, pretty females" from high-end stores to work in administrative roles at the Chicago headquarters. *Id.* ¶ 51. Easterbrook became known as a "player" who pursued intimate relationships with staff. *Id.*

As the culture changed, the human resources function that Fairhurst oversaw failed to address complaints adequately. Former Company managers reported that "HR leaders under Mr. Easterbrook ignored complaints about the conduct of co-workers and executives. Some of those people said they feared retaliation for reporting the conduct of co-workers and executives to HR." *Id.* ¶ 52. Two former executives reported that "the environment in HR during Fairhurst's tenure made employees feel as if they had little recourse for reporting bad behavior." *Id.* ¶ 59.

**D. The Company Faces Public Scrutiny Over Sexual Harassment.**

During the year after Easterbrook and Fairhurst took over, the Company began to face increasing public scrutiny about problems with sexual harassment and misconduct. In October 2016, more than a dozen Company workers from restaurants across the nation filed complaints with the Equal Employment Opportunity Commission ("EEOC") that contained disturbing allegations about sexual harassment and retaliation. Later that month, a fast-food worker advocacy group organized a walkout by Company employees in over thirty cities across the United States to draw attention to the EEOC complaints. Major news outlets covered these events.

In May 2018, the Company faced another round of EEOC complaints, this time identifying both individual instances of misconduct and broader systemic issues throughout the Company. Company employees claimed that the human resources function turned a blind eye to harassment.

In September 2018, Company workers from ten cities across the United States organized a one-day strike to protest sexual harassment and the failure of Company

management to address it. The protest attracted the attention of lawmakers, and in December 2018, United States Senator Tammy Duckworth sent an inquiry to Easterbrook about "multiple sexual harassment complaints made by employees who work at McDonald's Restaurants in Detroit, Chicago, Los Angeles, and six other cities." Compl. ¶ 113.

**E. Reports Of Misconduct By Fairhurst**

During the same month that Senator Duckworth sent her inquiry, the Board received reports that Fairhurst himself had committed acts of sexual harassment. During a Company party in November 2018 for the human resources staff, Fairhurst pulled a female employee onto his lap. Over thirty Company employees witnessed the incident, and several reported it to the Company's Compliance Department. The Compliance Department evaluated the reports and "concluded that David Fairhurst behaved and put himself in a position inconsistent with the Company's Standards of Business Conduct." Compl. ¶ 54.

On December 13, 2018, the Board's Audit & Finance Committee (the "Audit Committee") discussed Fairhurst's misconduct. Easterbrook advised the Audit Committee that an employee described a prior incident of sexual harassment by Fairhurst in December 2016 that had not been reported to the Compliance Department. Ex. 61 at 1. Easterbrook also reported that Fairhurst had "once before been warned about excessive drinking at Company events in the past." *Id.*

The Company ostensibly had a zero-tolerance policy for acts of sexual harassment. Under the Company's policy, Fairhurst's actions qualified as sexual harassment. Because Fairhurst had grabbed the employee and forced her onto his lap, his actions technically

constituted an assault. But Easterbrook recommended a deviation from the zero-tolerance policy. He proposed that Fairhurst's punishment should be "forfeiting 50% of his [target incentive plan] bonus payment for 2018" as well as "signing both an agreement regarding the conduct and a release." Compl. ¶ 61. The Audit Committee approved Easterbrook's proposal. *Id.*

After the Audit Committee meeting, Easterbrook directed the Senior Vice President of Human Resources to inform "all participants in the event that management had appropriately addressed the matter." *Id.* ¶ 62 (formatting added).

To document his arrangement with the Company, Fairhurst executed a "Last Chance" letter. Ex. 62 (the "Last Chance Letter"). The Last Chance Letter confirmed that Fairhurst's behavior was not an isolated incident: "Concerns have been raised to the company in the past and recently about your alcohol consumption at company-sponsored and company-related events, and separately about your personal conduct during some of those events which have made some employees uncomfortable." *Id.* at '423. The Last Chance Letter recited that Fairhurst had "demonstrated inappropriate and disruptive behavior while under the influence of alcohol at a company-related gathering and dinner of U.S. HR staff on November 8, 2018." *Id.*

The Last Chance Letter unambiguously stated that Fairhurst's actions violated the Company's Standards of Business Conduct. It also noted that Fairhurst's misconduct put "the Company at significant risk." *Id.* Despite those findings and concessions, Fairhurst continued to serve as the Company's Global Chief People Officer.

### F. Management And The Board Take Actions To Address The Company's Problems With Sexual Harassment And Misconduct.

The events of 2018 caused Company management and the Board to engage with the issue of sexual harassment and misconduct. In a memorandum dated January 17, 2019, Jerry Krulewitch, the Company's General Counsel, reported to the Board's Public Policy & Strategy Committee (the "Strategy Committee") about the EEOC complaints and the ten-city strike. Ex. 49. Krulewitch explained that in response to the focus on problems of sexual harassment and misconduct, "McDonald's teams have been proactively working to improve policies and programs related to these issues." *Id.* at 2. In the next sentence, Krulewitch reported that "[w]orking with insurance, we have created financial incentives for the franchisees to take the training, [REDACTED FOR NON-RESPONSIVENESS]."[2] In May 2019, during a meeting of the full Board, Krulewitch reported on the EEOC complaints. Ex. 51 at 8. He noted that "since the charges in 2018, the Company had been working diligently to enhance its programs and policies with regard to sexual harassment with a deliberate focus on the restaurants." *Id.* He then described actions the Company had

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[2] *Id.* The Company made this partial-sentence redaction, purportedly for non-responsiveness, as part of its production of Section 220 documents. This court has acknowledged that when producing books and records, a company may redact "material unrelated to the subject matter of the demand." *Okla. Firefighters Pension & Ret. Sys. v. Amazon.com, Inc.*, 2022 WL 1760618, at *13 (Del. Ch. June 1, 2022). Under that standard, a mid-sentence redaction raises questions. There is no reason to think that the author of the minutes incoherently injected an unrelated topic into an otherwise responsive sentence within a responsive paragraph dealing with the Company's response to concerns about sexual harassment. The outcome of this decision does not hinge on the improper redactions, but that will not always be the case.

taken, including revising its policies, providing training, offering new tools to franchisees, and engaging outside experts. *Id.* at 8–9.

In June 2019, Senator Duckworth and seven other United States Senators signed a joint letter to the Company, directed to Easterbrook, that asked ten specific questions about sexual harassment and other workplace safety issues. Ex. 86. The letter requested a response by June 25. *Id.*

Later that month, Fairhurst joined Krulewitch and Robert Gibbs, the Company's Chief Communications Officer, in authoring a memorandum for the Strategy Committee. Ex. 47 (the "June 2019 Memorandum"). The memorandum noted that at earlier meetings during the year, the directors had discussed "the issue of sexual harassment, as well as the proactive work we are doing to create a safe and respective workplace for our employees and to support the efforts of our independent owner/operators to do the same." *Id.* at 1. The memorandum noted that during a meeting in May 2019, the Strategy Committee had scheduled "a separate meeting to discuss these issues in more detail." *Id.*

The June 2019 Memorandum summarized the situation facing the Company and management's response. Under the heading "*What is occurring?*", the memorandum described the EEOC complaints and the allegations regarding systemic harassment. *Id.* Under the heading *"How is McDonald's responding to the issue of allegations of sexual harassment?*", the memorandum identified steps the Company was taking, including:

- A comprehensive review of the Company's anti-harassment policy.
- The engagement of the Rape, Abuse & Incest National Network ("RAINN") to advise the Company. The memorandum described RAINN as the largest anti-sexual

violence organization in the country and a pioneer in education programs about preventing sexual misconduct and harassment.

- A holistic review of the Company's training programs and the retention of Seyfarth Shaw at Work to assist the Company in providing training for both Company employees and franchise restaurant employees about how to establish and maintain a safe and respectful workplace.

- Additional crew, restaurant manager, and franchisee training on harassment, unconscious bias, and workplace safety.

- The establishment of a new, third-party managed hotline for employees at franchise restaurants to report complaints of any kind.

- A shared values commitment to be signed by franchisees that included a mutual understanding and responsibility for ensuring a safe, healthy, and respectful environment.

- A franchisee guide containing best practices and recommendations on establishing and maintaining a safe and respectful workplace.

- A cultural assessment including listening sessions to promote continuous improvement.

- An end to the Company's previous policy requiring mandatory arbitration of harassment and discrimination claims as a condition of employment.

*Id.* at 2–4.

The June 2019 Memorandum was part of the pre-reading materials for a special Strategy Committee meeting devoted to the subject of sexual harassment. During that meeting, Fairhurst provided an overview of the Company's people and gender strategy, including efforts to drive gender balance and improve diversity. Ex. 50 at 2. Krulewitch reported on the litigation against the Company and "the progress the Company had made in its efforts to promote a safe and respectful workplace." *Id.* at 1. At the end of the meeting, the chair of the Strategy Committee "concluded the discussion by confirming that the

Company (i) has developed a comprehensive plan around the issues of sexual harassment and safe and respectful workplace environments; (ii) will continue to be proactive; and (iii) will further evaluate how best to execute its strategy and be a leader on this issue."[3]

In September 2019, the Board received an update on the Company's Enterprise Risk Management ("ERM"). The presentation identified a "Respectful Workplace" as a "New Risk Theme" at the "Top Tier 2" level. Ex. 52 at '138. Under the Company's risk management system, a "Tier 1" risk is (i) "[c]ritical to McDonald's mission and values," (ii) "[a]ppropriate for ERM Committee discussion," and (iii) "[m]ay need further discussion around risk appetite." *Id.* at '142. A Tier 2 risk is one that has the "[p]otential for sustained, negative impact to brand, long term financial grown, or strategy position." *Id.* The Top Tier 2 risks are "[m]ore likely to become Tier 1 risks given the circumstances." *Id.*

That same month, during a special meeting of the Strategy Committee, Fairhurst joined Easterbrook, Gibbs, and Krulewitch in reporting to the Committee on a strategy to improve the Company's reputation as an employer. Ex. 55 at '921. A memorandum distributed to the Committee identified management's "ambition to strive for a leadership position by moving beyond compliance in the area of building a respectful and safe

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[3] *Id.* at 3. The next paragraph of the minutes was redacted for non-responsiveness. That redaction again raises questions. The minutes documented a special meeting of the Strategy Committee to consider the issue of sexual harassment at the Company and what was being done in response. The meeting as a whole was relevant. It is difficult to imagine what unrelated topic the minutes would have addressed.

workplace." *Id.* at 2. Management reported that they had successfully launched enhanced training "on a number of important topics including [REDACTED FOR NON-RESPONSIVENESS], sexual harassment and unconscious bias, as well as launching our Gender Balance & Diversity Program."[4]

**G. Easterbrook Leaves, And The Board Terminates Fairhurst For Cause.**

In October 2019, the Board learned that Easterbrook was engaging in a prohibited relationship with an employee. During a telephonic meeting on October 18, the Board ordered outside counsel to investigate Easterbrook's misconduct. At a meeting on October 26, the Board decided to negotiate a separation agreement with Easterbrook. During a meeting on November 1, the Board finalized the separation agreement and terminated Easterbrook without cause.

During the November 1, 2019 meeting, the Board also addressed "employment matters related to Mr. David Fairhurst." Ex. 63 at 6. The minutes from the meeting do not describe the discussion other than reciting that the Company's general counsel updated the Board on "his recent conversations" with Fairhurst. *Id.* The Board terminated Fairhurst for cause. It is reasonable to infer at the pleading stage that Fairhurst engaged in an additional act of sexual harassment that violated the Last Chance Letter.

[4] *Id.* at 2. This document provides yet another example of a redaction that raises questions. The four executives prepared a single-topic memorandum that was just over one page long. The Company included five redactions for non-responsiveness, including mid-sentence redactions. Unless the Company's top managers bizarrely injected unrelated content into a short piece, it seems likely that the entire document was responsive and should have been produced without redactions for non-responsiveness.

In a press release on November 3, 2019, the Company announced that Easterbrook was leaving the Company. The press release said only that Easterbrook had "violated company policy and demonstrated poor judgment" and described his relationship with an employee subordinate as "consensual." Ex. 65. The press release did not disclose that the Board had fired Fairhurst.

Fairhurst subsequently entered into a separation agreement with the Company, which documented that he would not be entitled to any severance or the payment of a bonus for 2019 under the Company's target incentive plan. Ex. 75 at 1. In the agreement, Fairhurst purported to have tendered his resignation as Executive Vice President and Global Chief People Officer effective as of November 4, 2019. *Id.* at 3.

**H. Employees File Multiple Lawsuits Against The Company.**

On November 12, 2019, less than two weeks after Easterbrook left and the Board terminated Fairhurst, Company workers filed a class action lawsuit challenging the Company's systemic problems with sexual harassment (the "*Ries* Action"). The plaintiffs in the *Ries* Action alleged that the Company had a toxic culture and that "sexual harassment is pervasive throughout McDonald's restaurants." Compl. ¶ 118. The *Ries* complaint contained detailed allegations about "routine, severe abuse" at Company restaurants while Fairhurst served as Global Chief People Officer. *Id.*

The *Ries* Action also detailed a lack of sexual harassment training at franchise restaurants. According to the *Ries* plaintiffs, almost two-thirds of restaurant employees worked at locations that did not provide any sexual harassment training. The *Ries* complaint also alleged that many restaurant employees lacked access to any human

resources support and that the Company's corporate human resources department under Fairhurst refused to help workers at franchise restaurants.

In April 2020, workers filed another class action, this time on behalf of workers at Company-owned restaurants in Florida, seeking damages for sexual harassment, retaliation, and related misconduct (the "*Fairley* Action"). The plaintiffs received support from Time's Up Legal Defense Fund, an anti-sexual harassment group.

The complaint in the *Fairley* Action contained allegations similar to the *Ries* Action about systemic failures to curb sexual harassment at Company restaurants while Fairhurst served as Global Chief People Officer. According to the *Fairley* Action, "three out of every four female non-managerial McDonald's employees have personally experienced sexual harassment at McDonald's, ranging from unwelcome sexual comments to unwanted touching, groping, or fondling, to rape and assault." *Id.* ¶ 137. The *Fairley* complaint alleged that "over 70% of those who reported sexual harassment they witnessed or experienced faced some form of retaliation, with 42% reporting loss of income as a result." *Id.* The *Fairley* complaint further alleged that the Company's human resources department was completely ineffective at preventing sexual harassment and discouraged employees from lodging complaints. It cited a recent poll, conducted while Fairhurst was Global Chief People Officer, which revealed that employees "at corporate restaurants are even more likely than workers at franchise restaurants to have experienced sexual harassment, with 83% of female non-managerial workers at corporate restaurants reporting having experienced at least one instance of sexual harassment, and 31% reporting having experienced eight or more types of sexual harassment." *Id.* ¶ 139.

A 2019 survey generated similar results. More than 75% of the Company's female workers reported being sexually harassed at work, and more than 71% reported that they suffered negative consequences for reporting harassment.

## I. This Litigation

After the public allegations about sexual harassment and misconduct at the Company, various stockholders sought books and records to investigate the possibility of corporate wrongdoing related to that topic. One group of plaintiffs filed this action. A group of plaintiffs who had sought books and records intervened, and the action was stayed pending resolution of their efforts to use the tools at hand to conduct an investigation. Once the investigation was complete, the current plaintiffs filed a consolidated complaint that added Fairhurst and Easterbrook as defendants.

Count III of the operative complaint asserts a claim against Fairhurst for breach of fiduciary duty. The complaint alleges that Fairhurst engaged in inappropriate conduct with female employees and exercised inadequate oversight in response to risks of sexual harassment and misconduct at the Company and its franchises. Fairhurst has moved to dismiss Count III on multiple grounds.

# II. LEGAL ANALYSIS

As one of his grounds for dismissal, Fairhurst contends that Count III fails to state a claim on which relief can be granted. *See* Ch. Ct. R. 12(b)(6). When considering such a motion, the court (i) accepts as true all well-pled factual allegations in the complaint, (ii) credits vague allegations if they give the opposing party notice of the claim, and (iii) draws all reasonable inferences in favor of the plaintiffs. *Cent. Mortg. Co. v. Morgan Stanley*

*Mortg. Cap. Hldgs. LLC*, 27 A.3d 531, 535 (Del. 2011). The motion to dismiss will be denied "unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances." *Id.*

Fairhurst contends that the plaintiffs have only sued him for breach of the duty of oversight. That is not correct. The plaintiffs have sued Fairhurst for breach of the duty of oversight, and they also have sued Fairhurst for breaching his duty of loyalty by engaging personally in acts of sexual harassment. Both theories state claims on which relief can be granted.

## A. An Officer's Duty Of Oversight

Fairhurst seeks to defeat the plaintiffs' claim for breach of the duty of oversight by arguing that Delaware law does not recognize an oversight claim against corporate officers. Although no Delaware decision has stated the proposition in so many words, diverse authorities indicate that officers owe a fiduciary duty of oversight as to matters within their areas of responsibility. Those authorities include the reasoning of the original *Caremark* opinion, the Delaware Supreme Court's holding that the duties of officers are the same as the duties of directors, decisions from other jurisdictions and academic commentary, and the additional duties that officers owe as agents. This decision confirms that officers owe a duty of oversight.

### 1. The Source Of Oversight Duties

Chancellor Allen's landmark opinion in *Caremark* is generally credited with creating the duty of oversight, but the concept originated earlier in the Delaware Supreme Court's decision in *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del.

1963). That decision was understood to establish "the protective 'red flags' rule," under which directors could be liable for failing to take action only if they were aware of red flags indicating wrongdoing and consciously chose not to act. Martin Lipton & Theodore N. Mirvis, *Chancellor Allen and the Director*, 22 Del. J. Corp. L. 927, 939 (1997). In memorable language, the *Allis-Chalmers* court stated that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." 188 A.2d at 130. Under *Allis-Chalmers*, directors appeared to have an obligation to respond if information reached them, but no duty to set up an information system to learn about issues within the company. A limited duty of oversight arose only if the directors had already learned enough to suspect that there were issues that needed overseeing.

In *Caremark*, Chancellor Allen artfully explained why *Allis-Chalmers*' colorful reference to a system of corporate espionage "could not be generalized into a rule that, absent grounds for suspected law violation, directors had no duty to assure that an information gathering and reporting system exists to provide senior management and the board with material internal operating information, including as regards legal compliance." Lipton & Mirvis, *supra*, at 939. To the contrary, Chancellor Allen explained that the fiduciary mandate included a duty to make a good faith effort to ensure that

> information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

*Caremark*, 698 A.2d at 970.

Chancellor Allen also addressed when directors could be held liable for failing to implement a reporting system to facilitate board oversight. In the words of the *Caremark* decision,

> only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.

*Id.* at 971 (emphasis omitted).

In *Stone v. Ritter*, the Delaware Supreme Court adopted the reasoning of *Caremark* as a standard of liability for director oversight and identified two types of *Caremark* claims. 911 A.2d 362, 370 (Del. 2006). The high court wrote that to survive a motion to dismiss an oversight claim for failure to plead demand futility under Rule 23.1, a plaintiff must allege particularized facts supporting a reasonable inference that either "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Id.* That framing has led to oversight claims being called either a prong-one *Caremark* claim or a prong-two *Caremark* claim.

A plaintiff typically pleads a prong-one *Caremark* claim by alleging that the board lacked the requisite information systems and controls. Using more functional terminology, that species of claim can be called an "Information-Systems Claim" or an "Information-Systems Theory." A plaintiff typically pleads a prong-two *Caremark* claim by alleging that the board's information systems generated red flags indicating wrongdoing and that the directors failed to respond. From a functional perspective, the second type of claim can be called a "Red-Flags Claim" or a "Red-Flags Theory." *Cf. City of Detroit Police & Fire Ret. Sys. v. Hamrock*, 2022 WL 2387653, at *17 (Del. Ch. June 30, 2022). This decision uses the functional labels or comparable variants. Technically, only the Information-Systems Claim derives from *Caremark*. The Red-Flags Claim traces its lineage to *Allis-Chalmers*.

The *Stone* decision only recognized oversight duties for directors. Neither the Delaware Supreme Court nor this court has expressly held that officers also owe oversight duties.

The case for recognizing that officers owe oversight duties starts with the reasoning of the *Caremark* decision itself. One of the reasons Chancellor Allen provided for recognizing the board's duty of oversight was "the seriousness with which the corporation law views the role of the corporate board." *Caremark*, 698 A.2d at 970. That same seriousness extends to the role of officers. Although Section 141(a) of the Delaware General Corporation Law (the "DGCL") provides that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors," 8 *Del. C.* § 141(a), "it is the rare corporation that is actually 'managed by' the board; most corporations are managed 'under the direction of' the board." J. Travis Laster & John Mark

Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 Bus. Law. 33, 36 (2015). "In the typical corporation, it is the officers who are charged with, and responsible for, running the business of the corporation." Megan W. Shaner, *The (Un)Enforcement of Corporate Officers' Duties*, 48 U.C. Davis L. Rev. 271, 285 (2014). "In fact, without officers, there would be no one to make important day-to-day operational decisions or to supervise the lower-level employees who keep a firm running." Nadelle Grossman, *The Duty to Think Strategically*, 73 La. L. Rev. 449, 488 (2013) [hereinafter *Think Strategically*].

Because of this reality, "[m]onitoring and strategy are not exclusively the dominion of the board. Actually, nondirector officers may have a greater capacity to make oversight and strategic decisions on a day-to-day basis." Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. Ill. L. Rev. 1131, 1160–61 (2013). Indeed, from that perspective, the *Caremark* oversight role "is more suited to corporate officers who are responsible for managing the day-to-day affairs of the corporate enterprise." Dominick T. Gattuso & Vernon R. Proctor, *Reining in Directors and Officers in Corporate America in Delaware, the Answer Is Not to Expand Their Personal Liability*, Bus. L. Today, January/February 2010, at 46, 49. Chancellor Allen's first reason for recognizing oversight duties for directors—the seriousness with which the law takes the role—thus applies equally to officers.

A second reason that Chancellor Allen provided for recognizing the board's duty of oversight was the "fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141." *Caremark*,

698 A.2d at 970. The board's need for information leads ineluctably to an imperative for officers to generate and provide that information:

> Whereas a corporate board meets periodically—roughly six to ten times a year—senior officer engagement with the corporation is continuous. From a practical perspective, a board's ability to effectively monitor is contingent upon adequate information flow, usually from senior officers functioning in a nondirectorial capacity.

Simmons, *supra*, at 1160. For relevant and timely information to reach the board, the officers who serve as the day-to-day managers of the entity must make a good faith effort to ensure that information systems are in place so that the officers receive relevant and timely information that they can provide to the directors. *Think Strategically*, *supra*, at 488. It follows that officers must have a duty to make a good faith effort to establish an information system as a predicate to fulfilling their obligation to provide information to the board. *Id.* at 488–89.

A related point is that officers must make decisions in their own right. The *Caremark* decision recognizes this dimension of officer duties when framing the Information-Systems Claim: Corporate fiduciaries can face liability if they knowingly fail to adopt an internal information and reporting system that is "reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." 698 A.2d at 970. As this passage shows, Chancellor Allen recognized that both senior management and the board need actionable information, because both management and the

board need to be able to make decisions. The fact that officers require information to do their jobs provides further support for officers having oversight obligations.

A third reason that Chancellor Allen provided for recognizing the board's duty of oversight was the importance of having compliance systems in place so the corporation could receive credit under the federal Organizational Sentencing Guidelines. *Id.* at 970. That consideration does not stop at the board level either. The Guidelines state that "[h]igh-level personnel of the organization shall ensure that the organization has an effective compliance and ethics program, as described in this guideline. Specific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program."[5] The Guidelines define an organization's "high-level personnel" as "individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization," which includes "a director; *an executive officer*; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance; and an individual with a substantial ownership interest." *Id.* § 8A1.2 cmt. 3(B) (emphasis added).

The Guidelines thus explicitly call for executive officers to undertake compliance and oversight obligations. They also call for high-level personnel to ensure that

> [s]pecific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program. Individual(s) with operational responsibility shall report periodically to high-

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[5] U.S. Sent'g Guidelines Manual § 8B2.1(b)(2)(B) (U.S. Sent'g Comm'n 2021), *available at* https://www.ussc.gov/guidelines/2021-guidelines-manual/annotated-2021-chapter-8.

> level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program. To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.

*Id.* § 8B2.1(b)(2)(C). The steps necessary to meet the expectations of the Guidelines thus extend beyond the board. The importance of officer-level involvement is so apparent that the Organizational Sentencing Guidelines are credited with helping to create a new C-level position: the Chief Compliance Officer.[6] It would seem hard to argue that, simply by virtue of being an officer, the Chief Compliance Officer could not owe a duty of oversight. That, however, is the logical implication of Fairhurst's position that only directors can owe a duty of oversight.

The *Caremark* decision was primarily about the dimension of the oversight duty that supports the Information-Systems Claim. The three foundational premises for recognizing the duty supporting such a claim easily encompass officers. It follows that this dimension of the oversight duty applies to officers.

The dimension of the oversight duty that supports the Red-Flags Claim also applies to officers. That underlying obligation flows from *Allis-Chalmers*. In *Caremark*, Chancellor Allen reframed the earlier decision as having not rejected the obligation to

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[6] Kathleen C. Grilli et al., U.S. Sent'g Comm'n, *The Organizational Sentencing Guidelines: Thirty Years of Innovation and Influence* 42, 46 (2022), available at https://www.ussc.gov/sites/default/files/pdf/research-and-publications/research-publications/2022/20220829_Organizational-Guidelines.pdf.

establish information and reporting systems. Instead, he explained that *Allis-Chalmers* "can be more narrowly interpreted as standing for the proposition that, absent grounds to suspect deception, neither corporate boards *nor senior officers* can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealing on the company's behalf." *Caremark*, 188 A.3d at 969 (emphasis added). Chancellor Allen thus proceeded from the premise that senior officers could be liable on a Red-Flags Claim under the *Allis-Chalmers* rationale if they knew about information that foreclosed reasonable reliance on the integrity of the company's employees.

Just as it makes sense for the Information-Systems Obligation to extend to officers, it also makes sense for the Red-Flags Obligation to extend to officers. As the day-to-day managers of the entity, the officers are optimally positioned to identify red flags and either address them or report upward to more senior officers or to the board. The officers are far more able to spot problems than part-time directors who meet a handful of times a year. The Red-Flags Obligation simply recognizes that the officers who are running the business on a full-time basis have a duty to address or report upward regarding what they see.

**2. Officers Owe The Same Duties As Directors.**

The Delaware Supreme Court's decision to equate the fiduciary obligations of officers with those of directors provides a second reason why officers owe oversight duties. In *Gantler v. Stephens*, the Delaware Supreme Court held that "the fiduciary duties of officers are the same as those of directors." 965 A.2d 695, 709 (Del. 2009). Everyone agrees that directors owe a fiduciary duty of oversight that includes both the Information-Systems Obligation and the Red-Flags Obligation. If officers owe the same duties as

directors, then as to matters within their areas of responsibility, officers owe a duty of oversight. Declining to recognize that officers owe a fiduciary duty of oversight would mean, *contra Gantler*, that the fiduciary duties of officers were not the same as those of directors.

Admittedly, neither the Delaware Supreme Court nor this court has said explicitly that officers owe oversight duties. Scholars, however, have reasoned that by equating officer duties with director duties, *Gantler* established that officers owe oversight duties.[7]

Federal bankruptcy courts have reasoned similarly. In a decision that preceded *Gantler* by one year, the United States Bankruptcy Court for the District of Delaware held

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[7] William R. Heaston, *Copycat Compliance and the Ironies of "Best Practice"*, 24 U. Pa. J. Bus. L. 750, 762 n.56 (2022) (asserting that *Caremark* obligations "apply with equal force to senior corporate executives" (citing *Gantler*)); Richard W. Blackburn & Jeffrey J. Binder, 3 *Successful Partnering Between Inside and Outside Counsel* § 47:6 (April 2021 Update) ("The *Caremark* principles apply not only to directors, but also to a corporation's officers." (citing *Gantler*)); Paul E. McGreal, *Caremark in the Arc of Compliance History*, 90 Temp. L. Rev. 647, 678 (2018) ("In its 2009 decision in *Gantler v. Stephens*, the Delaware Supreme Court held that corporate officers owe the same fiduciary duties as directors, which includes the *Caremark* duty of oversight." (footnotes omitted)); Paul E. McGreal, *Corporate Compliance Survey*, 73 Bus. L. 817, 835 (2018) ("In *Gantler v. Stephens*, the Delaware Supreme Court held that 'the fiduciary duties of officers are the same as those of directors.' As these duties include the 'fiduciary duties of care and loyalty,' and the *Caremark* duty of oversight is part of the duty of loyalty, *Gantler* meant that corporate officers owe the *Caremark* duty of oversight." (footnotes omitted)); Michael R. Siebecker & Andrew M. Brandes, *Corporate Compliance and Criminality: Does the Common Law Promote Culpable Blindness?*, 50 Conn. L. Rev. 387, 441 n.49 (2018) ("[T]he Delaware Supreme Court held in 2009 that the *Caremark* standards of oversight apply not only to directors, but also to officers." (citing *Gantler*)); Nadelle Grossman, *Turning A Short-Term Fling into A Long-Term Commitment: Board Duties in A New Era*, 43 U. Mich. J.L. Reform 905, 970 (2010) (asserting that officers owe duties of oversight and citing *Gantler*).

that the Chapter 7 bankruptcy trustee had stated an Information-Systems Claim under *Caremark* against Brian T. Licastro, who had served as the vice president of operations and in-house general counsel for the debtors. *In re World Health Alts., Inc.*, 385 B.R. 576, 571 (Bankr. D. Del. Apr. 9, 2008). The trustee alleged that the debtors' directors and officers misrepresented the debtors' performance in their publicly filed financial reports and in tax filings. *Id.* at 583. The trustee alleged that as general counsel, Licastro owed a duty to implement and monitor an information system capable of flagging material misrepresentations. *Id.* at 591. Because the debtors were Florida corporations, the law of that jurisdiction applied, but in the absence of applicable authority, the court looked to Delaware law for guidance. *Id.* at 590. Licastro contended that the duty of oversight only applied to directors, not officers. *Id.* Citing decisions from this court that anticipated *Gantler* by equating officer duties with director duties, the court reasoned that officers also owed a duty of oversight and that the trustee had pled a viable Information-Systems Claim against Licastro.[8]

In reaching that conclusion, the *World Health* court relied on an earlier decision in which the United States Court of Appeals for the Third Circuit held that a Chapter 7 trustee stated a Red-Flags Claim against two officers of a Delaware corporation. *In re Tower Air, Inc.* 416 F.3d 229, 234 (3d Cir. 2005). The trustee alleged that "Tower Air's officers did

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[8] *Id.* at 592. To be clear, the *World Health* court did not use the term "Information-Systems Claim." That is my characterization of the type of oversight claim that the decision allowed to proceed.

nothing when they were told by the corporate Director of Safety of quality assurance problems with aircraft maintenance and of failures to record maintenance and repair work." *Id.* at 239. The court of appeals rejected the officers' contention that those allegations failed to state a viable claim: "Under no circumstances should aircraft maintenance problems be ignored. Lives are on the line. . . . The officers' alleged passivity in the face of negative maintenance reports seems so far beyond the bounds of reasonable business judgment that its only explanation is bad faith." *Id.* In a footnote, the court acknowledged that it was "less sure" about whether the "alleged failure to report maintenance problems to the directors, or their alleged failure to advise the directors concerning the long-term financial ramifications of the failure to maintain the engines, constitutes irrationality or inattention," but held that it did not need to reach that issue. *Id.* at 239 n.14. The *Tower Air* court thus allowed a Red-Flags Claim to go forward against the officers and, as a result of that holding, allowed an Information-Systems Claim to survive pleading-stage review.[9]

Finally, the United States Bankruptcy Court for the Central District of California touched on oversight issues in *In re AWTR Liquidation Inc.*, 548 B.R. 300 (Bankr. C.D. Cal. Mar. 11, 2016). A Chapter 7 trustee asserted claims for breach of fiduciary against the debtor's directors and officers. *Id.* at 305. The debtor was a California corporation, but in the absence of applicable authority, the court looked to Delaware law for guidance. *Id.* at 311. The court cited *Gantler* as holding that directors and officers have the same duties. *Id.*

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[9] As with the *World Health* decision, the *Tower Air* decision did not use these terms. They represent my characterization of the oversight claims at issue in the case.

at 313. The court then discussed the duty of oversight for purposes of the claims against all of the defendants, noting that the fiduciaries had a duty to establish an information system, but that if they had made an attempt to implement one, then the business judgment rule called for substantial deference to their decisions. *Id.* at 316–18 The court then held that the complaint pled facts supporting an inference that the presumptions of the business judgment rule were rebutted, thereby permitting an Information-Systems Claim to proceed. *Id.* at 318. The only time that the court distinguished between director and officer duties was in rejecting the plaintiffs' argument that the business judgment rule did not protect officers under California law. *Id.* at 320. While acknowledging that California authorities stood for that proposition, the court held that the plaintiffs could not rely on the officer exception because their complaint did "not sufficiently distinguish between their alleged acts and omissions as *officers*, as distinguished from their capacity as *directors*." *Id.* at 320. The *AWTR* decision thus equated director duties with officer duties, incorporated *Caremark* obligations into the officers' duties, and permitted an Information-Systems Claim to proceed.

All of the foregoing authorities hold that officers owe the same duties as directors. Because directors owe a duty of oversight, these authorities indicate that officers owe a duty of oversight.

### 3. The Officer's Duty As Agent

A third source of authority for oversight obligations is the additional duties that officers owe as agents who report to the board. *See Lebanon Cnty. Empls.' Ret. Fund v. AmerisourceBergen Corp.*, 2020 WL 132752, at *21 (Del. Ch. Jan. 13, 2020) ("Officers

also are fiduciaries in their capacities as agents who report to the board of directors."), *aff'd*, 243 A.3d 417 (Del. 2020). Agents are fiduciaries.[10] As agents, officers "owe additional and more concrete duties to their principal." *Harron*, 275 A.3d 843–44; *see* Restatement of Agency, *supra*, §§ 8.02–.12.

The agent's specific duties include an obligation to provide information to the principal:

> An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when
>
> (1) subject to any manifestation by the principal, the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal; and

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[10] *Restatement (Third) of Agency* § 1.01 (Am. L. Inst. 2006), Westlaw (database updated Jan. 2023) [hereinafter Restatement of Agency] (defining agency as "the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act"); *id.* § 8.01 ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship"); *see Sci. Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 962 (Del. 1980) ("It is true, of course, that under elemental principles of agency law, an agent owes his principal a duty of good faith, loyalty and fair dealing."); Ramon Casadesus-Masanell & Daniel F. Spulber, *Trust and Incentives in Agency*, 15 S. Cal. Interdisc. L.J. 45, 68 (2005) ("While all agents are fiduciaries, not all fiduciaries are agents."); Thomas Earl Geu, *A Selective Overview of Agency, Good Faith and Delaware Entity Law*, 10 Del. L. Rev. 17, 20 (2008) (explaining that fiduciary status is "a result of agency" and collecting authorities establishing the point); Barak Orbach, *D&O Liability for Antitrust Violations*, 59 Santa Clara L. Rev. 527, 528 n.2 (2020) ("All agents are fiduciaries but not all fiduciaries are agents"). There are Delaware cases which assert errantly that an agency relationship, standing alone, does not give rise to fiduciary duties on the part of the agent. For a discussion of those decisions, see *Metro Storage International LLC v. Harron*, 275 A.3d 810, 843 n.14 (Del. Ch. 2022).

> (2) the facts can be provided to the principal without violating a superior duty owed by the agent to another person.

Restatement of Agency, *supra*, § 8.11. "The agent's duty is satisfied if the agent uses reasonable effort to provide the information, acting reasonably and consistently with any directions furnished by the principal." *Id.* cmt. b. Notably, the duty extends beyond what the agent actually knows to encompass what the agent has reason to know or should know.

Writing while a member of this court, Chief Justice Strine followed the Restatement of Agency and held that officers have a duty to disclose to a superior officer or the board "material information relevant to the affairs of the agency entrusted to them." *Hampshire Gp., Ltd. v. Kuttner*, 2010 WL 2739995, at *13 (Del. Ch. July 12, 2010). Then-Vice Chancellor Strine explained that for purposes of liability, a failure to share information must have been "the product of gross negligence or disloyalty." *Id.* In other words, he recognized a standard of conduct at the officer level that included a duty to act carefully, loyally, and in good faith to gather and provide information, with the standard of liability for the care dimension of the duty measured by gross negligence. By recognizing the duty to provide information, *Hampshire* lays the foundation for an officer-level duty consistent with an Information-Systems Claim.

The agent-based duties of officers also provide the foundation for a Red-Flags Claim. As agents, officers "owe a duty to disclose relevant information if they have notice of facts which they should know may affect the decisions of their principals as to their conduct." *Triton Constr. Co., Inc. v. E. Shore Elec. Servs., Inc.*, 2009 WL 1387115, at *14 (Del. Ch. May 18, 2009), *aff'd*, 2010 WL 376924 (Del. Jan. 14, 2010) (ORDER). By

definition, a red flag constitutes information that is material to the officer's duties or which a senior officer or the board would wish to have.

The fact that officers are agents provides additional support for recognizing that officers have an oversight duty.

#### 4. Officer Accountability To The Board

The foregoing authorities all indicate that officers owe oversight duties. A contrary holding would create a gap in the ability of directors to hold officers accountable. Reasonable minds can disagree about whether, as a matter of policy, stockholders should be able to sue to hold an officer accountable for a failure to exercise oversight. But wherever one might stand on that issue, it is hard to argue that a board of directors should not be able to hold an officer accountable for a failure of oversight.

As the preceding discussion shows, an indispensable part of an officer's job is to gather information and provide timely reports to the board about the officer's area of responsibility. Pause for a moment and envision an officer telling a board that the officer did not have any obligation to gather information and provide timely reports to the board. The directors would quickly disabuse the officer of that notion, and an officer who did not get with the program would not hold that position for long.

Another critical part of an officer's job is to identify red flags, report upward, and address them if they fall within the officer's area of responsibility. Once again, pause and envision an officer telling the board that their job did not include any obligation to report on red flags or to address them. A similar learning opportunity would result.

In the unrealistic hypothetical where an officer declares those contrarian beliefs upfront, the directors are in a position to disabuse the officer of his misconceptions or terminate the officer's role. But directors may only learn about an officer's failure to establish information systems or to identify and report red flags after a corporate trauma has occurred. It is unfathomable that a board would sign off on an officer's expressed intent to put his head in the sand, not make any effort to gather information or report to the board, and not make any effort to address red flags. It is similarly unfathomable that a board could not take action if an officer failed to fulfill those obligations. Yes, a board might determine that disciplining or terminating the officer was sufficient and that a lawsuit was not necessary. But in a case where the officer's failure to exercise oversight had caused the corporation harm, a board could decide to assert a claim for breach of fiduciary duty against an officer. The board should be able to do so.

As this discussion shows, a holding that officers did not owe oversight obligations would not be limited to derivative claims by stockholders. It would apply equally to a board's ability to hold officers accountable. Denying a board of directors the ability to hold officers accountable for oversight failures would undermine the board's statutory authority under Section 141(a).

A holding that officers did not owe oversight obligations also would extend to other actors who can pursue the corporation's claims. To date, questions about an officer's duty of oversight have arisen in bankruptcy litigation, and that makes some sense. Bankruptcy can be viewed as the ultimate corporate trauma, and a bankruptcy trustee seeking to recover on behalf of the estate has an incentive to identify the culpable actors and the ability to

assert the corporation's claims against them without having to plead demand futility or show wrongful refusal. The bankruptcy trustee also can act free of past ties to the officer and without concern that a lawsuit might generate discovery that would support a claim against the directors themselves. When a firm fails because officers have failed to establish proper information systems or ignored red flags, a bankruptcy trustee should be able to pursue the culpable parties. Failing to recognize a duty of oversight for officers would prevent a bankruptcy trustee from pursuing those causes of action on behalf of the estate and its beneficiaries.

The oversight duties of officers are an essential link in the corporate oversight structure. The bulwark against the stockholders liberally asserting oversight claims against officers is not the invalidity of the legal theory. Rather, it is the fact that oversight claims are derivative, so the board controls the claim unless a stockholder can plead demand futility or show wrongful refusal. It is those doctrines, applied at the pleading stage under Rule 23.1, that minimize the risk of oversight claims against officers, not the absence of any duty of oversight.

The role of the board in providing oversight for officers also illustrates how a case could result in different outcomes as to different actors. While it seems likely that if a court found a board liable for breach of an oversight obligation, then the officers with responsibility for that area also would be liable, the converse is not true. A board could direct an officer to establish an information system to cover their area, or a board could reasonably believe that an officer had established one. If the officer failed to fulfill those responsibilities, and the board did not consciously act in bad faith by not following up, then

the directors would be in a position to hold the officer accountable without facing oversight liability themselves. The ability of directors to rely on reports from an officer is also pertinent. *See* 8 *Del. C.* § 141(e). If an officer was not providing adequate oversight, but the directors did not have reason to know that, then the board could have relied on the officer in good faith. Again, the directors would be in a position to hold the officer accountable without facing oversight liability themselves.

The officers' role in the corporate oversight structure provides additional support for holding that officers owe oversight duties. Failing to confirm that officers owe oversight duties would undermine the directors' ability to fulfill their statutory obligation to direct and oversee the business and affairs of the corporation.

**5. The Absence Of Delaware Precedent**

In response to the plaintiffs' assertion that an officer-level duty of oversight exists, the defendants argue that officers cannot owe a duty of oversight because *Stone* only embraced the *Caremark* standard for directors and, to date, Delaware cases have only applied the duty of oversight to directors. That observation is descriptively accurate, but it does not follow that officers do not owe oversight duties. For centuries dating back to the Roman satirist Juvenal, Europeans used the phrase "black swan" as a figure of speech for something that did not exist. Then in the late eighteen century, Europeans arrived on the shores of Australia, where they found black swans. The fact that no one had seen one before did not mean that they could not or did not exist. *See* Nicholas Nassim Taleb, *The Black Swan: The Impact of the Highly Improbable* xvii (2d. ed. 2010). Stated less esoterically, the existence of confirmatory evidence for one proposition need not disconfirm another

proposition. *Id.* at 53. Framed in terms of the issue in this case, decisions recognizing director oversight duties confirm that directors owe those duties; those decisions do not rule out the possibility that officers also owe oversight duties.

As this decision has explained, officers' oversight duties flow from multiple sources, including the reasoning of the original *Caremark* decision, the equating of officer duties with director duties in *Gantler*, agency principles, and the accountability structure that exists between officers and the board of directors. The absence of an earlier decision holding that officers owe oversight duties likely has a more practical explanation. Before January 1, 2004, Delaware's jurisdiction-by-consent statute did not extend to officers. *See* Del. S.B. 126, 149th Gen. Assem., 81 Del. Laws ch. 83 (2003). After that date, stockholder plaintiffs moved slowly to name officers as defendants. Only recently has naming officers as defendants become more frequent, prompting the General Assembly to authorize exculpation for officers for stockholder claims, albeit not for claims by or in the name of the corporation, effective August 1, 2022. Del. S.B. 273, 151st Gen. Assem., 83 Del. Laws ch. 377 (2022).

Although there is no Delaware precedent directly on point, both sides try to invoke this court's decision in *AIG.* There, Chief Justice Strine held while serving as a member of this court that stockholder plaintiffs had stated a derivative claim for breach of fiduciary duty against AIG's CEO (Greenberg) and two senior officers (Matthews and Tizzio). *In re Am. Int'l Gp., Inc. Consol. Deriv. Litig. (AIG)*, 965 A.2d 763 (Del. Ch. 2009), *aff'd sub nom. Tchrs.' Ret. Sys. of La. v. PricewaterhouseCoopers LLP*, 11 A.3d 228 (Del. 2011) (TABLE). The plaintiffs maintain that the case shows that an oversight claim can proceed

against an officer. Observing that all three defendants also served on AIG's board, the defendants argue that the opinion only sustained the claim against the defendants in their capacity as directors. Both sides are partially right.

The plaintiffs in *AIG* alleged that Matthews and Tizzio assisted Greenberg in engaging in intentional misconduct to inflate the value of AIG by billions of dollars through a variety of fraudulent financial schemes. The plaintiffs pled detailed facts about the fraudulent financial schemes themselves, but relatively little "about the specific involvement of Matthews (more particularly) and Tizzio (to a lesser degree) in the fraudulent financial schemes." *Id.* at 795. Based on the detailed factual pleading about the schemes and Matthews and Tizzio's longstanding roles as senior officers in charge of areas where the schemes took place, the court drew the inferences that Matthews and Tizzio were both complicit in the schemes and knew "that AIG's internal controls were inadequate and too easily bypassed." *Id.* The court also drew the inference that

> even when Matthews and Tizzio were not directly complicitous in the wrongful schemes, they were aware of the schemes and knowingly failed to stop them. In that regard, I find it inferable that Matthews and Tizzio were aware of misconduct that should have been brought to the attention of AIG's independent directors (including the Audit Committee) but chose to conceal their knowledge, despite having a fiduciary duty to speak.

*Id.* at 799.

This passage indicates that Matthews and Tizzio were (i) aware of the fraudulent schemes in their capacities as officers and (ii) in those capacities, "knowingly failed to stop them." *Id.* The passage also indicates that Matthews and Tizzio acquired knowledge as officers that "should have been brought to the attention of AIG's independent directors

(including the Audit Committee)." *Id.* Those statements point to an officer-level duty of oversight, including a duty to share information with the board and to respond to red flags.

To be sure, the court held that the plaintiffs stated oversight claims against Matthews and Tizzio in their capacity as directors. It is therefore not possible to read *AIG* as holding that officers have oversight duties. What the *AIG* case does not do is hold that officers cannot owe oversight duties. Instead, the legal theory sustained in the *AIG* case rests on what are, at a minimum, the core components of officer oversight duties.[11]

**6. The Scope Of An Officer's Oversight Duty**

For the reasons previously discussed, officers owe duties of oversight comparable to those of directors. But that does not mean that the situational application of those duties will be the same. "Although the fiduciary duty of a Delaware director is unremitting, the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the

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[11] Neither side cited *Akorn, Inc. v. Fresenius KABI AG*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018). That decision concerned whether a buyer could terminate a merger agreement because the target corporation had suffered a material adverse effect ("MAE"). One of the MAEs that the buyer proved at trial was a deviation from the target's as-represented condition regarding regulatory compliance that was so great as to constitute an MAE. *Id.* at *81. The target company's CEO, Raj Rai, testified that he was concerned about regulatory compliance, but the court discredited his testimony and concluded "that he does not regard it as a priority." *Id.* at *13. In a footnote, the court noted that "[a]nother plausible and more alarming inference is that Rai consciously disregarded Akorn's quality issues, including its data integrity problems." *Id.* at *13 n.112. The court collected evidence showing that Rai chaired a quality oversight committee and received reports on quality issues, but never read them. *Id.* Although the court did not come out and say it, the implication was that Rai had a duty to oversee the quality and compliance function and breached that duty by consciously disregarding it.

corporation or its shareholders." *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998). The same is true for officers, who regularly operate in different contexts than directors.

Most notably, directors are charged with plenary authority over the business and affairs of the corporation. *See* 8 *Del. C.* § 141(a). That means that "the buck stops with the Board." *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 835 (Del. Ch. 2011). It also means that the board has oversight duties regarding the corporation as a whole.

Although the CEO and Chief Compliance Officer likely will have company-wide oversight portfolios, other officers generally have a more constrained area of authority. With a constrained area of responsibility comes a constrained version of the duty that supports an Information-Systems Claim.[12] For example, the Chief Financial Officer is responsible for financial oversight and for making a good faith effort to establish reasonable information systems to cover that area. The Chief Legal Officer is responsible for legal oversight and for making a good faith effort to establish reasonable information systems to cover that area. The executive officer in charge of sales and marketing is not

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[12] *See Think Strategically*, *supra*, at 489 ("[A]n officer should only be required to oversee matters falling within her scope of authority."); *see also* Paul E. McGreal, *Corporate Compliance Survey*, 71 Bus. Law. 227, 242 (2016) ("[T]he officers charged with day-to-day operations may owe a more precisely defined *Caremark* duty. For example, one could frame breach of the chief compliance and ethics officer's initial *Caremark* duty as an utter failure to take steps to implement any one of the components of a compliance and ethics program—i.e., risk assessment, policies, training, monitoring, auditing, or discipline. Under this view, the board's duty is to get the compliance ball rolling, and the chief compliance and ethics officer's duty is to keep that ball moving in the right direction.").

responsible for the financial or legal reporting systems. And of course, the board can tailor the officers' obligations and responsibilities.

For similar reasons, officers generally only will be responsible for addressing or reporting red flags within their areas of responsibility, although one can imagine possible exceptions. If a red flag is sufficiently prominent, for example, then any officer might have a duty to report upward about it. An officer who receives credible information indicating that the corporation is violating the law cannot turn a blind eye and dismiss the issue as "not in my area."

Another important question is the standard of liability for officers. As with directors, officers only will be liable for violations of the duty of oversight if a plaintiff can prove that they acted in bad faith and hence disloyally.

As scholars have chronicled, Delaware's oversight jurisprudence has evolved from the original *Caremark* decision, where the oversight duty could sound in both loyalty or care, to a strictly loyalty-based regime.[13] The corporation in *Caremark* had an exculpatory provision that eliminated director liability for breaches of the duty of care. After noting that the failure to ensure that a corporation information and reporting system existed could, "under some circumstances . . . render a director liable for losses caused by non-compliance

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[13] *See, e.g.*, Martin Petrin, *Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective*, 5 Va. L. & Bus. Rev. 433, 441–47 (2011); Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. Sch. L. Rev. 717, 726–33 (2010); Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559, 594–604 (2008).

with applicable legal standards," Chancellor Allen observed in a footnote that "questions of waiver of liability under certificate provisions authorized by 8 *Del. C.* § 102(b)(7) may also be faced." *Caremark*, 698 A.2d at 970 & n.27. That comment only makes sense if, in the absence of an exculpatory provision, a breach of the duty of care could support an otherwise actionable claim. Other references in the decision also acknowledged that a breach of the duty of care could lead to a failure of oversight.[14]

In another portion of the opinion, however, Chancellor Allen expressed his view that a pure breach of the duty of care, absent conduct that rose to the level of bad faith, should not support a monetary damages award:

> Indeed, one wonders on what moral basis might shareholders attack a *good faith* business decision of a director as "unreasonable" or "irrational". Where a director *in fact exercises a good faith effort to be informed and to exercise appropriate judgment*, he or she should be deemed to satisfy fully the duty of attention. If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors. [15]

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[14] *See* Bainbridge, *supra*, at 596–97 (collecting passages). Ironically, the actual language of the *Allis-Chalmers* case, from which the Red-Flags Claim derives, acknowledged the possibility of liability for recklessness or gross negligence, which the court framed as cavalier neglect: "In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence." 188 A.2d at 130.

[15] *Caremark*, 698 A.2d at 968. The passage in question has the flavor of a rejoinder to the Delaware Supreme Court's decision in *Cede & Co. v. Technicolor, Inc.*, 634 A.2d

It is possible to read this passage as indicating that a breach of the duty of care should never support liability, whether as an oversight claim or otherwise.

Writing as a member of this court, Chief Justice Strine took up this aspect of *Caremark* and held that director liability for oversight claims always requires a showing of bad faith. *See Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003). In *Stone*, the Delaware Supreme Court adopted the *Guttman* formulation and stated that a breach of the duty of loyalty, such as acting in bad faith, was a "necessary condition to liability." *Stone*, 911 A.2d at 364; *see* Banbridge, *supra*, at 595. After *Stone,* then-Vice Chancellor Strine acknowledged that *Caremark* duties carried overtones of care, but explained that "to hold directors liable for a failure in monitoring, the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care." *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007). After becoming the Chief Justice, he authored a Delaware Supreme Court decision that made a similar statement: "If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of

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345 (Del. 1993). As the trial judge in that case, Chancellor Allen had *assumed* that the directors failed to exercise due care, then relied on *Barns v. Andrews*, 298 F. 614 (S.D.N.Y. 1924), to hold that any assumed breach had not proximately caused any damages. *Cinerama, Inc. v. Technicolor, Inc.*, 1991 WL 111134, at *17 (Del. Ch. June 24, 1991) (subsequent history omitted). On appeal, the Delaware Supreme Court reversed, relied on what it described as the Chancellor's "presumed findings" to hold that the directors had breached their duty of care, rejected the Chancellor's reliance on *Barnes*, and imposed on the directors an obligation to prove on remand that the transaction was entirely fair. 634 A.2d at 351. In *Caremark*, Chancellor Allen relied prominently on *Barnes* as supporting "the core element of any corporate law duty of care inquiry: whether there was a good faith effort to be informed and exercise judgment." 698 A.2d at 968.

care. A failure to make that effort constitutes a breach of the duty of loyalty." *Marchand v. Barnhill*, 212 A.3d 805, 824 (Del. 2019).

There is room to debate whether the same loyalty-based framework that governs directors should apply to officers, or whether officers could be held liable for a failure of oversight caused by a breach of the duty of care.[16] To state a care-based claim, a plaintiff would have to plead and later prove that the oversight failure resulted from gross negligence. For purposes of Delaware entity law, a showing of gross negligence requires conduct akin to recklessness.[17]

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[16] Even where directors are concerned, there is a hint that care continues to play a role. The *Stone-Guttman* formulation of *Caremark* liability as requiring bad faith takes care-based liability out of the equation and renders exculpatory provisions superfluous, yet Delaware decisions frequently refer to the presence of an exculpatory provision as a factor when analyzing a *Caremark* claim. *See, e.g.*, *Firemen's Ret. Sys. of St. Louis v. Sorenson*, 2021 WL 4593777, at *8 (Del. Ch. Oct. 5, 2021) ("Because Marriott's certificate of incorporation contains a provision exculpating its directors for breaches of the duty of care, as permitted under 8 *Del. C.* § 102(b)(7), the plaintiff must plead with particularity facts that support a meritorious claim for breach of the duty of loyalty." (cleaned up)); *In re Goldman Sachs Gp., Inc. S'holder Litig.*, 2011 WL 4826104, at *18 (Del. Ch. Oct. 12, 2011) ("The likelihood of directors' liability [for a *Caremark* claim] is significantly lessened where, as here, the corporate charter exculpates the directors from liability to the extent authorized by 8 *Del. C.* § 102(b)(7)."); *In re Citigroup Inc., S'holder Deriv. Litig.*, 964 A.2d 106, 125 (Del. 2009) ("[T]he protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.").

[17] By using this standard, Delaware entity law protects fiduciaries by requiring a greater showing for liability than what is required in other areas of civil law, as well as an even greater showing than what is required to obtain a conviction for criminal negligence. In civil cases not involving business entities, the Delaware Supreme Court has defined gross negligence as "a higher level of negligence representing 'an extreme departure from the ordinary standard of care.'" *Browne v. Robb*, 583 A.2d 949, 953 (Del. 1999) (quoting

The arguments about the oversight regime that should apply to officers parallel the arguments about whether an officer's duty of care should resemble the director regime and require a showing of gross negligence, or whether it should track the agency regime and require only simple negligence. Scholars engaged in extensive debate on that topic.[18]

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W. Prosser, *Handbook of the Law of Torts* 150 (2d ed. 1955)), *cert. denied*, 499 U.S. 952 (1991). By statute, Delaware law defines "criminal negligence" as follows:

> A person acts with criminal negligence with respect to an element of an offense when the person fails to perceive a risk that the element exists or will result from the conduct. The risk must be of such a nature and degree that failure to perceive it constitutes a gross deviation from the standard of conduct that a reasonable person would observe in the situation.

11 *Del. C.* § 231(a). The same statute provides that a person acts recklessly when "the person is aware of and consciously disregards a substantial and unjustifiable risk that the element exists or will result from the conduct." *Id.* § 231(e). Under this framework, gross negligence "signifies more than ordinary inadvertence or inattention," but it is "nevertheless a degree of negligence, while recklessness connotes a different type of conduct akin to the intentional infliction of harm." *Jardel Co., Inc. v. Hughes*, 523 A.2d 518, 530 (Del. 1987).

For purposes of entity law, Delaware frames gross negligence as requiring a showing of recklessness. "In the corporate context, gross negligence means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607 (Del. Ch. Apr. 5, 1990) (internal quotation marks omitted). "Gross negligence has a stringent meaning under Delaware corporate (and partnership) law, one which involves a devil-may-care attitude or indifference to duty amounting to recklessness." *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at *4 (Del. Ch. Aug. 26, 2005) (internal quotation marks omitted). To be grossly negligent in this context, a decision "has to be so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion." *Solash v. Telex Corp.*, 1988 WL 3587, at *9 (Del. Ch. Jan. 19, 1988) (Allen, C.) (cleaned up).

[18] For examples of the debate, see Paul Graf, *A Realistic Approach to Officer Liability*, 66 Bus. Law. 315 (2011); Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865 (2005); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate*

The arguments in favor of a less protective standard for officers generally start from the observation that, while directors are part-time monitors who may meet a handful of times per year, officers are full-time employees who are deeply involved in corporate decision-making on a daily basis. Compared to directors, officers have greater knowledge about and responsibility for the areas under their control. They also receive significantly higher levels of compensation for doing their jobs. The arguments in favor of a more protective standard for officers generally rely on the same justifications that support the business judgment rule, including the risk of hindsight bias in judicial decision-making, the relative incompetence of judges in assessing business decisions, the disproportionate level of liability that an individual could face from harm to a large enterprise, the bluntness of liability as a tool for shaping behavior, and a concern that the threat of liability will cause good people to decline to serve. *See, e.g.*, Petrin, *supra*, at 460–73. Chancellor Allen highlighted some of those arguments in *Caremark*, when he observed that "a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors." 698 A.2d at 971.

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*Officers Are Fiduciaries*, 46 Wm. & Mary L. Rev. 1597 (2005); Lyman Johnson & Robert Ricca, *Reality Check on Officer Liability*, 67 Bus. Law. 75 (2011); A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 Bus. Law. 215 (1992).

When faced with this type of policy decision, Delaware courts generally view the latter set of considerations as more persuasive and opt for a more protective standard. For example, a comparatively recent series of decisions have adopted the director model for analyzing officers' duty of care.[19] Similar policy rationales about protecting directors and officers against unjustified lawsuits, and the importance of encouraging capable people to serve, drive Delaware's broad construction of advancement and indemnification rights.[20]

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[19] *See Harron*, 275 A.3d at 846 ("[The officer] also owed a duty of care, albeit a duty framed by the gross negligence standard and attendant corporate law concepts, rather than the simple negligence standard and attendant agency concepts."); *Harcum v. Lovoi*, 2022 WL 29695, at *27 (Del. Ch. Jan. 3, 2022) ("As discussed above, the Complaint does not state a claim that the Proxy contained material omissions or inaccurate disclosures. Even if any of the alleged omissions or inaccurate disclosures were material, I am not persuaded that they were the product of gross negligence on the part of [individual defendants] in their capacities as officers of the Company."); *Flannery v. Genomic Health, Inc.*, 2021 WL 3615540, at *1 (Del. Ch. Aug. 16, 2021) ("Even if *Revlon* did apply, the Complaint fails to well plead non-exculpated claims against each director. As to the claims against [the defendant] in her capacity as an officer, the Complaint fails to well plead either that she was conflicted, implicating her duty of loyalty, or that she acted with gross negligence at any time during the negotiation process, implicating her duty of care."); *In re Pattern Energy Gp. Inc. S'holders Litig.*, 2021 WL 1812674, at *66 (Del. Ch. May 6, 2021) ("An officer's compliance with the duty of care is evaluated for gross negligence."); *In re Baker Hughes Inc. Merger Litig.*, 2020 WL 6281427, at *15 (Del. Ch. Oct. 27, 2020) ("Under Delaware law, the standard of care applicable to the fiduciary duty of care of an officer is gross negligence."); *Buckley Fam. Tr. v. McCleary*, 2020 WL 1522549, at *10 (Del. Ch. Mar. 31, 2020) ("Under Delaware law, the standard of care applicable to the fiduciary duty of care of a director or officer is gross negligence." (citing *Gantler*'s equating of officer duties with director duties)).

[20] *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002) (explaining that indemnification operates "to encourage capable [individuals] to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve"); *accord Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005) ("Advancement is an especially important corollary to indemnification as an inducement for attracting capable individuals into corporate service."); *VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998)

A recent event with potential implications for officers' oversight duties is the statutory amendment authorizing limited exculpation for officers. Historically, officers have not been entitled to exculpation, rendering them subject to liability for the duty of care. *See Gantler*, 965 A.2d at 709 n.37. Effective August 1, 2022, the General Assembly amended Section 102(b)(7) of the DGCL to authorize corporations to exculpate officers for care-based liability for direct claims by stockholders. Del. S.B. 273, 151st Gen. Assem., 83 Del. Laws ch. 377 (2022). The amendment did not authorize exculpation for "any action by or in the right of the corporation." *Id.*

The bifurcated approach taken by the amendment might imply a legislative intent to preserve care-based liability for officers for derivative claims, including for breaches of the duty of oversight. But that is not the only inference. Claims for breaches of fiduciary duty generally focus on actions or decisions that a fiduciary has taken affirmatively. Although Delaware authorities regularly equate action and conscious inaction,[21] humans

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(explaining that advancement rights "encourag[e] capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity"); Ernest L. Folk, III, *The Delaware General Corporation Law: A Commentary and Analysis* 98 (Little, Brown & Co. ed., 1972) ("The invariant policy of Delaware legislation on indemnification is to promote the desirable end that corporate officials will resist what they consider unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation that they have served if they are vindicated." (quotation marks omitted)).

[21] *See Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) (subsequent history omitted) ("[A] conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule"); *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 183 (Del. Ch. 2014) ("The Complaint alleges that the Board had the ability to defer interest payments on the Junior Notes, that the Junior Notes would not receive anything in an orderly liquidation, that [Defendant] owned all of the Junior Notes,

intuitively distinguish between the two and associate greater culpability with an affirmative act rather than a conscious decision not to act.[22] The amendment to Section 102(b)(7) can be read as preserving care-based liability for officers when they act in a grossly negligent (*i.e.*, reckless) manner. It need not be read to suggest an intent to override the loyalty-based premise of oversight liability for officers and preserve care-based liability in that area.

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and that the Board decided not to defer paying interest on the Junior Notes to benefit [Defendant]. A conscious decision not to take action is just as much of a decision as a decision to act."); *In re China Agritech, Inc. S'holder Deriv. Litig.*, 2013 WL 2181514, at *23 (Del. Ch. May 21, 2013) ("The Special Committee decided not to take any action with respect to the Audit Committee's termination of two successive outside auditors and the allegations made by Ernst & Young. The conscious decision not to take action was itself a decision."); *Krieger v. Wesco Fin. Corp.*, 30 A.3d 54, 58 (Del. Ch. 2011) ("Wesco stockholders had a choice: they could make an election and select a form of consideration, or they could choose not to make an election and accept the default cash consideration."); *Hubbard v. Hollywood Park Realty Enters., Inc.*, 1991 WL 3151, at *10 (Del. Ch. Jan. 14, 1991) ("From a semantic and even legal viewpoint, 'inaction' and 'action' may be substantive equivalents, different only in form."); Jean-Paul Sartre, *Existentialism Is a Humanism* 44 (Carol Macomber trans., Yale Univ. Press 2007) ("[W]hat is impossible is not to choose. I can always choose, but I must also realize that, if I decide not to choose, that still constitutes a choice.").

[22] *See, e.g.*, David Gray, *"You Know You've Gotta Help Me Out . . ."*, 126 Penn. St. L. Rev. 337, 351–65 (2022) (identifying and rejecting reasons for distinction between acts and omissions); George C. Christie, *The Defense of Necessity Considered from the Legal and Moral Points of View*, 48 Duke L.J. 975, 1013 (1999) (applying intuition to the Trolley Problem and analogizing to common law distinction between misfeasance and nonfeasance). This intuition may stem from lived experience in which inaction is less likely to be intentional. *Cf.* Richard S. Kay, *Causing Death for Compassionate Reasons in American Law*, 54 Am. J. Comp. L. 693, 712 (2006) (explaining that the persistence of a distinction between action and inaction "may reflect some idea that inaction often can be explained by inadvertence or mistake, while positive actions are, more generally, intentional" and that when the categories each involve intentional decisions, "the differential legal treatment of misfeasance and nonfeasance seems contrived").

This decision concludes that oversight liability for officers requires a showing of bad faith. The officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore red flags.

**B. The Plaintiffs' Allegations Against Fairhurst Support An Oversight Claim.**

The plaintiffs claim that Fairhurst breached his "duty of care by exercising inadequate oversight over enterprise risk management, and with regard to sexual harassment happening at the Company's franchises." Compl. ¶ 182. The plaintiffs thus frame their oversight claim explicitly as a breach of the duty of care. As this decision has explained, officers owe a duty of oversight, but liability requires pleading and later proving bad faith. The allegation that Fairhurst's conduct breached the duty of care is insufficient.

It is tempting to stop there, but "Delaware has adopted the system of notice pleading that the Federal Rules of Civil Procedure ushered in, which rejected the antiquated doctrine of the 'theory of the pleadings'—*i.e.*, the requirement that a plaintiff must plead a particular legal theory." *HOMF II Inv. Corp. v. Altenberg*, 2020 WL 2529806, at *26 (Del. Ch. May 19, 2020), *aff'd*, 263 A.3d 1013 (Del. 2021). Under the theory of the pleadings, which was a feature of pleading at common law and of code pleading in some jurisdictions, a complaint had to "proceed upon some definite theory, and on that theory the plaintiff must succeed, or not succeed at all." *Mescall v. Tully*, 91 Ind. 96, 99 (1883). If the facts did not support the theory that the plaintiff had picked, then the court would not grant relief, even if the facts established an entitlement to relief under a different theory. *See* Fleming James, Jr., *The Objective and Function of the Complaint: Common Law—Codes—Federal Rules*, 14 Vand. L. Rev. 899, 910–11 (1961).

The Federal Rules of Civil Procedure "effectively abolished the restrictive theory of the pleadings doctrine, making it clear that it is unnecessary to set out a legal theory for the plaintiff's claim for relief." 5 Charles Alan Wright, Arthur R. Miller & A. Benjamin Spencer, *Federal Practice and Procedure* § 1219 (4th ed.), Westlaw (database updated Aug. 2022) [hereinafter Wright & Miller] (footnote omitted). Under the Federal Rules of Civil Procedure, "particular legal theories of counsel yield to the court's duty to grant the relief to which the prevailing party is entitled, whether demanded or not." *Gins v. Mauser Plumbing Supply Co.*, 148 F.2d 974, 976 (2d Cir. 1945) (Clark, J.). "[T]he federal rules—and the decisions construing them—evince a belief that when a party has a valid claim, he should recover on it regardless of his counsel's failure to perceive the true basis of the claim at the pleading stage, provided always that a late shift in the thrust of the case will not prejudice the other party in maintaining a defense upon the merits." 5 Wright & Miller, *supra*, § 1219 (footnote omitted). *See generally Johnson v. City of Shelby*, 574 U.S. 10, 11 (2014) (per curiam) (reversing dismissal of complaint for failure to articulate a claim under 42 U.S.C. § 1983; explaining that the Federal Rules of Civil Procedure rejected the "theory of the pleadings" and "do not countenance dismissal of a complaint for imperfect statement of the legal theory supporting the claim asserted").

Delaware adopted the federal rules and embraced their approach to pleading. *See* Hon. Daniel L. Herrmann, *The New Rules of Procedure in Delaware*, 18 F.R.D. 327, 327 (1956) ("In 1948, the Courts of Delaware shook off the shackles of mediaeval scholasticism and adopted Rules governing civil procedure modeled upon the Federal Rules of Civil Procedure." (internal quotation marks omitted)). Court of Chancery Rule 8,

which governs pleading, is based on the federal model, and Rule 8(f) provides that "[a]ll pleadings shall be so construed as to do substantial justice."

The real question, therefore, is whether the complaint contained a short, plain statement of facts sufficient to support a claim against Fairhurst for breach of the duty of oversight. *See* Ct. Ch. R. 8(a); *Central Mortg. Co.*, 27 A.3d at 535. Not fixating on the plaintiffs' use of the word "care" is particularly appropriate in this case, because before this decision, no Delaware court had held that a plaintiff must assert that an officer acted in bad faith or disloyally to support an oversight claim. As discussed in the prior section, there are non-frivolous arguments for care-based liability for officers where the duty of oversight is concerned.

The plaintiffs' oversight claim asserts that a culture of sexual misconduct and sexual harassment was allowed to develop at the Company. From a theoretical standpoint, nothing prevents a stockholder from asserting a derivative claim for breach of the duty of oversight based on that theory. *See* Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 Colum. L. Rev. 1583, 1641, 1643–46 (2018). "[C]orporate fiduciaries who fail to monitor harassment at their firms may be liable in certain circumstances under a *Caremark* theory." *Id.* at 1641. And "corporate fiduciaries who are aware of harassment but fail to react—or who affirmatively enable harassment to continue—may be sued for breach of the duties of care and loyalty." *Id.*

In this case, the plaintiffs describe their oversight claim as resting on Fairhurst knowing about evidence of sexual misconduct and acting in bad faith by consciously disregarding his duty to address the misconduct. In other words, the plaintiffs have asserted

a Red-Flags Claim. They have not asserted an Information-Systems Claim. They also have not asserted that Fairhurst consciously caused the Company to violate laws that protect against sexual harassment, such as Title VII of the Civil Rights Act of 1964 or state-level human rights laws. *See* Hemel & Lund, *supra*, at 1610, 1630. That type of claim—known colloquially as a "*Massey* Claim"—is not technically an oversight claim, but it has a similar feel. *See Lebanon Cnty. Empls.' Ret. Fund v. Collis*, 2022 WL 17841215, at *18 (Del. Ch. Dec. 22, 2022).

To plead a Red-Flags Claim that will survive a Rule 12(b)(6) motion, a plaintiff must plead facts supporting an inference that the fiduciary knew of evidence of corporate misconduct. The plaintiff also must plead facts supporting an inference that the fiduciary consciously failed to take action in response. The pled facts must support an inference that the failure to take action was sufficiently sustained, systematic, or striking to constitute action in bad faith. A claim that a fiduciary had notice of serious misconduct and simply brushed it off or otherwise failed to investigate states a claim for breach of duty. *AmerisourceBergen*, 2020 WL 132752, at *20.

**1. The Existence Of Red Flags**

The plaintiffs' Red-Flags Claim asserts that Fairhurst permitted a toxic culture to develop at the Company that turned a blind eye to sexual harassment and misconduct. As the red flags evidencing that growing culture, the plaintiffs cite a series of events, with the following pertinent to the claim against Fairhurst:

- Easterbrook and Fairhurst took over at the Company in 2015.

- Easterbrook and Fairhurst promoted a party atmosphere at the Company that emphasized drinking.

- The human resources department ignored complaints about the conduct of co-workers and executives.

- Employees feared retaliation for reporting complaints to the human resources department.

- In October 2016, over a dozen Company employees filed complaints with the EEOC about sexual harassment and misconduct at the Company.

- Later that month, employees in over thirty cities across the United States staged a one-day walkout to protest problems with sexual harassment and misconduct at the Company.

- In December 2016, Fairhurst engaged in an act of sexual harassment that was not reported to the Company's Compliance Department and did not reach the Audit Committee or the Board.

- In May 2018, over a dozen Company employees filed coordinated complaints with the EEOC.

- In September 2018, Company workers from ten cities organized a one-day strike to protest the Company's culture of sexual harassment.

- In November 2018, Fairhurst engaged in an act of sexual harassment at a party for the human resources staff. Over thirty Company employees witnessed the incident, and several reported it to the Company's Compliance Department. The Compliance Department concluded that Fairhurst violated the Company's Standards of Business Conduct.

- In December 2018, the Audit Committee reviewed the incident involving Fairhurst and chose to discipline him and require that he execute the Last Chance Letter.

- Also in December 2018, Senator Duckworth wrote a letter to the Company about sexual harassment complaints against the Company.

- In June 2019, Senator Duckworth joined with seven other United States Senators in writing to the Company and asking specific questions about sexual harassment and workplace safety.

- In October 2019, the Board learned that Easterbrook was engaging in a prohibited relationship with a Company employee.

- In November 2019, after investigating Easterbrook's misconduct, the Board terminated Easterbrook without cause.
- Also in November 2019, the Board terminated Fairhurst with cause, inferably because he had violated the terms of his Last Chance Letter and engaged in an additional act of sexual harassment.
- Also in November 2019, workers filed the *Ries* Action against the Company, alleging that it had a toxic culture that accommodates sexual harassment.
- In April 2020, workers filed the *Fairley* Action against the Company, seeking damages for sexual harassment, retaliation, and related misconduct.

Based on these events, the plaintiffs seek an inference that Fairhurst ignored red flags about sexual harassment at the Company, resulting in harm that manifested itself through the lawsuits and attendant reputational harm.

These allegations support Fairhurst's knowledge of red flags. As Global Chief People Officer, he was the executive officer with day-to-day responsibility for overseeing the human resources function and promoting a safe and respectful environment. He was supposed to have his ear to the ground and be knowledgeable about the Company's employees. For someone in Fairhurst's position, the coordinated EEOC complaints in October 2016, followed by a thirty-city walkout, were massive red flags. He should have been figuring out whether something was seriously wrong and either addressing it or reporting upward to the CEO and the directors. For someone in Fairhurst's position, the second round of coordinated EEOC complaints in May 2018, followed by a second one-day strike in ten cities in September 2018, was another set of red flags. He again should have been figuring out whether something was seriously wrong and either addressing it or reporting upward to the CEO and the directors.

The Section 220 documents that the Company produced support the inference that the management team regarded these events as red flags. In January 2019, the Company's General Counsel reported to the Strategy Committee about the EEOC complaints and management's deployment of resources to address sexual harassment and misconduct at the Company. In May, the General Counsel discussed the same issues with the full Board. In June, the Strategy Committee held a special meeting devoted solely to those issues and the Company's response. In September, the Company's enterprise risk management assessment added a "Respectful Workplace" as a "New Risk Theme" at the "Top Tier 2" risk level.

At the pleading stage, it is reasonable to infer that there were problems with sexual harassment and misconduct at the Company. It is also reasonable to infer that Fairhurst knew about them. The alternative inference—that the Company's Global Chief People Officer did not know—is not reasonable. In any event, Fairhurst undoubtedly knew about them by June 2019 because, during that month, he co-authored a memorandum to the Strategy Committee about management's response.

The plaintiffs have pled facts supporting an inference that by October 2016, Fairhurst knew that there were potential problems with sexual harassment and misconduct at the Company. That satisfies the first element of a Red-Flags Claim.

**2. The Response To The Red Flags**

Pleading red flags is not enough. The plaintiffs also must plead facts supporting an inference that Fairhurst acted in bad faith by consciously ignoring red flags. Fiduciaries of a Delaware corporation are presumed to act in good faith. *E.g.*, *In re Walt Disney Co. Deriv.*

*Litig.*, 906 A.2d 27, 52 (Del. 2006). A complaint must plead facts supporting a contrary inference.

Several factors support an inference of *scienter*. First, there are the allegations about Fairhurst's own participation in multiple acts of sexual harassment. He committed an act of sexual harassment in December 2016, shortly after the first set of EEOC complaints and the associated thirty-city walkout. He committed another act of sexual harassment in November 2018, after the second round of EEOC complaints and the ten-city strike. He committed a third act of sexual harassment in November 2019, after spending the prior year focusing with the rest of the management team on ways to address the Company's problems with sexual harassment and misconduct. When considering whether a defendant consciously ignored red flags regarding a culture of sexual harassment and misconduct, it is reasonable to give weight to the fact that the defendant himself committed multiple acts of sexual harassment, including repeating the behavior after being disciplined and given a last chance. It is reasonable to infer that such an individual could consciously turn a blind eye to red flags about similar conduct by others.

Second, the complaint alleges that under Fairhurst's watch, the human resources department ignored complaints about the conduct of co-workers and executives. The complaint also alleges that employees feared retaliation for reporting complaints to the human resources department. Those allegations support the inference that as a serial harasser, Fairhurst was consciously failing to do what he should have done to address problems with sexual harassment and misconduct. Instead, he and Easterbrook were promoting and enjoying the party atmosphere at headquarters.

Third, there is an absence of evidence from the Section 220 production indicating that Fairhurst took action to report upward to the director level about sexual harassment issues before June 2019. There is a similar absence of evidence from the Section 220 production indicating that the Company was taking meaningful action to address problems with sexual harassment and misconduct until January 2019. It is reasonable to infer that the events of 2018 prompted Company management to begin focusing on the issue and caused the directors to engage. The directors' realization that the Company's Global Chief People Officer had committed two known acts of sexual harassment doubtless contributed to their decision to make the issue a priority for 2019.

To be sure, there is record evidence indicating that during 2019, Fairhurst was part of the effort by Company management to address the problem of sexual harassment and misconduct. Most notably, he co-authored a memorandum for the Strategy Committee's meeting in June 2019 that described what action the Company was taking in response to the red flags about sexual harassment. He also gave presentations to the Strategy Committee in June and September. The actions that Company management took, such as adopting an updated anti-sexual harassment policy and creating new employee training programs, would have involved the human resources department that Fairhurst led.

Beginning in 2019, therefore, it is not possible to draw an inference that Fairhurst consciously ignored the Company's problems with sexual harassment and misconduct. But it is also fair to note that Fairhurst had been disciplined for sexual harassment in November 2018. He was part of the problem, and he was caught, so he had to be part of the solution. Of course, he also engaged in a third act of sexual harassment in November 2019 and was

terminated for it. It is reasonable to infer that Fairhurst's acts of sexual harassment constituted knowing misconduct.

Given the pled facts, it is possible that even during 2019, Fairhurst went through the motions of assisting his colleagues while continuing to turn a blind eye to instances of harassment until his termination in November 2019 ended his tenure at the Company. It is also possible that Fairhurst will not face liability for conduct that occurred during 2019 because he participated in the Company's response. At the pleading stage, it is not possible to decide between these inferences or determine the metes and bounds of Fairhurst's potential liability. It is enough to hold that the complaint's allegations support a claim against Fairhurst for breach of the duty of oversight.

### C. The Plaintiffs' Allegations Against Fairhurst State A Claim For Breach Of The Duty Of Loyalty As To His Own Acts Of Harassment.

The plaintiffs also claim that Fairhurst breached his fiduciary duties by engaging personally in acts of sexual harassment. That theory states a claim on which relief can be granted.

"[F]iduciaries violate the duty of loyalty when they engage in harassment themselves." Hemel & Lund, *supra*, at 1641. Although "[t]he standard of loyalty is measured by no fixed scale," a director's duty of loyalty "requires an undivided and unselfish loyalty to the corporation" and "demands that there shall be no conflict between duty and self-interest." *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939). "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests." *Id.* When a fiduciary "intentionally acts with a purpose other than that of

advancing the best interests of the corporation," the fiduciary acts in bad faith, which constitutes a breach of the duty of loyalty. *Disney*, 906 A.2d at 67. "[A] CEO or other corporate officer who uses a position of power to harass, intimidate, or assault employees clearly acts for a purpose other than that of advancing the company's interests."[23]

The prior section details the specific allegations contained in the complaint about multiple incidents of sexual harassment by Fairhurst. When Fairhurst engaged in sexual harassment, he was not acting subjectively to further the best interests of the Company.[24] He therefore was acting in bad faith. The allegations against Fairhurst accordingly support a claim for breach of the duty of loyalty.

In response to the plaintiffs' assertion that sexual harassment constitutes a breach of the duty of loyalty, Fairhurst argues that the plaintiffs failed to plead facts supporting an inference that he subjectively intended to harm the Company. Dkt. 60 at 20. Yes, for a fiduciary to act with a subjective intent to harm a corporation is one form of bad faith. *Disney*, 906 A.2d at 64. And bad faith also encompasses "intentional dereliction of duty [or] a conscious disregard for one's responsibilities." *Id.* at 66. And a fiduciary acts in bad

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[23] Hemel & Lund, *supra*, at 1641-42 (citing *Prozinski v. Ne. Real Estate Servs.*, 797 N.E.2d 415, 423–24 (Mass. App. Ct. 2003) (holding that when an officer "allegedly embarked on a course of sexual harassment of [a] receptionist," his "placement of his own interests above those of the company he served could be found by a fact finder to constitute an act of disloyalty")).

[24] *See, e.g.*, Hemel & Lund, *supra*, at 1642 ("The consequences for the firm go well beyond the risk of liability: Sexual harassment in the workplace potentially damages employee morale, drives talented individuals away from the firm, and endangers the company's reputation.").

faith where he possesses a "dishonest purpose or moral obliquity." *McGowan v. Ferro*, 859 A.2d 1012, 1036 (Del. Ch. 2004), *aff'd*, 873 A.2d 1099 (Del. 2005) (TABLE).

More generally, a fiduciary acts in bad faith when the fiduciary "intentionally acts with a purpose other than that of advancing the best interests of the corporation." *Stone*, 911 A.2d at 369. "It makes no difference the reason why the [fiduciary] intentionally fails to pursue the best interests of the corporation." *Frederick Hsu Living Tr. v. ODN Hldg. Corp.*, 2017 WL 1437308, at *27 (Del. Ch. Apr. 14, 2017) (cleaned up). "Bad faith can be the result of any emotion that may cause a [fiduciary] to intentionally place his own interests, preferences or appetites before the welfare of the corporation." *Id.* (cleaned up). "Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge, . . . shame or pride." *In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989) (Allen, C.).

It is not reasonable to infer that Fairhurst acted in good faith and remained loyal to the Company while committing acts of sexual harassment, violating company policy, violating positive law, and subjecting the Company to liability. It is reasonable to infer that Fairhurst acted disloyally and for an improper purpose, unrelated to the best interests of the Company.

Although this analysis seems straightforward, some might question as a matter of policy whether a claim for breach of fiduciary duty should extend to acts of sexual

harassment.[25] After all, a corporation can terminate the offending employees, and there often will be a claim for breach of an employment agreement. Meanwhile, victims can pursue remedies under federal and state law. Some might ask whether the Court of Chancery should be hearing sexual harassment claims and worry that recognizing such a claim will open the floodgates to employment-style litigation.

A flood of new employment-style claims seems unlikely. Like an oversight claim, a claim for breach of duty based on the officer's own acts of sexual harassment is derivative, so all of the protections associated with derivative claims apply. The claim is not one that a victim has standing to bring against a solvent corporation: Until a victim

[25] A New York decision held that a corporation failed to state a claim for breach of the duty of loyalty under New York law against a former executive vice president who was terminated based on sexual harassment complaints from several current and former employees. *Pozner v. Fox Broad. Co.*, 74 N.Y.S.3d 711, 712 (N.Y. Sup. Ct. 2018). The court reasoned that the duty of loyalty "has only been extended to cases where the employee act[s] directly against the employer's interests—as in embezzlement, improperly competing with the current employer or usurping business opportunities." *Id.* at 713-14. Under Delaware law, the duty of loyalty is not so narrow. Regardless, it is reasonable to infer that when a fiduciary engages in sexual harassment, the fiduciary acts directly against the corporation's interest by harming an employee, jeopardizing the corporation's relationship with that employee and other employees, and subjecting the company to potential liability. This court noted the existence of the *Pozner* case when assessing after trial whether a corporation proved a claim against a former director and officer for engaging in a "campaign of harassment" against fellow directors and former employees that involved "inflammatory name-calling," aggressive posturing during meetings, and retaliation against employees that included no longer speaking with an employee and having another employee check her work. *See Pers. Touch Hldg. Corp. v. Glaubach*, 2019 WL 937180, at *23-25 n.299 (Del. Ch. Feb. 25, 2019). With little precedent to go on, the *Glaubach* decision identified *Pozner* in passing. *Id.* at *25 n.299. The *Glaubach* decision did not rely on *Pozner* or endorse its reasoning. The *Glaubach* decision did not involve a claim that a fiduciary had breached the duty of loyalty under Delaware law by engaging in sexual harassment.

obtains a judgment against the corporation, the victim is a contingent creditor, and after judgment, an actual creditor.

A claim for breach of fiduciary duty is also not duplicative of other remedies. In many cases, a claim for breach of an employment agreement may be a possible cause of action, but not all fiduciaries have employment agreements. Directors rarely do. If an officer or director personally engages in acts of sexual harassment, and if the entity suffers harm, then either the governing body of the entity (or, if necessary, a plaintiff acting properly on its behalf) should be able to assert a claim for breach of fiduciary duty in an effort to shift the loss that the entity suffered to the human actor who caused it.

Sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable. The claim against Fairhurst for his own acts of sexual harassment survives review under Rule 12(b)(6).

## III. CONCLUSION

The plaintiffs have pled a claim against Fairhurst for breach of the duty of oversight. The plaintiffs also have pled a claim against Fairhurst for breach of the duty of loyalty based on the specific acts of sexual harassment in which he engaged. Fairhurst's motion to dismiss under Rule 12(b)(6) is denied.

**IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE**

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| IN RE McDONALD'S CORPORATION | ) | |
| STOCKHOLDER DERIVATIVE | ) | C.A. No. 2021-0324-JTL |
| LITIGATION | ) | |

**OPINION DISMISSING CLAIMS AGAINST DIRECTOR DEFENDANTS**

Date Submitted: December 15, 2022
Date Decided: March 1, 2023

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**LASTER, V.C.**

McDonald's Corporation ("McDonald's" or the "Company") is one of the world's largest employers. The plaintiffs are stockholders of the Company who have sued derivatively on its behalf. They allege that from 2015 until 2020, the Company's directors ignored red flags about a corporate culture that condoned sexual harassment and misconduct. They contend that the Company suffered harm in the form of employee lawsuits, lost employee trust, and a damaged reputation. As defendants, they have named nine directors who served during the critical period (the "Director Defendants").

In advancing this claim, the plaintiffs rely on the principle that corporate fiduciaries cannot act loyally and in the best interests of the corporation they serve if they consciously ignore evidence indicating that the corporation is suffering or will suffer harm. To state a claim under this theory, the plaintiffs must allege facts supporting an inference that the directors knew about a problem—epitomized by the proverbial red flag—yet consciously ignored it. The plaintiffs must do more than plead that the directors responded in a weak, inadequate, or even grossly negligent manner. The pled facts must indicate a serious failure of oversight sufficient to support an inference of bad faith.

Although the Director Defendants argue otherwise, the plaintiffs have pled facts supporting an inference that the Director Defendants knew about a problem with sexual harassment and misconduct at the Company. The complaint identifies a series of events during 2018 that put the Director Defendants on notice of a threat to the Company, including (i) a wave of coordinated complaints filed with the Equal Employment Opportunity Commission ("EEOC") that contained disturbing allegations about acts of sexual harassment and retaliation at the Company, (ii) a ten-city strike by Company

workers across the United States, and (iii) an inquiry from a United States Senator seeking to investigate issues of sexual harassment and misconduct at the Company.

That is enough to support a pleading-stage inference, but there is one more, brutal fact: In December 2018, the Director Defendants learned that the Company's Global Chief People Officer and head of its worldwide human resources function, the very executive officer specifically charged with promoting a culture of inclusion and respect at the Company, had engaged in an act of sexual harassment. Not only that, but the investigation into the 2018 incident uncovered a prior incident of sexual harassment by the Global Chief People Officer in 2016. The Global Chief People Officer also had been warned about his consumption of alcohol at Company events. When the head of the human resources function has repeatedly engaged in sexual harassment, that is the most vibrant of red flags regarding a potential problem with sexual harassment and misconduct.

What the complaint does not support is an inference that the Director Defendants failed to respond. The confluence of events during 2018, including the revelations about the Global Chief People Officer, led to action. Throughout 2019, the Director Defendants engaged with the problem of sexual harassment and misconduct at the Company. They worked with Company management on a response that included (i) hiring outside consultants, (ii) revising the Company's policies, (iii) implementing new training programs, (iv) providing new levels of support to franchisees, and (v) taking other steps to establish a renewed commitment to a safe and respectful workplace.

Given that response, it is not possible to draw a pleading-stage inference that the Director Defendants acted in bad faith. The pled facts do not support a reasonably conceivable claim against them for breach of the duty of oversight.

In a distinct but related claim, the plaintiffs allege that the Director Defendants breached their fiduciary duties by terminating the Company's CEO without cause in November 2019 after learning that he had engaged in an inappropriate relationship with an employee. The plaintiffs argue that the Director Defendants had grounds to terminate the CEO for cause, yet acted in their own self-interest by approving a no-cause termination because they feared that if they did the right thing and terminated the CEO for cause, then they would face an ugly litigation that would expose their own failures to address the Company's problems with sexual harassment and misconduct. The plaintiffs also allege that the Director Defendants acted hastily and without conducting a thorough investigation because they did not want to confront the potential extent of their own failures. A full investigation, the plaintiffs say, would have turned up additional evidence of the CEO's misconduct, including three other improper relationships between the CEO and Company employees. In addition, the plaintiffs note that during the same month that the Director Defendants terminated the CEO without cause, they terminated the Global Chief People Officer with cause after learning that he had engaged in yet another incident of misconduct. The plaintiffs seek an inference that the Director Defendants knew the correct course of action, yet chose a no-fault termination because it was the path of least resistance and avoided a potential examination of their own oversight failures.

This court has previously rejected similar arguments and held that the business judgment rule protects a board's decision to terminate an executive without cause, even if the situation might support a with-cause termination. To rebut the protections of the business judgment rule, the plaintiffs advance their theory of self-interest based on the Director Defendants' mishandling of the problems with sexual harassment and misconduct at the Company, but the pled facts do not support an inference that the Director Defendants mishandled those issues. The pleading-stage record shows that the Director Defendants engaged meaningfully. It is not reasonably conceivable that the Director Defendants sought to provide the CEO with a no-fault termination out of self-interest. It is also not reasonably conceivable that the Director Defendants breached their duty of care. Assuming for the sake of argument that they had breached their duty of care by not conducting a more thorough investigation, the Company's certificate of incorporation contains an exculpatory provision, so the directors would not face liability for that shortcoming.

Reasonable minds can disagree about whether the Director Defendants made the right decision by opting initially to terminate the CEO without cause. Even if the Defendant Directors made an objectively wrong decision, the business judgment rule protects them from liability for a good faith error.

The plaintiffs have challenged two other decisions that the Director Defendants made: (i) the decision to hire the CEO in the first place, and (ii) the decision to give the Global Chief People Officer one last chance after learning of his repeated acts of sexual harassment. Those decisions are similarly debatable. The business judgment rule protects those decisions as well.

The plaintiffs' final claim is for waste. To plead a waste claim, a plaintiff must identify a transaction that is so one-sided that no rational person would approve it. Typically, that involves a transaction in which one side receives no meaningful consideration. Contemporary cases view waste as a means of pleading facts that would support an inference that the fiduciary defendants acted in bad faith.

The plaintiffs assert that by terminating the CEO without cause, the Director Defendants allowed him to keep millions of dollars in compensation while obtaining comparatively little for the Company in return. Although reasonable minds could disagree with the Director Defendants' course of action, the bargain is not so out of whack as to constitute waste. Some might argue that the get was inadequate to support the give and that a termination for cause would have been more beneficial to the Company and its reputation in the long run. That is not the test. The decision to terminate the CEO without cause was not so extreme as to support a pleading stage inference of bad faith.

The Director Defendants' motion to dismiss the claims against them is granted.

## I. FACTUAL BACKGROUND

The facts are drawn from the operative complaint and the documents it incorporates by reference. At this stage of the proceedings, the complaint's allegations are assumed to be true, and the plaintiffs receive the benefit of all reasonable inferences.[1] This decision

[1] Citations in the form "Compl. ¶ —" refer to allegations in the plaintiffs' amended and consolidated complaint. Citations in the form "Ex. — at —" refer to exhibits to the Transmittal Declaration of S. Reiko Rogozen, which the Director Defendants filed in

examines the Director Defendants' motion to dismiss the claims against them for failure to state a claim on which relief can be granted. The factual background therefore focuses on the alleged facts pertinent to those claims.

**A. The Company**

The Company is a Delaware corporation with its principal place of business in Chicago, Illinois. When this litigation began, there were more than 36,000 McDonald's-branded restaurants in over 100 countries. The Company both operates corporate-owned restaurants and acts as a franchisor. In the year immediately preceding this litigation, the Company earned approximately $19 billion in revenue. Corporate-owned restaurants accounted for $8 billion while franchised restaurants produced $11 billion.

The Company has over 200,000 employees, and franchises employ another two million, making the Company one of the world's largest employers. Over half (55%) of all Company and franchise employees are women. At more senior levels, the percentage of women decreases, and just over one-fourth (27%) of the Company's officers are female.

Young people in entry-level positions make up a large portion of the Company's workforce, and the Company prides itself on being "America's best first job." Compl. ¶ 26. The Company's Standards of Business Conduct and its Human Rights Policy call for cultivating "respectful workplaces" and creating a professional environment that "builds trust, protects the integrity of our brand and fuels our success." *Id.* ¶ 28.

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support of their motion. Page citations refer to the internal pagination or, if there is none, then to the last three digits of the control number.

### B. A New CEO And His New Global Chief People Officer

In 2015, the Company faced its first sales decline in twelve years. To turn the Company around, the board of directors (the "Board") hired Stephen J. Easterbrook as CEO. Easterbrook was a longtime Company employee who served in various positions from 1993 until 2011, including as Senior Vice President for the United Kingdom and Northern Europe. After a brief hiatus, Easterbrook returned to the Company in 2013 as Executive Vice President and Chief Brand Officer. In March 2015, Easterbrook formally became CEO and started working out of the Company's headquarters in Chicago, Illinois.

When the Board appointed Easterbrook to the position of CEO, the directors knew that he was engaged in an intimate relationship with a public relations consultant who was working for the Company under a contract with a third-party firm. The plaintiffs allege that the relationship violated the terms of the Company's Dating, Nepotism and Fraternization Policy, which prohibited employees from engaging in relationships with independent contractors and vendors when the employees have "the direct or indirect authority to engage the services of such independent contractor or vendor." Compl. ¶ 46. The plaintiffs allege that as Chief Brand Officer, Easterbrook was involved in the Company's public relations efforts and therefore had direct or indirect authority over the contractor. According to the complaint, the Board promoted Easterbrook and opted to "sign off on the relationship under assurances that [the consultant] would be removed from the McDonald's account," then never followed up to confirm that she was removed. *Id.* (formatting omitted).

After becoming CEO, Easterbrook promptly promoted David Fairhurst to the position of Global Chief People Officer. Fairhurst, another longtime Company employee, previously served as the Company's Vice President and Chief People Officer for Europe. He and Easterbrook became close personal friends while working together in the Company's London office. Fairhurst joined Easterbrook at the Company's Chicago headquarters.

**C. A Party Atmosphere**

Easterbrook and Fairhurst promoted and participated in a "party atmosphere" at the Chicago headquarters. Compl. ¶ 49. The eighth floor of the Chicago office had an open bar where executives hosted weekly happy hours. Easterbrook and Fairhurst frequently attended with their management teams. "Male employees (including senior corporate executives) engaged in inappropriate behavior at these happy hour events, routinely making female employees feel uncomfortable." *Id.* ¶ 6; *see id.* ¶ 50.

Employees frequently drank alcohol at other Company-affiliated events. Easterbrook, Fairhurst, and other Company executives, including the Senior Vice President of Human Resources, participated in drinking excursions. Easterbrook and Fairhurst developed reputations for flirting with female employees, including their executive assistants.

The Company grew to resemble a boys' club. Recruiters were encouraged to hire "young, pretty females" from high-end stores to work in administrative roles at the Chicago headquarters. *Id.* ¶ 51. Easterbrook became known as a "player" who pursued intimate relationships with staff. *Id.*

As the culture changed, the human resources function failed to address complaints adequately. Former Company managers reported that "HR leaders under Mr. Easterbrook ignored complaints about the conduct of co-workers and executives. Some of those people said they feared retaliation for reporting the conduct of co-workers and executives to HR." *Id.* ¶ 52. Two former executives reported that "the environment in HR during Fairhurst's tenure made employees feel as if they had little recourse for reporting bad behavior." *Id.* ¶ 59.

**D. The Company Faces Public Scrutiny Over Sexual Harassment.**

During the year after Easterbrook and Fairhurst took over, the Company began to face increasing public scrutiny about problems with sexual harassment and misconduct. In October 2016, more than a dozen Company workers from restaurants across the nation filed complaints with the EEOC that contained disturbing allegations of sexual harassment and retaliation. Later that month, a fast-food worker advocacy group organized a walkout by Company employees in over thirty cities across the United States to draw attention to the EEOC complaints. Major news outlets covered these events.

In May 2018, the Company faced another round of EEOC complaints, this time identifying both individual instances of misconduct and broader systemic issues throughout the Company. In September 2018, Company workers from ten cities across the United States organized a one-day strike to protest sexual harassment and the failure of Company management to address it. The protest attracted the attention of lawmakers, and in December 2018, United States Senator Tammy Duckworth sent an inquiry to Easterbrook about "multiple sexual harassment complaints made by employees who work at

McDonald's Restaurants in Detroit, Chicago, Los Angeles, and six other cities." Compl. ¶ 113.

### E. Reports Of Misconduct By Fairhurst

In the same month that Senator Duckworth sent her inquiry, the Board received reports that Fairhurst himself had committed acts of sexual harassment. During a Company party in November 2018 for the human resources staff, Fairhurst pulled a female employee onto his lap. Over thirty Company employees witnessed the incident, and several reported it to the Company's Compliance Department. The Compliance Department evaluated the reports and "concluded that David Fairhurst behaved and put himself in a position inconsistent with the Company's Standards of Business Conduct." Compl. ¶ 54.

On December 13, 2018, the Board's Audit & Finance Committee (the "Audit Committee") discussed Fairhurst's misconduct. Easterbrook informed the Audit Committee that an employee had recently described a prior incident of sexual harassment by Fairhurst in December 2016 that had not been reported to the Compliance Department.[2] Easterbrook also reported that Fairhurst "had once before been warned about excessive drinking at Company events in the past." *Id.*

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[2] The minutes state: "Mr. Easterbrook then described events reported by another employee about matters with Mr. Fairhurst in December 2016 that had not been previously reported to Compliance." Ex. 61 at 1. The plaintiffs interpret this sentence to mean that Easterbrook already knew about the December 2016 incident, having learned about it at some earlier point, yet he neither reported it to the Audit Committee nor took any action to address it. That is not a reasonable reading. While the minutes could have been drafted more clearly, the context makes clear that Easterbrook was describing an event from 2016 that an employee reported in 2018, as part of the investigation into the 2018 incident.

The Company ostensibly had a zero-tolerance policy for acts of sexual harassment. Under the Company's policy, Fairhurst's actions qualified as sexual harassment. Because Fairhurst had grabbed the employee and forced her onto his lap, his actions technically constituted an assault. But Easterbrook recommended a deviation from the no-tolerance policy. He proposed that Fairhurst's punishment should be "forfeiting 50% of his [target incentive plan] bonus payment for 2018" and "signing both an agreement regarding the conduct and a release." Compl. ¶ 61. The Audit Committee approved Easterbrook's proposal.

After the Audit Committee meeting, Easterbrook directed the Senior Vice President of Human Resources to inform "all participants in the event that management had appropriately addressed the matter." *Id.* ¶ 62 (formatting omitted).

To document his arrangement with the Company, Fairhurst executed a "Last Chance" letter. Ex. 62 (the "Last Chance Letter"). The Last Chance Letter confirmed that Fairhurst's behavior was not an isolated incident: "Concerns have been raised to the company in the past and recently about your alcohol consumption at company-sponsored and company-related events, and separately about your personal conduct during some of those events which have made some employees uncomfortable." *Id.* at '423. The Last Chance Letter recited that Fairhurst had "demonstrated inappropriate and disruptive behavior while under the influence of alcohol at a company-related gathering and dinner of U.S. HR staff on November 8, 2018." *Id.*

The Last Chance Letter unambiguously stated that Fairhurst's actions violated the Company's Standards of Business Conduct. It also noted that Fairhurst's misconduct put

"the Company at significant risk." *Id.* Despite those findings and concessions, Fairhurst continued to serve as the Company's Global Chief People Officer.

### F. Management And The Board Take Action To Address The Company's Problems With Sexual Harassment And Misconduct.

The events of 2018 caused Company management and the Board to engage with the issue of sexual harassment and misconduct. In a memorandum dated January 17, 2019, Jerry Krulewitch, the Company's General Counsel, reported to the Board's Public Policy & Strategy Committee (the "Strategy Committee") about the EEOC complaints and the ten-city strike. Ex. 49. Krulewitch explained in response to the focus on problems of sexual harassment and misconduct, "McDonald's teams have been proactively working to improve policies and programs related to these issues," including modified and improved policies. *Id.* at 2. Krulewitch also reported that "[w]orking with insurance, we have created financial incentives for the franchisees to take the training, [REDACTED FOR NON-RESPONSIVENESS]." *Id.*

On May 23, 2019, during a meeting of the full Board, Krulewitch reported on "recent EEOC charges" and "previous EEOC charges regarding similar topics that had been filed in 2018." Ex. 51 at 8. He noted that "since the charges in 2018, the Company had been working diligently to enhance its programs and policies with regard to sexual harassment with a deliberate focus on the restaurants." *Id.* He then described actions the Company had taken, including revising policies, providing training, offering new tools to franchisees, and engaging outside experts. *Id.* at 8–9.

In June 2019, Senator Duckworth and seven other United States Senators signed a joint letter to the Company, directed to Easterbrook, that asked ten specific questions about sexual harassment and other workplace safety issues. Ex. 86. The letter requested a response by June 25. *Id.*

Later that month, Krulewitch, Fairhurst, and Robert Gibbs, the Company's Chief Communications Officer, submitted a memorandum to the Strategy Committee. Ex. 47 (the "June 2019 Memorandum"). The memorandum noted that at earlier meetings during the year, the directors had discussed "the issue of sexual harassment, as well as the proactive work we are doing to create a safe and respectful workplace for our employees and to support the efforts of our independent owner/operators to do the same." *Id.* at 1. The memorandum also noted that during a meeting in May 2019, the Strategy Committee had scheduled "a separate meeting to discuss these issues in more detail." *Id.*

The June 2019 Memorandum summarized the situation facing the Company and management's response. Under the heading "*What is occurring?*", the memorandum described the EEOC complaints and the allegations about systemic harassment. *Id.* Under the heading "*How is McDonald's responding to the issue of allegations of sexual harassment?*", the memorandum identified steps the Company was taking, including:

- A comprehensive review and update of the Company's anti-harassment policy.
- The engagement of the Rape, Abuse & Incest National Network ("RAINN") to advise the Company. The June 2019 Memorandum described RAINN as the largest anti-sexual violence organization in the country and a pioneer in education programs about preventing sexual misconduct and harassment.
- A holistic review of the Company's training programs and the retention of Seyfarth Shaw at Work to assist the Company in providing training for both Company

employees and franchise restaurant employees about how to establish and maintain a safe and respectful workplace.

- Additional crew, restaurant manager, and franchisee training on harassment, unconscious bias, and workplace safety.
- The establishment of a new, third-party managed hotline for employees at franchise restaurants to report complaints of any kind.
- A shared values commitment to be signed by franchisees that included a mutual understanding and responsibility for ensuring a safe, healthy, and respectful environment.
- A franchisee guide containing best practices and recommendations on establishing and maintaining a safe and respectful workplace.
- A cultural assessment, including listening sessions to promote continuous improvement.
- An end to the Company's previous policy requiring mandatory arbitration of harassment and discrimination claims as a condition of employment.

*Id.* at 2–4.

The June 2019 Memorandum was part of the pre-reading materials for a special meeting of the Strategy Committee devoted to the subject of sexual harassment. During that meeting, Krulewitch reported on the litigation against the Company and "the progress the Company had made in its efforts to promote a safe and respectful workplace." Ex. 50 at 2. Fairhurst provided an overview of the Company's people and gender strategy, including efforts to drive gender balance and improve diversity. *Id.* At the end of the meeting, the chair of the Strategy Committee "concluded the discussion by confirming that the Company (i) has developed a comprehensive plan around the issues of sexual harassment and safe and respectful workplace environments; (ii) will continue to be

proactive; and (iii) will further evaluate how best to execute its strategy and be a leader on this issue." *Id.* at 3.

In September 2019, the Board received an update on the Company's Enterprise Risk Management ("ERM"). The associated presentation identified a "Respectful Workplace" as a "New Risk Theme" at the "Top Tier 2" level. Ex. 52 at '138. Under the Company's risk management system, a "Tier 1" risk is (i) "[c]ritical to McDonald's mission and values," (ii) "[a]ppropriate for ERM Committee discussion," and (iii) "[m]ay need further discussion around risk appetite." *Id.* at '142. A Tier 2 risk is one that has the "[p]otential for sustained, negative impact to brand, long term financial grown, or strategic position." *Id.* Top Tier 2 risks are "[m]ore likely to become Tier 1 risks given the right circumstances." *Id.*

That same month, during a special meeting of the Strategy Committee, Easterbrook, Fairhurst, Gibbs, and Krulewitch reported on a strategy to improve the Company's reputation as an employer. Ex. 55 at 1. A memorandum distributed to the committee identified management's "ambition to strive for a leadership position by moving beyond compliance in the area of building a respectful and safe workplace." *Id.* at 2. Management reported that they had successfully launched enhanced training "on a number of important topics including [REDACTED FOR NON-RESPONSIVENESS], sexual harassment and unconscious bias, as well as launching our Gender Balance & Diversity Program." *Id.* at 2.

**G. The Board Terminates Easterbrook And Fairhurst.**

On October 17, 2019, the Board learned that Easterbrook was engaging in a prohibited relationship with an employee. During a telephonic meeting on October 18, the

Board ordered outside counsel to investigate. Outside counsel did not search Easterbrook's corporate email account or his devices. Outside counsel only questioned Easterbrook and the employee who was the subject of the report. Easterbrook denied that he had engaged in relationships with any other employees, and outside counsel accepted that response.

Eight days later, during a meeting on October 26, 2019, outside counsel presented the results of the investigation. The Board decided to negotiate a separation agreement with Easterbrook that contemplated a termination without cause. The final agreement permitted Easterbrook to keep all prior compensation and to receive the full value of his severance package. His "Separation Benefits" included "a cash severance payment equal to 26 weeks of base salary, a prorated annual bonus for 2019, health insurance continuation at active employee rates for six months post-termination, continued vesting of stock options for three years post-termination and prorated vesting of performance-based restricted stock units." Compl. ¶ 74.

At the time, the Company calculated the total value of the compensation that Easterbrook received under the separation agreement to be $47,534,341, with $43,999,937 comprised of equity awards. *See* Dkt. 84 Ex. A ¶ 18. The plaintiffs object that the Company did not seek to recover a portion of the compensation Easterbrook received during his tenure as CEO. They put the combined value of Easterbrook's compensation and his severance package at $125.8 million. Compl. ¶¶ 11, 74.

During a meeting on November 1, 2019, the Board approved the separation agreement. The minutes of the meeting recite that the Board chose to terminate Easterbrook "without cause" with the goal of "minimizing disruption to the Company and its

stakeholders." Ex. 63 at 6. The minutes note that the Board also took into account the potential for Easterbrook to file litigation challenging a for-cause termination and the uncertainty over whether the Company "would prevail in such a dispute." *Id.* at 2.

During the meeting, the Board addressed "employment matters related to Mr. David Fairhurst." Compl. ¶ 77. The minutes do not describe the discussion other than reciting that the Company's general counsel updated the Board on "his recent conversations" with Fairhurst. *Id.* The Board terminated Fairhurst for cause. *Id.*

In a press release on November 3, 2019, the Company announced that Easterbrook was leaving the Company. The press release said only that Easterbrook had "violated company policy and demonstrated poor judgment" and described his relationship with an employee subordinate as "consensual." *Id.* ¶ 79. The press release did not disclose that the Board had fired Fairhurst.

The plaintiffs criticize how the Board documented its actions. The Board did not prepare formal minutes for its meetings on October 18 and October 26, 2019. The only written record of those meetings appears as part of the minutes for the November 1 meeting, which describe a "recap" the Board received. *Id.* ¶ 73. The plaintiffs view the absence of a contemporaneous record about highly sensitive conduct involving the Company's CEO as a reason to be suspicious about what took place.

### H. Stockholders Object To Easterbrook's Termination Without Cause.

After the announcement of Easterbrook's termination without cause, a coalition of union pension funds publicly attacked the Board's decision. The coalition asserted that it "defies belief to claim that the termination of an executive who has admitted to violating

an express and unambiguous provision of McDonald's Standards of Business Conduct was undertaken 'without cause.'" Compl. ¶ 85. The coalition protested that by allowing Easterbrook to keep his full severance package, the Board "failed to disincentivize violations of its code of conduct." *Id.* ¶ 86. The coalition objected that it was "hard to imagine how a board could set a worse 'tone at the top' than this, particularly considering the Company's painfully slow and still inadequate response to widespread sexual harassment in McDonald's restaurants." *Id.*

Meanwhile, on November 12, 2019, Company workers filed a class action lawsuit challenging the Company's systemic problems with sexual harassment (the "*Ries* Action"). The plaintiffs in the *Ries* Action alleged that the Company had a toxic culture and that "sexual harassment is pervasive throughout McDonald's restaurants." *Id.* ¶ 118. The *Ries* complaint contained detailed allegations about "routine, severe abuse" at Company restaurants while Easterbrook and Fairhurst were in charge. *Id.*

The *Ries* Action also detailed a lack of sexual harassment training at franchise restaurants. According to the *Ries* plaintiffs, almost two-thirds of restaurant employees worked at locations that provided no sexual harassment training. The *Ries* complaint alleged that many restaurant employees had no access to human resources support and that the Company's corporate human resources department under Fairhurst refused to help workers at franchise restaurants.

**I. The Vote-No Campaign**

In April 2020, the same coalition of union pension funds that had protested Easterbrook's termination without cause sought to change the composition of the Board.

In a public letter, the coalition asked Company stockholders to vote against reelecting Board Chair Enrique Hernandez, Jr. and Compensation Committee Chair Richard H. Lenny to "hold the board accountable for its poor decision-making" in terminating Easterbrook without cause. Compl. ¶ 87.

Glass, Lewis & Co. recommended that stockholders vote against the Company's say-on-pay proposal and against Lenny's reelection, noting that the Board's decision to "allow[] a significant portion of Mr. Easterbrook's outstanding equity awards to continue vesting after his departure . . . illustrates a lack of willingness on the board's part to appropriately enforce the Company policy violated by Easterbrook, and sets a poor precedent for the remaining executive team." *Id.* ¶ 88. Glass Lewis further noted that "exempting CEOs from key provisions of crucial rules around corporate policy sets a questionable tone at the top, with negative potential ramifications for a firm's culture and even the opportunity to create new, unique governance risks." *Id.*

That same month, workers filed another class action, this time on behalf of workers at Company-owned restaurants in Florida, seeking damages for sexual harassment, retaliation, and related misconduct (the "*Fairley* Action"). The plaintiffs received support from Time's Up Legal Defense Fund, an anti-sexual harassment group.

The complaint in the *Fairley* Action contained allegations similar to the *Ries* Action about systemic failures to curb sexual harassment at Company restaurants. According to the *Fairley* Action, "three out of every four female non-managerial McDonald's employees have personally experienced sexual harassment at McDonald's, ranging from unwelcome sexual comments to unwanted touching, groping, or fondling, to rape and assault." *Id.*

¶ 137. The *Fairley* complaint alleged that "over 70% of those who reported sexual harassment they witnessed or experienced faced some form of retaliation, with 42% reporting loss of income as a result." *Id.* The *Fairley* complaint further alleged that the Company's human resources department was completely ineffective at preventing sexual harassment and discouraged employees from lodging complaints. It cited a recent poll, which revealed that employees "at corporate restaurants are even more likely than workers at franchise restaurants to have experienced sexual harassment, with 83% of female non-managerial workers at corporate restaurants reporting having experienced at least one instance of sexual harassment, and 31% reporting having experienced eight or more types of sexual harassment." *Id.* ¶ 139.

A 2019 survey generated similar results. More than 75% of the Company's female workers reported being sexually harassed at work, and more than 71% reported that they suffered negative consequences for reporting harassment.

**J. The Company Sues Easterbrook.**

In July 2020, a Company employee reported that Easterbrook had engaged in a sexual relationship with another employee in addition to the relationship that led to his termination. This time, the Board conducted a more thorough investigation.

The investigation revealed that during 2018 and 2019, in addition to the relationship that prompted Easterbrook's termination, Easterbrook had engaged in sexual relationships with at least three Company employees. Easterbrook had used his Company email account to transmit dozens of nude, partially nude, or sexually explicit photographs and videos, including photographs of the three Company employees. His relationship with the

employee that prompted his termination had involved sexually explicit private messages and video calls.

The investigation revealed that Easterbrook misused Company resources to promote his relationships. Shortly after his first sexual encounter with one of the employees, Easterbrook granted her restricted stock units worth hundreds of thousands of dollars. He did the same thing days before his first sexual encounter with a second employee. Easterbrook also used the Company's private aircraft for personal trips with his paramours.

On July 21, 2020, the Board resolved to pursue litigation against Easterbrook. In August, the Company filed suit, seeking to claw back Easterbrook's severance package. The complaint alleged that Easterbrook lied during the original investigation into his misconduct and deleted incriminating evidence from his cell phone.

As part of his defense, Easterbrook contended that the Board knew about his relationships when the directors approved his separation agreement. He argued that, at a minimum, the directors should have known, and that the Board did not conduct a more meaningful investigation before agreeing to the terms of his separation because the Board did not want to generate evidence that it had turned a blind eye to Easterbrook's misconduct. Easterbrook advanced that argument to support a defense of waiver. The plaintiffs have embraced the theory to assert that the Director Defendants' acted in their own self-interest when deciding to terminate Easterbrook without cause.

In December 2021, the Company and Easterbrook reached a settlement in which Easterbrook agreed to return or forfeit cash and stock compensation worth $105 million. The settlement included mutual global releases of claims. As part of the settlement,

Easterbrook admitted that he "failed at times to uphold McDonald's values and fulfill certain of my responsibilities." Compl. ¶ 96. He did not retract his allegations that the Board knew about his misconduct.

**K. This Litigation**

Beginning in April 2020, five months after Easterbrook's termination and contemporaneous with the "Vote No" campaign against two Company directors, various stockholders sought books and records to investigate concerns about sexual harassment and misconduct at the Company. Two stockholders filed this action. Certain stockholders who had sought books and records intervened, and the action was stayed pending resolution of their efforts to use the tools at hand to obtain information. After their investigation was complete, the current plaintiffs filed an amended and consolidated complaint.

The operative complaint asserts three counts against the Director Defendants. All of the Director Defendants have served on the Board since at least 2015. The Director Defendants (i) decided to hire Easterbrook and sign off on his relationship with the public relations consultant, (ii) were in office for the duration of Easterbrook and Fairhurst's tenures at the Company, (iii) decided to terminate Fairhurst with cause in November 2019, and (iv) decided to terminate Easterbrook without cause in November 2019. The Director Defendants who served on the Audit Committee adopted Easterbrook's recommendation to discipline Fairhurst and enter into the Last Chance Letter with him in December 2018, rather than terminating him at that point under the Company's purported policy of zero-tolerance for acts of sexual harassment and misconduct.

Count I of the complaint asserts that the Director Defendants breached their fiduciary duties by opting to terminate Easterbrook without cause. Count I also contends that the Director Defendants breached their fiduciary duties by not addressing Easterbrook and Fairhurst's known misconduct earlier. In concrete terms, the plaintiffs seem to assert that the Director Defendants should not have (i) approved Easterbrook's promotion to CEO at a time when he was having a relationship with a consultant or (ii) entered into the Last Chance Letter with Fairhurst.

Count II asserts that the Director Defendants breached their duty of oversight by failing to remedy severe, widespread sexual harassment at the Company.

Count IV is a claim for waste. The plaintiffs contend that by causing the Company to enter into the initial separation agreement with Easterbrook that granted him lucrative separation benefits, the Director Defendants signed off on an agreement that no rational person would support.

The complaint names Easterbrook and Fairhurst as defendants. In Count III, the complaint alleges that Easterbrook and Fairhurst (i) breached their duty of loyalty by engaging in sexual misconduct, (ii) violated the Company's policies by engaging in sexual misconduct, and (iii) breached their duty of oversight by failing to address the problem of sexual harassment and misconduct at the Company. The court entered an order dismissing the claims against Easterbrook because the Company released those claims when it settled with him. Dkt. 86. The court issued a decision holding that the allegations against Fairhurst stated claims on which relief could be granted. *In Re McDonald's Corp. S'holder Deriv. Litig.*, — A.3d —, 2023 WL 387292 (Del. Ch. Jan. 25, 2023).

### L. The SEC Determination

On January 9, 2023, the U.S. Securities and Exchange Commission ("SEC" or "Commission") announced that it had reached a settlement with Easterbrook and the Company concerning their respective public statements about Easterbrook's termination. *See* Dkt. 84 Ex. A. The SEC found that

> Easterbrook did not disclose other physical relationships with company employees and withheld information relevant to the internal investigation. . . . Easterbrook's conduct violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act and caused violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-11 thereunder.

*Id.* ¶ 1. The SEC barred Easterbrook from serving as an officer or director of a public company for a period of five years and imposed a civil penalty of $400,000. *Id.* ¶¶ C, E. The SEC ordered Easterbrook to pay disgorgement and prejudgment interest of $52,728,069, but deemed that order satisfied by Easterbrook's settlement with the Company. *Id.* ¶ D.

The SEC also found that when describing Easterbrook's termination in its proxy statement, the Company violated Section 14(a) of the Exchange Act and Rule 14a-3 by failing to disclose that the Board "exercised discretion in terminating Easterbrook 'without cause' under the relevant compensation plan documents after finding that he violated corporate policy, allowing Easterbrook to retain certain equity-based compensation that would have been forfeited if the company had terminated him for cause." *Id.* ¶ 2. The SEC did not impose a penalty on the Company "based upon its cooperation in a Commission investigation or related enforcement action." *Id.* ¶ G.

## II. LEGAL ANALYSIS

The Director Defendants have moved to dismiss Counts I, II, and IV on multiple grounds, including for failure to state claims on which relief can be granted. *See* Ct. Ch. R. 12(b)(6). When considering a Rule 12(b)(6) motion, the court (i) accepts as true all well-pled factual allegations in the complaint, (ii) credits vague allegations if they give the opposing party notice of the claim, and (iii) draws all reasonable inferences in favor of the plaintiffs. *Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Hldgs. LLC*, 27 A.3d 531, 535 (Del. 2011). The motion to dismiss will be denied "unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances." *Id.*

### A. Count II: The Claim For Breach Of The Duty Of Oversight

In Count II of the complaint, the plaintiffs contend that the Director Defendants breached their duty of oversight by failing to take action to address a toxic corporate culture that condoned sexual harassment and misconduct. Although starting with Count II addresses the counts of the complaint out of order, beginning there is helpful because the plaintiffs contend that the threat of liability that the Director Defendants faced on the theory advanced in Count II provided a reasonably conceivable motivation for the directors to act self-interestedly when taking the actions that the plaintiffs challenge in Count I.

The plaintiffs have failed to state a claim on which relief can be granted against the Director Defendants for breach of the duty of oversight. Although they have pled facts supporting an inference that red flags came to the attention of the Director Defendants, they have not alleged facts supporting a reasonable inference that the Director Defendants acted in bad faith in response to those red flags.

### 1. The Parameters Of A Claim For Breach Of The Duty Of Oversight

A claim for breach of the duty of oversight is known colloquially as a *Caremark* claim, in a tip of the judicial hat to Chancellor Allen's landmark decision. *See In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996). Before *Caremark*, the leading decision on the duty of oversight was *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), which was interpreted to have embraced "the protective 'red flags' rule," under which directors could not be held liable for wrongdoing at the company unless they were confronted with red flags indicating the existence of wrongdoing and failed to address it. Martin Lipton & Theodore N. Mirvis, *Chancellor Allen and the Director*, 22 Del. J. Corp. L. 927, 939 (1997).

The actual analysis in *Graham* was not so stark as the manner in which the case was later understood. The plaintiffs had argued that directors could be held liable "for losses suffered by their corporations by reason of their gross inattention to the common law duty of actively supervising and managing the corporate affairs." *Allis-Chalmers*, 188 A.2d at 130. In a ruling pre-dating the adoption of gross negligence as the liability standard for the duty of care, the Delaware Supreme Court observed that "directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent [persons] would use in similar circumstances." *Id.* The plaintiffs argued that "even though they had no knowledge of any suspicion of wrongdoing on the part of the company's employees, [the directors] still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time

to have brought it to an end." *Id.* The Delaware Supreme Court rejected this argument using language that became the principal legacy of the decision:

> On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.

*Id.*

Despite that language, the Delaware Supreme Court recognized in *Allis-Chalmers* that directors could be held liable if they failed to act where cause for suspicion existed:

> In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.

*Id.* The *Allis-Chalmers* decision thus indicated that directors had no duty to set up a reasonable information system to facilitate board-level oversight. They could rely on management and only needed to act when "grounds for suspicion" came to their attention. *Id.* Those rulings translated into the consensus interpretation that directors had no duty to act except in response to red flags.[3]

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[3] *See, e.g.*, Michael J. Borden, *Of Outside Monitors and Inside Monitors: The Role of Journalists in* Caremark *Litigation*, 15 U. Pa. J. Bus. L. 921, 926–27 (2013) (observing that under *Allis-Chalmers*, "[s]o long as there were no red flags indicating a likelihood of

In *Caremark*, Chancellor Allen artfully explained why the colorful language in *Allis-Chalmers* about a system of corporate espionage "could not be generalized into a rule that, absent grounds for suspected law violation, directors had no duty to assure that an information gathering and reporting system exists to provide senior management and the board with material internal operating information, including as regards legal compliance." Lipton & Mirvis, *supra*, at 939. *Caremark*'s contribution was to explain that a board's fiduciary duties encompass the need to make a good faith effort to ensure that

> information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

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the wrongdoing in question, the board could not be held responsible if it occurred"); Eric J. Pan, *Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine*, 38 Fla. St. U. L. Rev. 209, 212 (2011) ("[*Allis-Chalmers*] introduced the notion that boards have a duty to act when they become aware of wrongdoing (i.e., red flags)."); E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-First Century*, 25 Del. J. Corp. L. 131, 138 (2000) ("The Delaware Supreme Court, in the *Graham v. Allis-Chalmers* case in the mid-'60s said directors would be liable in the event that they were warned by red flags, but perhaps not otherwise." (footnote omitted)). This approach has been compared to "the well-known aphorism that 'every dog gets one bite.'" Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559, 577 (2008). "Just as a dog's master is not liable unless the master knew ex ante that the dog has a propensity to bite, directors are liable under [*Allis-Chalmers*] only if they are on notice that firm employees have a propensity for misconduct. Just as a prior bite puts a dog's master on such notice, prior criminal violations or breaches of fiduciary duty can put directors on notice. Just as masters have an affirmative duty to control dogs of an inherently vicious breed, moreover, directors will be held liable when they recklessly fail to monitor an obviously untrustworthy employee." *Id.*

698 A.2d at 970. In other words, the directors had a basic duty to attempt to obtain information about what was happening within the corporation. They could not opt for the more leisurely role of clam-like passive instrumentalities, awaiting whatever tidbits of information the managerial tides brought their way.

After *Caremark*, considerable debate existed about whether the duty of oversight implicated the duty of loyalty, the duty of care, or both. The *Allis-Chalmers* decision had contemplated potential liability for both. 188 A.2d at 130. Likewise, at different points in the *Caremark* opinion, Chancellor Allen used different formulations of the duty. Some suggested liability for care or loyalty; others spoke in terms of good faith.[4] The corporation in *Caremark* had an exculpatory provision that eliminated director liability for breaches of the duty of care. *See* 698 A.2d at 971 & n.28. Theoretically, therefore, the *Caremark* framework could have contemplated liability for both, but with the exculpatory provision ruling out the possibility of liability for a breach of the duty of care.

Writing as a member of this court, Chief Justice Strine reformulated the nature of the oversight duty and held that director liability for a breach of the duty of oversight requires a showing of bad faith. *See Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003). In *Stone v. Ritter*, the Delaware Supreme Court adopted the *Guttman* formulation and stated

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[4] *See, e.g.*, Bainbridge et al., *supra*, at 596–97 (describing different passages); Robert T. Miller, *Wrongful Omissions by Corporate Directors: Stone v. Ritter and Adapting the Process Model of the Delaware Business Judgment Rule*, 10 U. Pa. J. Bus. & Emp. L. 911, 937–40 (2008) (discussing different formulations).

that a breach of the duty of loyalty, such as action in bad faith, was a "necessary condition to liability." 911 A.2d 362, 369–70 (Del. 2006); *see* Bainbridge et al., *supra*, at 595.

The *Stone* decision identified two possible paths for a plaintiff to plead a claim for breach of the duty of oversight. As the Delaware Supreme Court framed it, to survive a motion to dismiss an oversight claim for failure to plead demand futility under Rule 23.1, a plaintiff must allege particularized facts supporting a reasonable inference that either "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Stone*, 911 A.2d at 370. This framing has led to the claims being called prong-one and prong-two *Caremark* claims. Technically, only a prong-one claim traces its lineage to *Caremark*. A prong-two claim traces its lineage to *Allis-Chalmers*.

A plaintiff typically pleads a prong-one *Caremark* claim by alleging that the board lacked the requisite information system and controls. Using more functional terminology, that species of claim can be called an "Information-Systems Claim" or an "Information-Systems Theory." A plaintiff typically pleads a prong-two *Caremark* claim by alleging that the board's information system generated red flags indicating wrongdoing to which the directors failed to respond. From a functional perspective, the second type of claim can be called a "Red-Flags Claim" or a "Red-Flags Theory." *Cf. City of Detroit Police & Fire Ret. Sys. v. Hamrock*, 2022 WL 2387653, at *17 (Del. Ch. June 30, 2022). The duties underlying

the two species of *Caremark* claim can be called an "Information-Systems Obligation" and a "Red-Flags Obligation," respectively.

**2. Applying Oversight Principles To Sexual Harassment And Misconduct**

Conceptually, nothing prevents a stockholder from asserting a derivative claim for breach of the duty of oversight based on problems involving sexual harassment. *See* Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 Colum. L. Rev. 1583, 1641, 1643–46 (2018). "[C]orporate fiduciaries who fail to monitor harassment at their firms may be liable in certain circumstances under a *Caremark* theory." *Id.* at 1641. And "corporate fiduciaries who are aware of harassment but fail to react—or who affirmatively enable harassment to continue—may be sued for breach of the duties of care and loyalty." *Id.*

Stockholder plaintiffs have brought claims for breach of the duty of oversight based on failures to address sexual harassment and obtained significant results. Stockholders of Twenty-First Century Fox, Inc. filed a derivative suit over sexual harassment at the company by Roger Ailes and Bill O'Reilly, and the company settled for a $90 million payment from its insurers and the establishment of a "Workplace Professionalism and Inclusion Counsel." *See* Stipulation & Agreement of Settlement, Compromise, & Release Ex. A (Non-Monetary Relief), *City of Monroe Empls.' Ret. Sys. v. Murdoch*, C.A. No. 2017-0833-AGB (Del. Ch. Nov. 20, 2017); Hemel & Lund, *supra*, at 1622. Stockholders of Liberty Tax, Inc., a much smaller company, achieved a proportionately more significant settlement in a suit based on sexual harassment and other misconduct by its former CEO, John Hewitt. *See* Stipulation & Agreement of Settlement & Release, *Asbestos Workers'*

*Phila. Pension Fund v. Hewitt*, C.A. No. 2017-0883-AGB (Del. Ch. Mar. 15, 2019); Hemel & Lund, *supra*, at 1623–24.

In this case, the plaintiffs describe their oversight claim as resting on the directors knowing about evidence of sexual misconduct and acting in bad faith by consciously failing to address the misconduct. In other words, the plaintiffs have asserted a Red-Flags Claim. They have not asserted an Information-Systems Claim. They also have not asserted that the Director Defendants consciously caused the Company to violate laws that protect against sexual harassment, such as Title VII of the Civil Rights Act of 1964 or state-level human rights laws. *See* Hemel & Lund, *supra*, at 1610, 1630. That type of claim—known colloquially as a "*Massey* Claim"—is not technically an oversight claim, but it has a similar feel. *See Lebanon Cnty. Empls.' Ret. Fund v. Collis*, 2022 WL 17841215, at *18 (Del. Ch. Dec. 22, 2022).

To plead a Red-Flags Claim, a plaintiff "must plead particularized facts that the board knew of evidence of corporate misconduct—the proverbial red flag—yet acted in bad faith by consciously disregarding its duty to address that misconduct." *Reiter v. Fairbank*, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016); *accord In re Boeing Co. Deriv. Litig.*, 2021 WL 4059934, at *33 (Del. Ch. Sept. 7, 2021). Framed in terms of the pleading standard for the Director Defendants' Rule 12(b)(6) motion, the plaintiffs must plead facts supporting an inference that the red flags came to the attention of the Director Defendants, as well as facts supporting an inference that the Director Defendants consciously failed to take action in response to the red flags. The pled facts must support an inference that the failure to take action was sufficiently sustained, systematic, or striking

to constitute action in bad faith. As an example of the last of the three, a failure to take any action to investigate problems with airplane safety after a devastating airplane crash could support the inference of bad faith necessary for a Red-Flags Claim, even though there was only a single, particularly graphic and devastating red flag. *Cf. Boeing*, 2021 WL 4059934, at *34 (identifying but declining to reach issue). "A claim that directors had notice of serious misconduct and simply brushed it off or otherwise failed to investigate states a claim for breach of duty." *Lebanon Cnty. Empls.' Ret. Fund v. AmerisourceBergen Corp.*, 2020 WL 132752, at *20 (Del. Ch. Jan. 13, 2020), *aff'd,* 243 A.3d 417 (Del. 2020).

To plead a Red-Flags Claim, a plaintiff does not have to plead that the red flags (or a single, striking red flag) concerned "mission critical" risks. That phrase has acquired talismanic importance in the aftermath of *Marchand v. Barhill*, 212 A.3d 805 (Del. 2019), where the Delaware Supreme Court reversed this court's dismissal of an Information-Systems Claim.

In its decision, the Delaware Supreme Court used the "mission critical" phrase exactly once. When rejecting the defendants' argument that management's reports to the board on the company's general operations were enough to constitute a monitoring system, the Court said the following:

> But if that were the case, then *Caremark* would be a chimera. At every board meeting of any company, it is likely that management will touch on some operational issue. Although *Caremark* may not require as much as some commentators wish, it does require that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks. In Blue Bell's case, food safety was essential and mission critical. The complaint pled facts supporting a fair inference that no board-level system of monitoring or reporting on food safety existed.

*Marchand*, 212 A.3d at 824 (footnote omitted).

The mission critical phrase thus appeared in the Court's application of the standard for an Information-Systems Claim to the facts of the case. The rule statement in the decision was that *Caremark* "does require that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks." *Id.* That framing acknowledged that *Caremark* may require more, although not as much as some commentators might wish, but held that the doctrine at least requires attention to the corporation's central compliance risks.

Turning to the facts in *Marchand*, the Delaware Supreme Court reasoned that food safety was a central compliance risk because it "was essential and mission critical." *Id.* That does not mean that *Caremark* only applies to "essential and mission critical risks." Although it is fair to infer that all "essential and mission critical risks" qualify as "central compliance risks," it is also possible that some "central compliance risks" may not reach the level of "essential and mission critical."

The *Marchand* decision did not address a Red-Flags Claim. Not surprisingly, the decision did not refer to the concept of mission critical risks as part of a Red-Flags Claim.

In post-*Marchand* cases, litigants have focused intently on the "mission critical" phrase. That is understandable. For plaintiffs, the *Marchand* case provided a template for surviving a motion to dismiss, and alleging that a particular risk was "mission critical" become part of the template. For defendants, turning the application of the test into the standard made the standard tougher to meet. A case in which the facts clear the bar set by the operative test will include statements describing why that is true. By logical necessity,

the description will be more extreme than the test. The *Marchand* case exemplifies that reality. The phrase "essential and mission critical" deploys more intense terms to explain why those risks qualified as "central compliance risks." By taking the more intense words from the application and reframing them as the standard, the defendants can boost the standard.[5]

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[5] Although the reframing of the standard favors the defendants in this scenario, both sides of the caption can find it advantageous. One example that I have discussed in other cases involves a response to the Delaware Supreme Court's holding in *Dell* that the management buyout in that case had sufficient indicia of pricing reliability to deserve "heavy, if not dispositive weight" for determining fair price in an appraisal. *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*, 177 A.3d 1, 23 (Del. 2017). Summarizing its reasoning, the high court characterized the sale process in that case as featuring "fair play, low barriers to entry, outreach to all logical buyers, and the chance for any topping bidder to have the support of Mr. Dell's own votes." *Id.* at 35. After that decision, appraisal petitioners attempted to reframe those indicia as the floor for a transaction that was sufficiently reliable to warrant receiving weight in the fair value determination. By doing so, they attempted to treat the factual application as if it were the test. But all that the Delaware Supreme Court held in *Dell*—and in sister cases like *DFC* and *Aruba*—was that the sale processes in those cases were sufficiently good to deserve heavy, if not dispositive, weight. "The decisions did not address when a sale process would be sufficiently bad that a trial court could give the deal price no weight. The decisions also did not address when a sale process that was not as good would still be good enough for a trial court to give the deal price weight. Technically, the holdings did not delineate when a sale process was sufficiently good that the trial court should give it heavy if not dispositive weight. The Delaware Supreme Court could have believed the sale processes in [those cases] warranted that level of consideration without excluding the possibility that a not-as-good sale process could deserve the same treatment." *In re Appraisal of Columbia Pipeline Grp., Inc.*, 2019 WL 3778370, at *42 (Del. Ch. Aug. 12, 2019) (discussing *Dell*, *DFC Glob. Corp. v. Muirfield Value P'rs*, 172 A.3d 346 (Del. 2017), and *Verition P'rs Master Fund Ltd. v. Aruba Networks, Inc.*, 210 A.3d 128 (Del. 2019)); *accord In re Stillwater Mining Co.*, 2019 WL 3943851, at *21–22 (Del. Ch. Aug. 21, 2019), *aff'd sub nom. Brigade Leveraged Cap. Structures Fund Ltd. v. Stillwater Mining Co.*, 240 A.3d 3 (Del. 2020). Another example that I discussed recently involves the Delaware Supreme Court's decision in *Papendick v. Bosch GmbH*, 410 A.2d 148 (Del. 1979), where the high court addressed whether the formation of a Delaware entity could supply the necessary minimum contacts with this state to support personal jurisdiction over its parent corporation. *Id.* at 152. When applying

The *Marchand* decision actually holds that when directors fail to make any effort to establish an information system to address central compliance risks, then that failure supports an inference of bad faith. The extent to which the Information-Systems Obligation might extend to other risks depends on the facts. Time and attention are precious commodities, and with limited supplies of each, officers and directors must make judgments about what risks to monitor. When making those decisions, officers and directors are presumed to act loyally, in good faith, and with due care (*i.e.*, on an informed basis). Unless one of those presumptions is rebutted, the decision is protected by the business judgment rule. Outside of central compliance risks, including essential or mission critical risks, a plaintiff will have difficulty rebutting the business judgment rule where officers or directors have made a good faith decision regarding the level of monitoring resources, if any, to assign to a risk.

The concept of central compliance risks, including essential or mission critical risks, does not play a similar role for a Red-Flags Claim. If an officer or director learns of evidence indicating that the corporation is suffering or will suffer harm, then the officer or

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the minimum contacts test, the senior tribunal cited several factors, including that the formation of the acquisition vehicle had been "an integral component of [the] total transaction . . . to which the plaintiff's instant cause of action relates." *Id.* at 20. Since *Papendick*, parties arguing against the assertion of personal jurisdiction have argued that the formation of a Delaware entity must be "an integral component" of the challenged transaction, thereby converting the case-specific application of the minimum contacts test into a new and more onerous integral-component test. *See Harris v. Harris*, — A.3d —, 2023 WL 165967, at *19–20 (Del. Ch. Jan. 12, 2023) (discussing the reinterpretation of *Papendick*; "The *Papendick* court did not hold that meeting 'an integral component' test was required to establish jurisdiction.").

director has an obligation to respond. To mix metaphors, a red flag can come out of the blue.

The decision about what to do in response to a red flag is one that an officer or director is presumed to make loyally, in good faith, and on an informed basis, so unless one of those presumptions is rebutted, the response is protected by the business judgment rule. That generally means that a plaintiff can only plead a Red-Flags Claim by alleging facts supporting an inference of bad faith. And that is where the concept of central compliance risks, including essential or mission critical risks, can reenter the analysis. All else equal, if a red flag concerns a central compliance risk, then it is easier to draw an inference that a failure to respond meaningfully resulted from bad faith. Vice Chancellor Slights explained this point in *Clovis* when he repeated the oft-quoted phase that "red flags are only useful . . . when visible to the careful observer," and added the gloss that "as *Marchand* makes clear, the careful observer is one whose gaze is fixed on the company's mission critical regulatory issues."[6] A fixed gaze does not mean tunnel vision, and the expectation that fiduciaries will respond more readily to red flags affecting core compliance risks does not mean that fiduciaries can ignore red flags about other risks. Put differently, an inference of bad faith is more likely when a red flag concerns an essential

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[6] *In re Clovis Oncology, Inc. Deriv. Litig.*, 2019 WL 4850188, at *13 (Del. Ch. Oct. 1, 2019); *accord Teamsters Local 443 Health Servs. & Ins. Plan v. Chou*, 2020 WL 5028065, at *18 (Del. Ch. Aug. 24, 2020); *In re MetLife Ins. Deriv. Litig.*, 2020 WL 4746635, at *14 (Del. Ch. Aug. 17, 2020).

or mission critical risk, but a Red-Flags Claim is not dependent on the signal relating to an essential or mission critical risk.

The plaintiffs therefore were not obligated to plead that the red flags associated with the Company's culture of sexual harassment and misconduct involved a mission critical risk, nor is the court required to draw an inference of mission criticality before the plaintiffs can state a claim. But assuming that hurdle did exist, the plaintiffs cleared it.

It is easy to draw a pleading-stage inference that maintaining employee safety is both essential and mission critical. The fiduciary principle requires that directors and officers act prudently, loyally, and in good faith to maximize the value of the corporation over the long-term for the benefit of the holders of its undifferentiated equity, who have presumptively committed their permanent capital to an entity with a presumptively permanent existence. *Frederick Hsu Living Tr. v. ODN Hldg. Corp.*, 2017 WL 1437308, at *18 (Del. Ch. Apr. 14, 2017). Employees perform the work that affects the value of the corporation. To remain true to the fiduciary principle and build value over the long term, corporate fiduciaries must take care of the corporation's workers.

Compliance with labor and employment law is an essential corporate obligation. Sexual harassment and misconduct render the workplace unsafe. Acts of sexual harassment and misconduct can result in serious injury to the corporation. The acts obviously harm the affected employees. At the same time, the acts jeopardize the corporation's relationship with other employees, create a risk that customers and clients will defect to competitors, and subject the corporation to potential liability under state and federal law.

Here, the contents of the Section 220 production provide case-specific support for viewing sexual harassment and misconduct as a serious risk. In September 2019, the Board received an update on the Company's enterprise risk that identified a "Respectful Workplace" as a "New Risk Theme" at the "Top Tier 2" level. Ex. 52 at '138. Under the Company's risk management system, Top Tier 2 risks are "[m]ore likely to become Tier 1 risks given the right circumstances." *Id.* Tier 1 risks include those that are "[*c*]*ritical* to McDonald's *mission* and values." *Id.* (emphasis added). The court does not have to infer that sexual harassment and misconduct constituted a mission critical risk. The Company said it.[7]

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[7] A case from more than two decades ago does not cast doubt on the significance of sexual harassment and misconduct as a risk that corporate fiduciaries must address. *See White v. Panic*, 783 A.2d 543 (Del. 2001). The alleged harm to the corporation in the *Panic* case resulted from a board of directors having approved serial settlements in eight different sexual harassment suits filed against the corporation and its CEO. *Id.* at 552. The Delaware Supreme Court declined to draw a pleading-stage inference that the directors were on notice that the CEO had harassed female employees or engaged in conduct for which the corporation could be held liable. *Id.* Having declined to draw an inference of knowledge, the high court also declined to infer that the directors could have acted intentionally or with reckless disregard for their fiduciary duties when approving the settlements and taking other actions that allegedly condoned or encouraged the CEO's misconduct. *Id.* The Court saw no reason to view the series of settlements as "anything other than routine business decisions." *Id.* at 553. The Court also noted that the plaintiff had failed to conduct a pre-suit investigation using Section 220. *Id.* at 556–57. Since the *Panic* case, there has been much hard-won learning on the subjects of sexual harassment and misconduct, the harm they cause, and the risks they pose to a corporation. *See generally* Amelia Miazad, *Sex, Power, and Corporate Governance*, 54 U. Cal. Davis L. Rev. 1913, 1915–21 (2021) (describing changes in the corporate governance ecosystem catalyzed by the #MeToo movement)); Tom C.W. Lin, *Executive Private Misconduct*, 88 Geo. Wash. L. Rev. 327, 341 (2020) (describing the contemporary socioeconomic landscape in which the private misconduct of executives can have "very serious and often public consequences" for their

### 3. The Existence Of Red Flags In This Case

The plaintiffs' Red-Flags Claim asserts that a culture of sexual harassment and misconduct was allowed to develop at the Company. As their evidence of red flags that should have put the Director Defendants on notice, the plaintiffs cite a series of events:

- Easterbrook and Fairhurst promoted a party atmosphere at corporate headquarters that included alcohol at Company events and drinking excursions with Company employees.
- In October 2016, over a dozen Company employees filed complaints with the EEOC.
- In May 2018, over a dozen Company employees filed complaints with the EEOC.
- In September 2018, Company workers from ten cities organized a one-day strike to protest the Company's culture of sexual harassment.
- In November 2018, Fairhurst engaged in an act of sexual harassment at a party for the human resources staff.
- In December 2018, the Board learned about Fairhurst's misconduct and required that he enter into the Last Chance Letter.
- Also in December 2018, Senator Duckworth wrote a letter to the Company about sexual harassment complaints against the Company.
- In June 2019, Senator Duckworth joined with seven other United States Senators in writing to the Company and asking specific questions about sexual harassment and workplace safety.
- In October 2019, the Board learned that Easterbrook was engaging in a prohibited relationship with a Company employee.
- In November 2019, after investigating Easterbrook's misconduct, the Board terminated Easterbrook without cause.

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corporations; discussing contributing factors, including "the #MeToo movement, changing understandings of public and private, and evolving societal expectations").

- Also in November 2019, the Board terminated Fairhurst with cause, inferably because he had violated the terms of his Last Chance Letter and engaged in an additional act of sexual harassment.

- Also in November 2019, workers filed the *Ries* Action against the Company alleging that it had a toxic culture that accommodates sexual harassment.

- A survey conducted in 2019, reported that more than 75% of McDonald's workers had been sexually harassed while on the job, and 71% of those employees suffered negative consequences for reporting the harassment.

- In April 2020, workers filed the *Fairley* Action against the Company, seeking damages for sexual harassment, retaliation, and related misconduct.

Although the plaintiffs reference the party atmosphere as a red flag, they do not plead when or how the Director Defendants learned about it. They instead appear to contend that the Director Defendants acted improperly by failing "to take affirmative remedial steps in the face of clear red flags from lawmakers, regulators, civil rights groups, and—perhaps most glaringly—McDonald's own employees concerning the rampant sexual harassment occurring at the Company's restaurants." Dkt. 67 at 69. They thus focus on the events that occurred in 2018 and 2019.

Relying on distinguishable precedent, the Director Defendants maintain that those events did not rise to the level of red flags.[8] They argue that the Company faces constant

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[8] The Director Defendants cite *Fisher v. Sanborn*, 2021 WL 1197577 (Del. Ch. Mar. 30, 2021), and *Pettry v. Smith*, 2021 WL 2644475 (Del. Ch. June 28, 2021). The *Fisher* decision declined to infer that a single action brought by a government agency constituted a red flag. 2021 WL 1197577, at *12–13, 16. The events of 2018 are more striking than that. The *Pettry* decision involved shipments of cigarettes that were immaterial in the context of the company's business. 2021 WL 2644475, at *9 n.101. This case involves the much more serious issue of a safe and respectful work environment, which is an issue for all employees.

pressure from unions, campaign groups, media, and politicians on employment-related issues like wages and sexual harassment. Perhaps, but the events of 2018 went beyond that. It is reasonable to infer that (i) a second round of coordinated filings of multiple EEOC complaints, (ii) a ten-city strike, and (iii) the letter from Senator Duckworth constituted a collective red flag.

Regardless, the indisputable red flag came in December 2018, when the Director Defendants learned that Fairhurst, the Company's Global Chief People Officer and the executive officer charged with day-to-day responsibility for ensuring that the Company maintained a safe and respectful environment, had engaged in two acts of sexual harassment. The act of sexual harassment from November 2018 was witnessed by over thirty employees and involved Fairhurst physically pulling an employee onto his lap. The investigation into that incident uncovered another instance of sexual harassment from December 2016.

When the head of human resources has engaged in multiple acts of sexual harassment, that is enough to put directors on notice of problems in the human resources area. Such an individual has evidenced a profound failure to understand the importance of a safe and respectful workplace or what that concept requires. Having such an individual in the position of Global Chief People Officer calls into question the integrity of the Company's human resources policies and the fairness of how they are applied in practice.

The plaintiffs have pled facts supporting an inference that by the end of 2018, the Director Defendants were on notice of problems at the Company with sexual harassment

and misconduct that had caused or threatened to cause the Company harm. That satisfies the first element of their Red-Flags Claim.

#### 4. The Response To The Red Flags In This Case

The plaintiffs next argue that the Director Defendants failed to respond to the red flags. That is where their Red-Flags Claim falls short.

The plaintiffs have pled facts supporting an inference that until the end of 2018, the Director Defendants were operating in business-as-usual mode. The Director Defendants received regular reports on litigation facing the Company, and those reports referenced claims like the EEOC complaints, but there are no documents in the Section 220 production that indicate any effort by the Director Defendants to investigate or address problems with sexual harassment and misconduct at the Company.

That business-as-usual attitude changed at the end of 2018. At that point, Company management began taking action, and the Director Defendants began focusing on the issue. In January 2019, management reported to the Strategy Committee about the EEOC complaints, the ten-city strike, and the communications from Senator Duckworth. *See* Ex. 49. Company management advised the Strategy Committee that teams of employees were "proactively working to improve policies and programs related to these issues," including modified and improved policies on sexual harassment and new training programs aimed at a safe and respectful workplace. *Id.* at 2. In May 2019, Company management reported on these issues to the full Board. *See* Ex. 51 at 8.

In June 2019, the Strategy Committee held a special meeting devoted to the issue of sexual harassment and misconduct. Company management provided the Strategy

Committee with the June 2019 Memorandum, which described the issues facing the Company and the steps that Company management was taking. Ex. 47 at 1. As discussed in the Factual Background, those steps included:

- The adoption of an updated anti-harassment policy.
- Retaining RAINN to advise the Company.
- A holistic review of the Company's training programs.
- The retention of Seyfarth Shaw at Work to design new and additional training programs.
- A new hotline for employees at franchise restaurants.
- A shared values commitment to be signed by franchisees
- A franchisee guide containing best practices and recommendations on establishing and maintaining a safe and respectful workplace.
- A cultural assessment, including listening sessions to promote continuous improvement.
- An end to the Company's previous policy requiring mandatory arbitration of harassment and discrimination claims as a condition of employment.

*Id.* at 2–4. At the end of the meeting, the chair of the Strategy Committee "concluded the discussion by confirming that the Company (i) has developed a comprehensive plan around the issues of sexual harassment and safe and respectful workplace environments; (ii) will continue to be proactive; and (iii) will further evaluate how best to execute its strategy and be a leader on this issue." Ex. 50 at 3.

The Director Defendants also elevated the importance of addressing sexual harassment and misconduct as an enterprise risk. In September 2019, the Board received an update on the Company's enterprise risk management that identified a "Respectful

Workplace" as a "New Risk Theme" at the "Top Tier 2" level. Ex. 52 at 14. That same month, during a special meeting of the Strategy Committee, Company management reported on a strategy to improve the Company's reputation as an employer. Ex. 55 at 1.

Finally, in November 2019, when the Board learned about Easterbrook's involvement in an improper relationship with an employee, the Board terminated him, albeit without cause. At the same meeting, after learning that Fairhurst had violated the terms of his Last Chance Letter, the Board terminated him with cause.

The plaintiffs disregard those actions and argue that it was not until July 2020 that the Strategy Committee considered adopting "[n]ew US brand standards [that] will ensure both [Company-owned restaurants] and franchisees provide safe, respectful, healthy and inclusive workplaces," including "sexual harassment training." Compl. ¶ 127. That is not a reasonable inference to draw from the pleading-stage record.

There is some evidence in the record suggesting that the interventions in 2019 did not fix the problem. Minutes from a meeting of the full Board on May 23, 2019, record the Company's general counsel making a report on another round of EEOC complaints that resembled the "the previous EEOC charges regarding similar topics that had been filed in 2018." Ex. 51 at 8. Whether the response fixed the problem is not the test. Fiduciaries cannot guarantee success, particularly in fixing a sadly recurring issue like sexual harassment. What they have to do is make a good faith effort.

The pleading-stage record shows that the Director Defendants responded to the red flags regarding the toxic culture that was developing at the Company. Because of the effort they made, it is not possible to infer that the Director Defendants acted in bad faith. The

claim for breach of the duty of oversight therefore fails to state a claim on which relief can be granted.

### B. Count I: The Decisions To Promote Easterbrook To CEO, Discipline Fairhurst, And Terminate Easterbrook Without Cause

In Count I of the complaint, the plaintiffs challenge three decisions that the Director Defendants made: (i) the decision to promote Easterbrook to CEO, (ii) the decision to discipline Fairhurst by having him enter into the Last Chance Letter, and (iii) the decision to terminate Easterbrook without cause. The business judgment rule protects each decision.

To determine whether directors have complied with their fiduciary duties, Delaware courts evaluate their actions through the lens of a standard of review. "Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness." *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011).

Delaware's default standard of review is the business judgment rule. That standard of review presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[9] Unless a plaintiff rebuts one of the elements of the rule,

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[9] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). In *Brehm v. Eisner*, the Delaware Supreme Court overruled seven decisions, including *Aronson*, to the extent those precedents reviewed a Rule 23.1 decision by the Court of Chancery under an abuse of discretion standard or otherwise suggested deferential appellate review. *See* 746 A.2d 244, 253 n.13 (Del. 2000) (overruling in part on this issue *Scattered Corp. v. Chi. Stock Exch.*, 701 A.2d 70, 72–73 (Del. 1997); *Grimes v. Donald*, 673 A.2d 1207, 1217 n.15 (Del. 1996); *Heineman v. Datapoint Corp.*, 611 A.2d 950, 952 (Del. 1992); *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991); *Grobow v. Perot*, 539 A.2d 180, 186 (Del. 1988); *Pogostin v. Rice*,

"the court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation's objectives." *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 598 (Del. Ch. 2010). Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty.[10] The business judgment rule thus provides "something as close to non-review as our law contemplates." *Kallick v. Sandridge Energy, Inc.*, 68 A.3d 242, 257 (Del. Ch. 2013). This standard of review "reflects and promotes the role of the board of directors as the proper body to

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480 A.2d 619, 624–25 (Del. 1984); and *Aronson*, 473 A.2d at 814). The *Brehm* Court held that going forward, appellate review of a Rule 23.1 determination would be *de novo* and plenary. 746 A.2d at 253. The seven partially overruled precedents otherwise remain good law. This decision does not rely on any of them for the standard of appellate review. Having described *Brehm*'s relationship to these cases, this decision omits the cases' cumbersome subsequent history, because stating that they were overruled by *Brehm* creates the misimpression that *Brehm* rejected a series of foundational Delaware decisions.

More recently, the Delaware Supreme Court overruled *Aronson* and *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), to the extent that they set out alternative tests for demand futility. *United Food & Com. Workers Union & Participating Food Indus. Empls. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. 2021). The high court adopted a single, unified test for demand futility. Although the *Zuckerberg* test displaced the prior tests, cases properly applying *Aronson* and *Rales* remain good law. *Id.* This decision therefore does not identify any precedents, including *Aronson* and *Rales*, as having been overruled by *Zuckerberg*.

[10] *See Brehm*, 746 A.2d at 264 ("Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule." (footnote omitted)); *In re J.P. Stevens & Co. S'holders Litig.*, 542 A.2d 770, 780–81 (Del. Ch. 1988) (Allen, C.) ("A court may, however, review the substance of a business decision made by an *apparently* well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." (internal citation omitted)).

manage the business and affairs of the corporation." *In re Trados Inc. S'holder Litig.* (*Trados I*), 2009 WL 2225958, at *6 (Del. Ch. July 24, 2009). *See generally* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L. Rev. 83 (2004).

Delaware's most onerous standard of review is the entire fairness test. When entire fairness governs, the defendants must establish "to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995) (citation omitted). "Not even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be objectively fair, independent of the board's beliefs." *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1145 (Del. Ch. 2006).

In between lies enhanced scrutiny, which is Delaware's "intermediate standard of review." *In re Trados Inc. S'holder Litig.* (*Trados II*), 73 A.3d 17, 43 (Del. Ch. 2013). It applies to "specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decisionmaking context can subtly undermine the decisions of even independent and disinterested directors."[11] Inherent in these situations

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[11] *Id.*; *accord Reis*, 28 A.3d at 457–59; *see Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994) ("[T]here are rare situations which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable."); *Dollar Thrifty*, 14 A.3d at 598 ("In a situation where heightened scrutiny applies, the predicate question of what the board's true motivation was comes into play. The court must take a nuanced and realistic look at the

are subtle structural and situational conflicts that do not rise to a level sufficient to trigger entire fairness review, but also do not comfortably permit expansive judicial deference.[12] Framed generally, enhanced scrutiny requires that the defendant fiduciaries "bear the burden of persuasion to show that their motivations were proper and not selfish" and that "their actions were reasonable in relation to their legitimate objective." *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 810 (Del. Ch. 2007).

The analysis starts with the default standard of the business judgment rule. None of the established situations in which enhanced scrutiny applies are present in this case, rendering that standard inapplicable. The question is whether the plaintiffs have alleged facts sufficient to rebut the presumptions of the business judgment rule, thereby creating a pleading stage inference that the Director Defendants will bear the burden of proving that their actions were entirely fair. Because the Director Defendants have not argued that their

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possibility that personal interests short of pure self-dealing have influenced the board to block a bid or to steer a deal to one bidder rather than another.").

[12] *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54, 82 (Del. Ch. 2014), *aff'd sub nom. RBC Cap. Mkts., LLC v. Jervis*, 129 A.3d 816 (Del. 2015); *accord Huff Energy Fund, L.P. v. Gershen*, 2016 WL 5462958, at *13 (Del. Ch. Sept. 29, 2016); *see Dollar Thrifty*, 14 A.3d at 597 ("Avoiding a crude bifurcation of the world into two starkly divergent categories—business judgment rule review reflecting a policy of maximal deference to disinterested board decisionmaking and entire fairness review reflecting a policy of extreme skepticism toward self-dealing decisions—the Delaware Supreme Court's *Unocal* and *Revlon* decisions adopted a middle ground."); *Golden Cycle, LLC v. Allan*, 1998 WL 892631, at *11 (Del. Ch. Dec. 10, 1998) (locating the *Unocal* and *Revlon* enhanced scrutiny standard between the business judgment rule and the entire fairness test).

decisions were entirely fair, rebutting the business judgment rule would result in the denial of their Rule 12(b)(6) motion.

At the pleading stage, to change the standard of review from the business judgment rule to entire fairness, the complaint must allege facts supporting a reasonable inference that there were not enough sufficiently informed, disinterested individuals who acted in good faith when taking the challenged actions to comprise a board majority. *See Aronson*, 473 A.2d at 812. Consequently, to determine whether to intensify the standard of review from business judgment to entire fairness, a court counts heads. *Frederick Hsu Living Tr.*, 2017 WL 1437308, at *26. If a director-by-director analysis leaves insufficient directors to make up a board majority, then the court will review the decision for entire fairness. *Id.*

"[T]he burden of pleading and proof is on the party challenging the decision to allege facts to rebut the presumption." *Solomon v. Armstrong*, 747 A.2d 1098, 1111–12 (Del. Ch. 1999). To plead that a director was interested and therefore cannot count toward the requisite majority, a plaintiff can allege facts showing that the director received "a personal financial benefit from a transaction that is not equally shared by the stockholders."[13] Or a plaintiff can allege facts showing that the director was a dual fiduciary

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[13] *Rales*, 634 A.2d at 936 (citations omitted); *accord Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally."); *Pogostin*, 480 A.2d at 624 ("Directorial interest exists whenever . . . a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.").

and owed a competing duty of loyalty to an entity that itself stood on the other side of the transaction or received a unique benefit not shared with the stockholders.[14] To plead that a director was not independent and therefore cannot count toward the requisite board majority, a plaintiff can plead facts showing a director is sufficiently loyal to, beholden to, or otherwise influenced by an interested party to undermine the director's ability to judge the matter on its merits.[15]

A plaintiff also may challenge a director's ability to count as part of the requisite majority by alleging facts that call into question whether the director acted in good faith. Delaware law "clearly permits a judicial assessment of director good faith" for the purpose

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[14] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding that officers of parent corporation faced conflict of interest when acting as subsidiary directors regarding transaction with parent); *accord Sealy Mattress Co. of N.J., Inc. v. Sealy, Inc.*, 532 A.2d 1324, 1336 (Del. Ch. 1987) (same); *see also Trados I*, 2009 WL 2225958, at *8 (treating directors as interested for pleading purposes in transaction that benefited preferred stockholders when "each had an ownership or employment relationship with an entity that owned Trados preferred stock").

[15] *Aronson*, 473 A.2d at 815 (stating that one way to allege successfully that an individual director is under the control of another is by pleading "such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person"); *Friedman v. Beningson*, 1995 WL 716762, at *4 (Del. Ch. Dec. 4, 1995) (Allen, C.) ("The requirement that directors exercise *independent judgment,* (*insofar as it is a distinct prerequisite to business judgment review from a requirement that directors exercise financially disinterested judgment*[])], directs a court to an inquiry into all of the circumstances that are alleged to have inappropriately affected the exercise of board power. This inquiry may include the subject of whether some or all directors are 'beholden' to or under the control, domination or strong influence of a party with a material financial interest in the transaction under attack, which interest is adverse to that of the corporation."). Classic examples involve familial relationships, such as a parent's love for and loyalty to a child. *See, e.g.*, *Harbor Fin. P'rs v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999).

of rebutting the business judgment rule. *In re Walt Disney Co. Deriv. Litig.* (*Disney II*), 906 A.2d 27, 53 (Del. 2006); *accord eBay Domestic Hldgs., Inc. v. Newmark*, 16 A.3d 1, 40 (Del. Ch. 2010). Bad faith encompasses both "an intent to harm [and] also intentional dereliction of duty."[16] "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation."[17] "It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation."[18] Bad faith can be the result of "any emotion [that] may cause a director to [intentionally] place his own interests, preferences or

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[16] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 240 (Del. 2009); *accord Disney II*, 906 A.2d at 64–66 (defining "subjective bad faith" as "conduct motivated by an actual intent to do harm," which "constitutes classic, quintessential bad faith," and "intentional dereliction of duty" as "a conscious disregard for one's responsibilities").

[17] *Disney II*, 906 A.2d at 67; *accord Stone*, 911 A.2d at 369 ("A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation . . . ."); *see Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996) (Allen, C.) (defining a "bad faith" transaction as one "that is authorized for some purpose *other than* a genuine attempt to advance corporate welfare or is *known to constitute* a violation of applicable positive law"); *In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989) (Allen, C.) (explaining that the business judgment rule would not protect "a fiduciary who could be shown to have caused a transaction to be effectuated (even one in which he had no financial interest) for a reason unrelated to a pursuit of the corporation's best interests").

[18] *In re Walt Disney Co. Deriv. Litig.* (*Disney I*), 907 A.2d 693, 760–79 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006); *see Nagy v. Bistricer*, 770 A.2d 43, 48 n.2 (Del. Ch. 2000) ("[R]egardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes," even if for a reason "other than personal pecuniary interest.").

appetites before the welfare of the corporation," including greed, "hatred, lust, envy, revenge, . . . shame or pride."[19]

### 1. The Decision To Promote Easterbrook To CEO

The plaintiffs contend that the Director Defendants breached their fiduciary duties in 2015 when they elevated Easterbrook to the position of CEO. The plaintiffs' principal objection is that when the Board made Easterbrook CEO, the directors knew that he was engaged in an intimate relationship with a public relations consultant. The plaintiffs allege that the relationship violated the terms of the Company's Dating, Nepotism and Fraternization Policy, which prohibited an employee from engaging in a relationship with an independent contractor or vendor when the employee had "the direct or indirect authority to engage the services of such independent contractor or vendor." Compl. ¶ 46.

The Director Defendants respond that Easterbrook's relationship was not a policy violation because, before Easterbrook became CEO, he did not have direct or indirect authority to engage the firm that employed the consultant. That response contradicts the complaint, which asserts that as Chief Brand Officer, Easterbrook oversaw the Company's public relations function and had direct or indirect authority over the consultant. Everyone agrees that after Easterbrook became CEO, he did have that authority, and the Board "sign[ed] off on the relationship under assurances that [the consultant] would be removed

[19] *RJR Nabisco*, 1989 WL 7036, at *15; *see Guttman*, 823 A.2d at 506 n.34 ("The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless.").

from the McDonald's account." *Id.* The plaintiffs object that the Board never followed up to ensure that the contractor was removed from the Company's account.

The decision to hire Easterbrook on the terms that the Director Defendants set was a classic business judgment. The plaintiffs have not pled facts sufficient to rebut any of the business judgment rule's presumptions. They have not alleged that any of the Director Defendants had an interest in the decision to promote Easterbrook, nor that any Director Defendant was otherwise not independent. A board has authority to authorize exceptions to corporate policies. Granting exceptions may be unwise, but an exception by itself does not suggest a fiduciary breach. It is not reasonably conceivable that the decision to promote Easterbrook was made in bad faith.

At most, the Director Defendants might have erred by failing to follow up on Easterbrook's relationship. That type of allegation implicates the duty of care. As in *Allis-Chalmers*, the Delaware Supreme Court has continued to recognize that directors have a fiduciary obligation to "inform themselves, prior to making a business decision, of all material information reasonably available to them."[20] But while that standard speaks of reasonableness, "under the business judgment rule director liability is predicated upon

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[20] *Aronson*, 473 A.2d at 812; *accord Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson*); *id.* at 877 ("Here, the issue is whether the directors informed themselves as to all information that was reasonably available to them.").

concepts of gross negligence." *Aronson*, 473 A.2d at 812. In the corporate context, gross negligence has its own special meaning that is akin to recklessness.[21]

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[21] *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 652 n.45 (Del. Ch. 2008) ("[T]he definition [of gross negligence in corporate law] is so strict that it imports the concept of recklessness into the gross negligence standard . . . ."); *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at *4 (Del. Ch. Aug. 26, 2005) ("Gross negligence has a stringent meaning under Delaware corporate (and partnership) law, one which involves a devil-may-care attitude or indifference to duty amounting to recklessness." (cleaned up)); *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) ("In the corporate context, gross negligence means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." (cleaned up)); *Solash v. Telex Corp.*, 1988 WL 3587, at *9 (Del. Ch. Jan. 19, 1988) (Allen, C.) (explaining that to be grossly negligent, a decision "has to be so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion" (cleaned up)).

In civil cases not involving business entities, the Delaware Supreme Court has defined gross negligence as "a higher level of negligence representing 'an extreme departure from the ordinary standard of care.'" *Browne v. Robb*, 583 A.2d 949, 953 (Del. 1990) (quoting W. Prosser, *Handbook of the Law of Torts* 150 (2d ed. 1955)). This test "is the functional equivalent" of the test for "[c]riminal negligence." *Jardel Co., Inc. v. Hughes*, 523 A.2d 518, 530 (Del. 1987). By statute, Delaware law defines "criminal negligence" as follows:

> A person acts with criminal negligence with respect to an element of an offense when the person fails to perceive a risk that the element exists or will result from the conduct. The risk must be of such a nature and degree that failure to perceive it constitutes a gross deviation from the standard of conduct that a reasonable person would observe in the situation.

11 *Del. C.* § 231(a). The same statute provides that a person acts recklessly when "the person is aware of and consciously disregards a substantial and unjustifiable risk that the element exists or will result from the conduct." *Id.* § 231(e). As with criminal negligence, the risk "must be of such a nature and degree that disregard thereof constitutes a gross deviation from the standard of conduct that a reasonable person would observe in the situation." *Id.*; *see id.* § 231(a). Under this framework, gross negligence "signifies more than ordinary inadvertence or inattention," but it is "nevertheless a degree of negligence, while recklessness connotes a different type of conduct akin to the intentional infliction of harm." *Jardel*, 523 A.2d at 530. The comparison shows the protectiveness of Delaware's

The decision to hire Easterbrook based on an assurance that the consultant would be removed, even without any intention to follow up, did not constitute gross negligence. It does not even rise to the level of simple negligence. The Board was entitled to rely on the assurance it received from Easterbrook. *See* 8 *Del. C.* § 141(e). The allegations regarding the hiring of Easterbrook do not support a claim on which relief could be granted.

### 2. The Decision To Discipline Fairhurst Rather Than Terminate Him

The plaintiffs contend that the three Director Defendants who served on the Audit Committee breached their fiduciary duties in December 2018 when they decided to discipline Fairhurst and require that he agree to the Last Chance Letter rather than terminating him with cause. The Company had a zero-tolerance policy for sexual harassment, yet the Audit Committee made an exception for Fairhurst. The plaintiffs criticize the Audit Committee for relying on Easterbrook to report on the matter and propose a set of consequences, when Easterbrook was Fairhurst's colleague, longtime personal friend, and drinking buddy.

In hindsight, there are many reasons to disagree with the Audit Committee's decision to offer Fairhurst one last chance. Nevertheless, that decision was a classic business judgment. The plaintiffs have not alleged that any of the Director Defendants on the Audit Committee had an interest in the decision or was otherwise not independent. It

standard: To hold a director liable for gross negligence requires conduct more serious than what is necessary to secure a conviction for criminal negligence.

is not reasonably conceivable that the decision to discipline Fairhurst rather than fire him was made in bad faith.

The plaintiffs' process-based criticisms implicate the duty of care. The complaint's allegations do not support an inference that the Audit Committee lacked any pertinent information. At worst for the members of the Audit Committee, they acted unreasonably by relying on Easterbrook notwithstanding his close friendship with Fairhurst. That failing would amount to simple negligence, not gross negligence. Even if it rose to the level of gross negligence, the Director Defendants are exculpated for breaches of the duty of care, so that theory fails to state a claim on which relief can be granted. *See In re Cornerstone Therapeutics Inc, S'holder Litig.*, 115 A.3d 1173, 1180 (Del. 2015).

The allegations regarding the disciplining of Fairhurst do not support a viable claim.

**3. The Decision To Terminate Easterbrook Without Cause**

The plaintiffs finally contend that the Director Defendants breached their fiduciary duties in November 2019 when they decided to terminate Easterbrook without cause after a short investigation that did not involve examining Easterbrook's emails or devices. The plaintiffs argue that the Director Defendants acted in a self-interested manner because they feared that if they terminated Easterbrook for cause, then he would challenge their decision, and it would become evident that the Director Defendants knew about and tolerated sexual harassment and misconduct at the Company. As the plaintiffs describe it, they seek an inference that the Director Defendants acted in bad faith by seeking "to keep secret the problems plaguing the Company—including its C-suite—with respect to pervasive sexual

harassment and sexual misconduct and to prevent the discovery of their own failures to put a stop to it." Dkt. 67 at 56.

As with the decision to discipline Fairhurst rather than fire him, there are many reasons to disagree with how the Board handled Easterbrook's termination. It seems likely that the Director Defendants now wish they had conducted a more thorough investigation in November 2019; learned about Easterbrook's improper relationships with three other employees; found the scandalous emails, texts, and videos; uncovered his misuse of Company resources; and terminated him for cause. In July 2020, when an employee reported that Easterbrook had engaged in an improper relationship with at least one other employee, that is what the Director Defendants did.

Assuming for the sake of analysis that the Director Defendants made a bad decision in November 2019 by not conducting a more meaningful investigation and not terminating Easterbrook for cause, that does not mean that the Director Defendants breached their duties. The business judgment rule recognizes that people can make mistakes, even when acting diligently, loyally, and in good faith.

As with the two earlier decisions that the plaintiffs challenge, the decision to terminate Easterbrook without cause was a classic business judgment. When considering similar allegations regarding costly no-fault terminations of CEOs after the CEOs engaged in misconduct that could support a for-cause termination, this court has deferred to the

directors' decision under the business judgment rule.[22] Two of those cases involved CEOs who had engaged in sexual misconduct or sexual harassment. *See Shabbouei*, 2020 WL 1609177, at *5; *Zucker*, 2012 WL 2366448, at *3–4.

The plaintiffs have not alleged that any of the Director Defendants had an interest in the decision or was otherwise not independent. The plaintiffs try to conjure an inference of bad faith from the idea that the Director Defendants were seeking to keep things quiet and protect themselves, and the plaintiffs can point to Easterbrook's assertion—in the case that the Company filed against him—that the Director Defendants knew about his conduct. That allegation, however, is not sufficient to overcome the presumption that the Director Defendants have acted in good faith. This decision has concluded that the Director Defendants did not face a threat of liability for their response to the issues of sexual harassment and misconduct. As this court has held when addressing similar arguments involving other no-fault terminations, the defendants could have rationally believed in subjective good faith that an amicable termination without cause was in the best interests of the Company.[23] True, "human nature may incline *even one acting in subjective good*

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[22] *See Shabbouei v. Potdevin*, 2020 WL 1609177, at *11–12 (Del. Ch. Apr. 2, 2020); *Zucker v. Andreessen*, 2012 WL 2366448, at *8–10 (Del. Ch. June 21, 2012); *see also Boeing*, 2021 WL 4059934, at *36.

[23] *See Shabbouei*, 2020 WL 1609177, at *11 ("Plaintiff proclaims that the Board had a duty to make a 'decision' to fire [the CEO] before [a member of the Board] attempted to negotiate his resignation. I see no basis to impose that duty . . . . The far more reasonable decision-making process would be . . . to determine whether [the CEO] would leave peacefully on mutually acceptable terms before deciding to go to war with him." (footnote omitted)); *Zucker*, 2012 WL 2366448, at *8–10 (finding that "[a]lthough the Board *could* have elected to pay [the CEO] nothing" and plaintiff was "entitled to the presumption" on

*faith* to rationalize as right that which is merely personally beneficial." *City Cap. Assocs. Ltd. P'ship v. Interco Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988). But that insight acknowledges that a person who fully rationalizes the personally beneficial conduct reaches the point of acting in subjective good faith. Unless a higher standard of review applies, the law provides no basis to challenge the director's good faith judgment, however misguided.

The criticism about an overly rapid investigation implicates the duty of care. "[I]n the world of business (as elsewhere), persons are often (or always) required to act on less than perfect or complete information." *Citron v. Fairchild Camera & Instrument Corp.*, 1988 WL 53322, at *17 (Del. Ch. May 19, 1988) (Allen, C.), *aff'd*, 569 A.2d 53 (Del. 1989). "Information is not without costs of various kinds. Whether the benefit of additional information is worth the cost—in terms of delay and in terms of alternative uses of time and money—is always a question that may legitimately be addressed by persons charged with decision-making responsibility." *Solash*, 1988 WL 3587, at *8. In other words, "the amount of information that it is prudent to have before a decision is made is itself a business

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a motion to dismiss that the CEO could have been terminated for cause, plaintiff's allegations failed to raise a reasonable doubt that the board's decision to pay the CEO $40 million under a separation agreement "was the product of a valid exercise of business judgment"); *see also Boeing*, 2021 WL 4059934, at *36 (explaining that even if board permitted CEO to resign "to avoid further public criticism, it is reasonable to infer that doing so was in furtherance of the legitimate business objective of avoiding further reputational and financial harm").

judgment of the very type that courts are institutionally poorly equipped to make." *RJR Nabisco*, 1989 WL 7036, at *19.

The Director Defendants consulted with outside counsel, who conducted an investigation. After that investigation, in consultation with counsel, the Director Defendants made the judgment that they had sufficient information to reach a decision. Although that judgment appears to have been a poor one, it is not an actionable one.

The plaintiffs object to the lack of minutes for the meeting on October 18, 2019, when the Board initially discussed the report of Easterbrook's improper relationship, and the follow-up meeting on October 26, when the Board decided to negotiate with Easterbrook regarding a no-fault departure. This court has held previously that a board's decision to meet informally in "un-minuted" meetings to discuss allegations of sexual harassment involving a CEO did not contribute to an inference of bad faith. *Shabbouei*, 2020 WL 1609177, at *12. As the court acknowledged, the failure to keep minutes can be a cause for suspicion. *Id.* It also may backfire, as it deprives the defendants and the court of the benefit of account of what took place, prepared close in time to the events themselves. Here, as in *Shabbouei*, the lack of minutes is not sufficient to support an inference of bad faith, whether viewed in isolation or in conjunction with the plaintiffs' other allegations.

At worst for the Director Defendants, the manner in which they proceeded when determining Easterbrook's fate could constitute a breach of the duty of care. I do not believe that an inference of gross negligence is reasonable. Regardless, it would not be actionable, because the Director Defendants are exculpated from damages for that claim. Because the

complaint only seeks damages as a remedy, even allegations supporting an inference of gross negligence would not support a claim on which relief can be granted. *See Cornerstone*, 115 A.3d at 1180.

The SEC action provides an interesting factual coda, but it does not affect the analysis from a Delaware law standpoint. The charge against McDonald's was a strict liability offense. *See Easterbrook & McDonald's Corp.*, Securities Act Release No. 11144 (Jan. 9, 2023); *accord Hilton Worldwide Hldgs. Inc.*, Exchange Act Release No. 90052, 2020 WL 5820430, at *3 (Sept. 30, 2020). It does not provide any basis to infer bad faith on the part of the directors. If anything, the SEC's findings confirm that Easterbrook misled the Board about the extent of his misconduct. The SEC found that during an interview on October 22, 2019, the Company's outside counsel asked Easterbrook whether he had engaged in sexual relationships with employees other than the relationship the Company was investigating. Easterbrook falsely said he had not. The SEC also found that Easterbrook withheld other potentially relevant information from the Company. Dkt. 84 Ex. A ¶¶ 6–8. The Director Defendants' initial determination to terminate Easterbrook without cause was thus made in good faith based on the information that Easterbrook provided.

### C. Count IV: The Claim For Waste

In Count IV, the plaintiffs allege that the Director Defendants' decision to permit Easterbrook to receive separation benefits, including severance, as part of a no-fault termination constituted waste. That claim fails as well.

A transaction constitutes waste when it is so one-sided that no rational person acting in good faith could approve it.[24] Put differently, it involves "an exchange that is so one-sided that no businessperson of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Brehm*, 746 A.2d at 263.

Historically, waste derived from the *ultra vires* doctrine and stood outside of the traditional framework of fiduciary review. *See generally* Harwell Wells, *The Life (and Death?) of Corporate Waste*, 74 Wash. & Lee L. Rev. 1239, 1243–48 (2017). Evidencing the different legal framework, non-unanimous stockholder ratification could not validate an action that constituted waste. *See Michelson v. Duncan*, 407 A.2d 211, 219, 223 (Del. 1979). Approval by a majority of disinterested shares could cure an unauthorized transaction with a director or officer of the corporation. *See id.* at 221–22.

Contemporary Delaware decisions have brought waste within the fiduciary framework of the business judgment rule by reconceiving waste as a means of pleading that the directors acted in bad faith.[25] "The Delaware Supreme Court has implicitly held

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[24] *E.g.*, *In re CBS Corp. S'holder Class Action & Deriv. Litig.*, 2021 WL 268779, at *52 (Del. Ch. Jan. 27, 2021); *In re Books-A-Million, Inc. S'holders Litig.*, 2016 WL 5874974, at *19 (Del. Ch. Oct. 10, 2016), *aff'd*, 164 A.3d 56 (Del. 2017) (TABLE); *In re Goldman Sachs Gp., Inc. S'holder Litig.*, 2011 WL 4826104, at *18 (Del. Ch. Oct. 12, 2011).

[25] *See, e.g.*, *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001) ("To prevail on a waste claim or a bad faith claim, the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."); *CanCan Dev., LLC v. Manno*, 2015 WL 3400789, at *20 (Del. Ch. May 27, 2015) (explaining that waste is "best understood as one means of establishing a breach of the duty of loyalty's subsidiary element of good faith"); *Se. Pa. Transp. Auth. v. AbbVie Inc.*, 2015 WL

that committing waste is an act of bad faith." *Disney I*, 907 A.2d at 749 (*citing White v. Panic*, 783 A.2d at 553–55). Pleading that a transaction is so one-sided as to suggest waste is thus one way to plead bad faith, although not the only way. *Id.*

The separation agreement with Easterbrook does not support a claim for waste under the traditional standard. By obtaining that agreement, the Board ended the tenure of a CEO who had engaged in an improper relationship. Through the separation agreement, the Board secured Easterbrook's swift exit with a letter of apology, a release from Easterbrook of potential claims against the Company (without giving Easterbrook a release in return), and a commitment to cooperate with the Company on post-termination matters. The separation agreement included non-competition, non-solicitation, and non-disclosure provisions. By reaching agreement with Easterbrook, the Board hoped the Company could avoid potentially costly and embarrassing litigation that would highlight problems with sexual harassment and misconduct that the Board was trying to address and put in the past. "These, by any measure, are corporate benefits," inconsistent with a traditional claim of waste. *Shabbouei*, 2020 WL 1609177, at *13.

For similar reasons, the separation agreement does not suggest a decision so extreme as to be inexplicable on any basis other than bad faith. In practice, this version of waste operates as an equitable escape hatch that permits a court to allow a claim to proceed past

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1753033, at *14 n.144 (Del. Ch. Apr. 15, 2015) ("This Court has found that, doctrinally, waste is a subset of good faith under the umbrella of the duty of loyalty . . . ."), *aff'd*, 132 A.3d 1 (Del. 2016) (TABLE), *overruled on other grounds by AmerisourceBergen Corp. v. Lebanon Cnty. Empls.' Ret. Fund*, 243 A.3d 417 (Del. 2020).

the pleading stage where something appears sufficiently amiss to warrant discovery. When seemingly rational defendants have made a seemingly irrational decision, often there is a hidden conflict of interest lurking in the shadows.

The facts of this case do not approach the level that might entitle a stockholder to proceed past the pleadings on a claim that the exchange was so extreme as to support an inference of bad faith. Thus, the complaint does not state a claim for waste arising out of Easterbrook's separation agreement. *Cf. Steiner v. Meyerson*, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995) (Allen, C.).

In an effort to undermine the Director Defendants' decision to terminate Easterbrook without cause, the plaintiffs point out that the Board later discovered that Easterbrook had engaged in more extensive misconduct, brought suit against him, and eventually settled that litigation for the return of $105 million in consideration. Those later events do not mean that the Board's earlier decision constituted waste. The separation agreement conferred meaningful benefits to the Company. The transaction was not so one-sided as to support an inference of bad faith. To the contrary, this decision has already found that the pled facts do not support an inference that the Director Defendants acted in bad faith. Repackaging those allegations as a claim for waste does not change the outcome.

### D. The Request To Convert The Motion To Dismiss To A Motion For Summary Judgment

The preceding analysis results in a pleading-stage dismissal of the plaintiffs' claims against the Director Defendants. The plaintiffs seek to avoid that outcome through a procedural argument. They contend that because the Director Defendants relied on matters

outside of the pleadings, the court should convert the motion to dismiss into a motion for summary judgment. Rule 12(b) states that if a defendant relies on matters outside of the pleadings when moving to dismiss a complaint under Rule 12(b)(6), then "the motion shall be treated as one for summary judgment and disposed of as provided in Rule 56, and all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56." Ct. Ch. R. 12(b). The court declines to take that step.

The plaintiffs correctly observe that in advocating for dismissal, the Director Defendants went far beyond the complaint. Their opening brief cited only ten sentences from the complaint in a twenty-one-page statement of facts, and it referenced those sentences principally to describe allegations that the Director Defendants proceeded to rebut. Instead of meaningfully engaging with the complaint, the Director Defendants constructed their own narrative from ninety-three exhibits comprising nearly 1,400 pages. Those submissions exceeded by an order of magnitude the page count of the complaint, the motions to dismiss, and the supporting briefs put together. *See CBS*, 2021 WL 268779, at *18–19 (making similar observation). The substance and scope of the Director Defendants' submissions have the look and feel of a motion for summary judgment, which understandably invites conversion. *See Acero Cap., L.P. v. Swrve Mobile, Inc.*, 2021 WL 2207197, at *1 (Del. Ch. June 1, 2021) (converting motion to dismiss supported by three declarations and thirty-two exhibits into motion for summary judgment).

The Director Defendants respond that they have simply relied on documents that the complaint incorporated by reference. The Company produced books and records in response to requests from a subset of the plaintiffs under a confidentiality agreement

containing a provision that deemed the full production incorporated by reference into any subsequent complaint.

Whether as a matter of contract or common law, incorporation by reference enables a court to review the actual documents to ensure that the plaintiff has not misrepresented their contents and that any inference the plaintiff seeks is reasonable.[26] The doctrine limits the ability of a plaintiff to take language out of context, because the defendants can point the court to the entire document. But the doctrine does not change the pleading standard that governs a motion to dismiss, nor does it permit a defendant to refute the well-pled allegations in a complaint. If there are factual conflicts in the documents or the circumstances support competing interpretations, and if the plaintiffs made a well-pled factual allegation, then the court must credit the allegation. *See Savor, Inc. v. FMR Corp.*, 812 A.2d 894, 896 (Del. 2002). The plaintiffs also remain entitled to "all reasonable inferences." *Id.* at 897. Consequently, if a document supports more than one inference, and if the inference that the plaintiffs seek is reasonable, then the plaintiffs receive the inference. *Id.* "Section 220 documents, hand selected by the company, cannot be offered to rewrite an otherwise well-pled complaint." *Clovis*, 2019 WL 4850188, at *14 n.216.

By relying affirmatively on Section 220 materials in an effort to refute the plaintiffs' allegations, the Director Defendants went beyond what the incorporation-by-reference

[26] *See In re General Motors (Hughes) S'holder Litig.*, 897 A.2d 162, 169–70 (Del. 2006); *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 70 (Del. 1995); *In re Gardner Denver, Inc.*, 2014 WL 715705, at *2 & n.17 (Del. Ch. Feb. 21, 2014).

doctrine permits and invited conversion. The Company's extensive use of the redaction tool makes a Rule 56 conversion more attractive. This court has acknowledged that when producing books and records, a company may redact "material unrelated to the subject matter of the demand." *Okla. Firefighters Pension & Ret. Sys. v. Amazon.com, Inc.*, 2022 WL 1760618, at *13 (Del. Ch. June 1, 2022). That standard recognizes that a stockholder is only entitled to inspect books and records that are necessary and sufficient to accomplish the stockholder's proper purpose. *Id.* It permits a company to redact material that is unrelated to the subject matter of the demand, such as sections of a multi-subject document that clearly do not have anything to do with the purpose of the stockholder's investigation.

Here, the Company engaged in questionable redaction practices, such as recurrent partial-sentence redactions. Although an occasional sentence may address a disparate and unrelated topic that warrants a partial-sentence redaction, the Company made partial-sentence redactions frequently. It seems unlikely that the drafters of the documents in the Section 220 production injected unrelated topics into otherwise responsive sentences so often. After all, we are not dealing with James Joyce and the multi-page monologue of Molly Bloom. We are not even talking about the paragraph-length opening sentence of *A Tale Of Two Cities*. We are talking about business writing, where the parts of sentences usually relate to a particular topic. It is difficult to credit that all of the Company's partial-

sentence redactions were warranted. A document should not look like the author of a ransom note scoured it to make a missive.[27]

Similar considerations apply when parties redact individual sentences from responsive paragraphs and individual paragraphs from responsive documents. Admittedly, as the length of a text increases, so does the likelihood that redactions will be appropriate. In this case, however, several of the Company's efforts appear questionable. For example, the Company produced a set of minutes for the June 2019 special meeting of the Strategy Committee. *See* Ex. 50. The sole purpose of the meeting was to consider the issue of sexual harassment—a topic plainly responsive to the demand—yet the Company redacted a paragraph of the minutes for non-responsiveness. The Company took a similar approach to a memorandum that four executives prepared for a September 2019 meeting of the Strategy Committee. Ex. 55. The memorandum was just over one page long and addressed a single topic, yet the Company made five redactions for non-responsiveness. That seems like editing.

The Director Defendants respond that the court previously addressed the propriety of their redactions. During the Section 220 proceeding, one of the stockholders who sought books and records challenged the Company's redactions, and the court upheld the

[27] Lest there be confusion, this admonition addresses partial-sentence redactions *for non-responsiveness*. It does not apply to partial-sentence redactions for privilege. The general principle is the same: Redactions should be as limited as possible. A partial-sentence redaction for privilege is desirable because it helps the reader assess the assertion of privilege.

production of the redacted documents as sufficient to fulfill the stockholders' purpose of exploring corporate wrongdoing. That ruling is helpful to the Company, but it does not foreclose conversion. When determining what information is necessary to satisfy a stockholder's purpose (while simultaneously stopping at what is sufficient), a court must make a difficult prediction based on comparatively little information. The merits of a specific claim are not at issue in a Section 220 proceeding, so the court cannot evaluate the documents against a particular theory. *AmerisourceBergen Corp. v. Lebanon Cnty. Empls.' Ret. Fund*, 243 A.3d 417, 437 (Del. 2020). After a stockholder plaintiff has asserted a specific claim, the court is in a better position to draw an inference about whether the Company's redactions withheld information that should have been provided.

When the documents from a Section 220 production contain gaps, a plaintiff can seek inferences about what the redacted material might say. A court can credit those inferences, and that outcome could be worse for the defendants than if the Company had produced the documents without redactions. Alternatively, a court can convert the motion to dismiss into a motion for summary judgment and allow some level of discovery before adjudicating the motion. Full-blown merits discovery need not follow. A court can tailor the extent of discovery to the needs of the case. Requiring some measure of discovery beyond the Section 220 documents, perhaps including electronic documents and

depositions from a limited number of custodians, both provides a more thorough record and creates an additional incentive for companies not to misuse the redaction tool.[28]

The possibility that a court could convert a motion to dismiss into a motion for summary judgment if a company's redactions appear sufficiently questionable should promote the integrity of the Section 220 process and the proper use of incorporation by reference. The mechanism of contractual incorporation by reference was intended to give corporations an incentive to produce more records, with the confidence that the documents could not be mischaracterized for pleading purposes. *See Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 798 (Del. Ch. 2016) (explaining bases for incorporation-by-reference condition), *abrogated on other grounds by Tiger v. Boast Apparel, Inc.*, 214 A.3d 933 (Del. 2019). The production of more records has two beneficial knock-on effects. First, potential plaintiffs can better evaluate whether to bring litigation and decide against it when the books and records show that a case lacks merit. Second, the court will have a better record for purposes of early case triage and can dismiss meritless claims with greater confidence about the risk of false negatives. Excessive redactions undermine those benefits.

The issue currently before the court is whether to convert a Rule 12(b)(6) motion into a Rule 56 motion and allow limited discovery. The Director Defendants also moved for dismissal under Rule 23.1, raising the question of whether a ruling regarding conversion

[28] Simply requiring production of the unredacted documents could create a counterproductive incentive similar to what exists when the only consequence for failing to produce a proper privilege log is a do-over where the non-compliant party gets to try again. *See Klig v. Deloitte LLP*, 2010 WL 3489735, at *6 (Del. Ch. Sept. 7, 2010).

would apply to that motion as well. It could, and logically would, because partial redactions create the same challenges for both motions.

Nothing prevents a court from analyzing demand futility on a motion for summary judgment. This court recently did so,[29] and earlier decisions suggested that possibility in dictum.[30] As the *BGC* court noted, demand futility is a substantive rule of Delaware law, which implies that the issue could be addressed after the pleading stage, including through a motion for summary judgment and even after trial. 2021 WL 4271788, at *5.

Although the substantive nature of the demand-futility inquiry indeed implies that demand futility could remain a live issue late in the case, other Delaware authorities suggest that demand futility should be addressed early, ideally on the pleadings, although if

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[29] *In re BGC P'rs, Inc. Deriv. Litig.*, 2021 WL 4271788, at *5 (Del. Ch. Sept. 20, 2021).

[30] In a decision denying a stay of discovery pending a ruling on the defendants' motion to dismiss under Rule 23.1, Chancellor Allen observed in dictum that "a motion challenging the standing of plaintiff to prosecute a derivative claim will, in the first instance, be addressed to the face of the complaint." *Kahn v. Tremont Corp.*, 1992 WL 205637, at *2 (Del. Ch. Aug. 21, 1992). In a footnote, he remarked: "I say in the first instance because when the pleading itself is sufficient to excuse pre-suit demand, defendants are, of course, still free to show on summary judgment by uncontradicted facts that the allegations made are untrue and there is therefore no proper standing." *Id.* at *2 n.2. In an earlier decision, after denying a motion to dismiss under Rule 23.1, Chancellor Allen remarked that "[i]f a review of the actual facts would show that these two aspects of the complaint are in fact and should in law be treated as completely independent, then that may be shown in an application for summary judgment." *Heineman v. Datapoint Corp.*, 1990 WL 154149, at *3 (Del. Ch. Oct. 9, 1990) (internal citation omitted). These comments contrast with his observations in *Harris v. Carter*, a decision discussed in the text, where he strongly endorsed the proposition that demand futility should be decided "at the filing of the complaint." 582 A.2d 222, 228 (Del. Ch. 1990).

warranted on a prompt motion for summary judgment. The other authorities indicate that a court generally should not evaluate (or reevaluate) demand futility later in the case, such as on a motion for summary judgment after the close of discovery or post-trial.

The first authority is the Delaware Supreme Court's decision in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). At the trial level in *Zapata*, this court held that after a plaintiff had properly initiated a derivative action and proceeded beyond the pleading stage, the defendants lacked the ability to divest the plaintiff of control over the action. *Maldonado v. Flynn*, 413 A.2d 1251, 1262 (Del. Ch. 1980) (subsequent history omitted). On appeal, the high court disagreed and recognized the special litigation committee as the judicially approved method for accomplishing that feat. *Zapata*, 430 A.2d at 786. In doing so, the Delaware Supreme Court explained that "where demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf" and emphasized that "some tribute must be paid to the fact that the lawsuit was properly initiated" by the derivative plaintiff. *Id.* at 784, 787. Chancellor Allen later described a *Zapata* committee as the "judicially approved method for the termination of derivative litigation through unilateral corporate action" and held that a controlling stockholder could not dispose of derivative litigation through a freeze-out merger without inviting judicial review of the transaction. *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757, 764 (Del. Ch. 1986). If defendants could divest a plaintiff of control over a derivative action by relitigating demand futility through a motion for summary judgment after the close of discovery or by arguing the issue on the merits after trial, then those mechanisms would provide meaningful alternatives to a *Zapata* committee, and little tribute would be paid to

the fact that a lawsuit had been properly initiated. The *Zapata* procedure suggests that a late-stage assessment of demand futility should not be in the cards.

Another authority is the Delaware Supreme Court's decision in *Braddock v. Zimmerman*, 906 A.2d 776 (Del. 2006), which adopted the reasoning of Chancellor Allen's decision in *Harris v. Carter*, 582 A.2d 222 (Del. Ch. 1990). The issue in both cases was whether the defendants could move again for dismissal under Rule 23.1 after a change in board composition that removed disabled directors from or added new disinterested and independent directors to the board. In *Harris*, Chancellor Allen explained that "the proper time to measure demand futility is at the filing of the complaint" and declined to reconsider demand futility after a change in board composition as to claims already in litigation. 582 A.2d at 228. He reasoned that demand doctrines "ought not to be so construed as to stall the derivative suit mechanism where it has been properly initiated," nor to "interrupt litigation" that a stockholder plaintiff had been pursuing. *Id.* at 231. He explained that "[w]hen claims have been properly laid before the court and are in litigation, neither Rule 23.1 nor the policy it implements requires that a court decline to permit further litigation of those claims upon the replacement of the interested board with a disinterested one." *Id.* Instead, the board should be required to form a *Zapata* committee or to act under *Zapata* as a committee of the whole. *Id.* But if a plaintiff asserted new claims in an amended complaint that were not already validly in litigation, then the defendants could move for summary judgment as to those claims. *Id.* at 230. Sixteen years later, the Delaware Supreme Court adopted both the rule and the reasoning of *Harris v. Carter* and quoted the foregoing statements. *See Braddock*, 906 A.2d at 785, 801–02. Both *Harris v. Carter* and

*Braddock* indicate that demand futility only should be addressed early in the case. If the issue of demand futility remained live throughout the case, then there should not have been any impediment to reconsidering demand futility after a change in board composition.

A third authority is the Delaware Supreme Court's decision in *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726 (Del. 1988). There, the high court held that "[w]hen a corporation chooses to take a position in regards to a derivative action asserted on its behalf, it must affirmatively object to or support the continuation of the litigation." *Id.* at 731. Applying that rule to the facts of the case, the Delaware Supreme Court found that a corporation had given its "tacit approval for the continuation of the litigation" and could not assert demand futility when the corporation failed to move to dismiss under Rule 23.1 at the outset of the case. *Id.* at 731. If the issue of demand futility remained live throughout the case, then, as with other defenses, the corporation should have been able to take a pass on the Rule 23.1 motion at the pleading stage and assert the defense on a motion for summary judgment or at trial.

Admittedly, these authorities do not hold explicitly that a court cannot reconsider demand futility late in the case or after trial, but they point towards an early-stage determination, usually on the pleadings but potentially on a motion for summary judgment. In offering this interpretation, I acknowledge that a selfish interest may color my view, because I do not relish the prospect of conducting *seriatim* demand-futility analyses, first on the pleadings, then after the close of discovery on a motion for summary judgment, and then again after trial, as this court generously did in *BGC. See In re BGC P'rs, Inc. Deriv.*

*Litig.*, 2022 WL 3581641, at *13 (Del. Ch. Aug. 19, 2022) (conducting post-trial analysis of demand futility and referencing prior assessments).

In sum, the lessons I draw from the combination of authorities are the following:

- Demand futility should be analyzed early in the case and not addressed (or readdressed) at later phases.
- Demand futility generally should be evaluated on the pleadings, without the benefit of discovery.
- Demand futility can be analyzed on summary judgment, and a court can convert a motion to dismiss into a motion for summary judgment to facilitate analysis.
- The defendants generally should expect one bite at the demand-futility apple. If the defendants believe that the allegations supporting demand futility are incorrect, then they can file a Rule 23.1 motion to preserve the defense under *Kaplan*, then move promptly for summary judgment on the issue of demand futility so that they can introduce evidence by affidavit showing that demand was not futile. Although a plaintiff would be entitled to some limited discovery under Rule 56(f), full merits discovery would not be warranted.
- There could be a situation in which a complaint presents a close call on the issue of demand futility, and the defendants opt to move to dismiss. If the motion fails, then the court would have discretion to entertain a motion for summary judgment on the demand futility issue, but the defendants could not claim a right to a redo.

Although the foregoing analysis supports the theoretical possibility of conversion, the facts of this case do not warrant it. First, the Director Defendants only introduced documents from the Section 220 production, so they technically stayed within the scope of the incorporation-by-reference provision to which the plaintiffs agreed.

Second, this court did rule previously that the redactions in the Section 220 documents were proper. Although not determinative for purposes of conversion, that decision deserves weight.

Third, the most extensive redactions appear in documents pre-dating the end of 2018, when it seems plain that the Board was operating in business-as-usual mode and not taking any action to address concerns about sexual harassment or misconduct at the Company. For purposes of the motion to dismiss, the court has credited the plaintiffs with the inference that the Board was operating in business-as-usual mode during that period.

Fourth, it is not reasonable to infer that the contents of the redactions in the documents from 2019 could affect the outcome of the motion to dismiss. Those documents demonstrate that management and the Director Defendants were seeking to respond to the red flags about sexual harassment and misconduct. Just as it seems unlikely that the redacted material addressed unrelated topics, it also seems unlikely that the redactions contained indications that management and the Director Defendants were not trying to respond to the red flags. It is reasonable to infer that the redacted portions could contain candid self-assessments along the lines of "we wish we had done this sooner" or "we have identified problems with our existing policies." Self-assessments of that type would not support a claim on which relief can be granted. They would reinforce the inference that management and the Director Defendants were responding to the red flags, including by acknowledging areas where improvement was clearly needed. When considering the redactions in context, it is not reasonably conceivable that they could contain snippets sufficient to draw an inference that the Director Defendants acted in bad faith. For example, it is not reasonable to infer that the redacted portions might contain statements along the lines of "we expect to these steps to generate positive PR, but we don't intend to expend resources enforcing any of our new policies or procedures."

The court will not convert either the Rule 12(b)(6) motion or the Rule 23.1 motion into a motion for summary judgment.

## III. CONCLUSION

The plaintiffs have failed to plead a claim against the Director Defendants for breach of the duty of oversight. They have failed to plead a claim against the Director Defendants for breach of fiduciary duty in connection with the decisions to promote Easterbrook to CEO, to discipline Fairhurst, and to terminate Easterbrook without cause. The plaintiffs have failed to plead a claim against the Director Defendants for waste. The claims against the Director Defendants are dismissed under Rule 12(b)(6).

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Case No. 2023-0304-JTL

**IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE**

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND, KIWI INVESTMENT MANAGEMENT WHOLESALE CORE GLOBAL FUND, KIWI INVESTMENT MANAGEMENT GLOBAL QUANTITATIVE FUND, CLEVELAND BAKERS AND TEAMSTERS PENSION FUND, derivatively on behalf of META PLATFORMS, INC.,

Plaintiffs,

vs.

MARK ZUCKERBERG, SHERYL K. SANDBERG, PEGGY ALFORD, MARC L. ANDREESSEN, ANDREW W. HOUSTON, NANCY KILLEFER, ROBERT M. KIMMITT, TRACEY T. TRAVIS, TONY XU, ERSKINE B. BOWLES, KENNETH I. CHENAULT, SUSAN D. DESMOND-HELLMANN, REED HASTINGS, JAN KOUM, PETER THIEL, JEFFREY D. ZIENTS, ANDREW BOSWORTH, MIKE SCHROEPFER, CHRISTOPHER K. COX, DAVID M. WEHNER, NICK CLEGG, JENNIFER G. NEWSTEAD,

Defendants,

-and-

META PLATFORMS, INC.,

Nominal Defendant.

C.A. No. 2023-0304-JTL

**VERIFIED SHAREHOLDER DERIVATIVE COMPLAINT**

**PUBLIC VERSION DATED MARCH 20, 2023**

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# GLOSSARY OF ABBREVIATIONS

| Abbreviation | Description |
|---|---|
| AROC | Audit & Risk Oversight Committee |
| CEI | Child Exploitative/Exploitation Imagery |
| CNCEI | Child Nudity/Child Exploitative Images |
| CSAM | Child Sexual Abuse Material |
| DQ | Data Quality |
| FB | Facebook |
| FOSTA | Fight Online Sex Trafficking Act |
| GTM | Ground Truth Machine |
| HEx | Human Exploitation |
| IG | Instagram |
| MS | Minor Sexualization |
| MSGR | Facebook Messenger |
| SESTA | Stop Enabling Sex Traffickers Act |
| TVPA | Trafficking Victims Protection Act |

Plaintiffs Employees' Retirement System of the State of Rhode Island, Kiwi Investment Management Wholesale Core Global Fund, Kiwi Investment Management Global Quantitative Fund, and Cleveland Bakers and Teamsters Pension Fund (collectively, "Plaintiffs"), by their undersigned attorneys, derivatively and on behalf of Nominal Defendant Meta Platforms, Inc. ("Meta" or the "Company"), file this Verified Shareholder Derivative Complaint against Defendants for breaches of fiduciary duty owed to the Company. Plaintiffs make the following allegations based upon personal knowledge as to themselves and their own acts, and upon information and belief as to all other matters, based on the investigation conducted by their attorneys. This investigation included, among other things, a review of documents produced by Meta in response to books-and-records demands under 8 *Del. C.* § 220 made by Meta stockholders; the Company's conference calls, announcements and press releases; filings made by the Company with the U.S. Securities and Exchange Commission ("SEC"); whistleblower complaints filed with the SEC and published by national news media; corporate governance documents available on the Company's website; governmental and regulatory investigations of the Company and documents related thereto; judicial decisions by federal and state courts in criminal and civil lawsuits against or

discussing Meta; Congressional testimony; and news reports concerning the Company.[1]

## NATURE OF THE ACTION

1. This case concerns the breaches by Meta's directors ("Board") and senior officers of their fiduciary duties with respect to the rampant and systemic sex trafficking, human trafficking, and child sexual exploitation flourishing on the Company's social media platforms, including Facebook and Instagram.

2. As described more fully below, Meta's directors and senior executives have been well aware for years that sex/human trafficking and child sexual exploitation were rampant on Facebook and Instagram. Senior officers, however, failed to exercise due care to root out these pernicious activities, and both the Company's officers and the Board failed to act in good faith to exercise oversight over the Company's social media platforms and the predatory criminal activity thriving on them.

3. In this shareholder derivative action, Plaintiffs, on behalf of Meta, seek to recover for the harm sustained by the Company as a result of the breaches of fiduciary duty by the Company's directors and officers.

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[1] All emphasis herein (***bold/italics***) is added unless otherwise noted.

4. An accumulating mass of evidence shows that for the past decade, Meta's platforms have assisted, supported, and facilitated perpetrators of widespread systemic sex trafficking, human trafficking, and child sexual exploitation that has occurred on a massive scale on Meta's platforms in the United States and worldwide. The victims are Facebook and Instagram users—both minors and adults—whose lives are forever devastated. The perpetrators are often organized human trafficking "rings" that systematically use Meta's platforms to lure, recruit, exploit, and even advertise their victims for trafficking. Substantial evidence demonstrates that although the Board and management have known about this increasing trend, both management and the Board have consciously turned a blind eye to sex trafficking, human trafficking, and child sexual exploitation occurring on Meta's platforms. The conduct of Meta's Board and management is unconscionable; and in the face of this evidence, the Board's and management's utter failure to monitor or oversee this problem, to educate themselves about its scope, or even to discuss it ***in any meeting at all***—constitute breaches of their fiduciary duties to the Company and its shareholders.

5. As discussed below, evidence of widespread sex trafficking and other human trafficking on Meta's platforms, and of the Board's inadequate or nonexistent response to that trend, is overwhelming and well documented by numerous reliable sources.

6. ***First***, in October 2019, *BBC News Arabic* published the results of its undercover investigation which revealed that "[i]n Saudi Arabia, hundreds" of "women [were] being sold on Instagram, which is owned by Facebook" in what a United Nations official described as "promoting an online slave market" and "the quintessential example of modern slavery," and commented that "[i]f Facebook or any other companies are hosting apps like these, they have to be held accountable." In response, on October 23, 2019, Meta "received [a] communication from Apple" in which Apple "threatened to pull FB & IG apps from its App Store due to them identifying content promoting 'domestic servitude.'" According to Meta's internal records, management concluded that the Company had been "***underreporting this behaviour***"; suffered from an "***absence of proactive detection***"; that "***newly created and existing [domestic servitude] content [was] not captured***" which "***meant that domestic servitude content remained on the platform***"; had been "***under-enforcing on confirmed abusive activity with a nexus to the platform***"; and that internal "***investigative findings demonstrate that <u>our platform enables all three stages of the human exploitation lifecycle</u> (recruitment, facilitation, exploitation) via complex real-world networks***. The traffickers, recruiters, and facilitators from these 'agencies' used FB profiles, IG profiles, Pages, Messenger, and WhatsApp."[2]

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[2] *See* Section II.F *infra*.

7. ***Second***, a June 8, 2021 report by the Human Trafficking Institute found that the majority of online sex trafficking in 2020 occurred on Facebook and Instagram.[3] Similarly, a June 16, 2022 report by the same organization again found that the majority of sex trafficking occurs online with Facebook and Instagram together accounting for the majority of online sex trafficking in 2019, 2020, and 2021. Likewise, according to the U.S. State Department, "in 2018 trafficking gangs increasingly used social media sites, particularly Facebook, to buy and sell women and girls for sex and labor exploitation."[4]

8. ***Third***, between 2013 and 2023, U.S. federal and state courts have issued at least 70 written decisions in criminal and civil cases involving sex trafficking that occurred on Meta's platforms.[5] Between 2009 and 2022, U.S. newspapers and media outlets published at least 175 articles detailing how sex traffickers—often organized trafficking "rings"—have systematically used Meta's platforms (including Facebook, Facebook Messenger, Instagram, and WhatsApp) to commit heinous crimes.[6]

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[3] *See* Section II.M *infra*.

[4] *See* Section II.K *infra*.

[5] *See* Section II.B *infra*. *See also* Exhibit 2.

[6] *See* Section II.A *infra*. *See also* Exhibit 1.

9. ***Fourth***, between 2012 and 2023, at least 129 federal and state courts issued written decisions in criminal and civil cases involving child sexual exploitation on Meta's platforms.[7] U.S. news and media outlets have also widely reported on the raging epidemic of child sexual exploitation occuring openly and unchecked on the Company's platforms. For example, in March 2022, a college professor described in *WIRED* magazine how her searching for "Facebook groups with names including 10, 11, or 12" concerning "the 10th, 11th, or 12th wards of the city of Pittsburgh" yielded dozens of "groups targeting children of those ages" with "over 81,000 members" openly soliciting children for sexual exploitation.[8] One 9,000-memer group appearing in the search results was named "Buscando novi@ de 9,10,11,12,13 años"—i.e., "[l]ooking for a 9-year-old girlfriend." Yet, when she "used Facebook's on-platform system" to report this group, an "automated response came back" stating "[t]he group had been reviewed and did not violate any 'specific community standards.'" And despite (or because of) her reporting this group, along with others, Facebook's AI algorithms caused "new child sexualization groups" to be "recommended to [her] as 'Groups You May Like.'"

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[7] *See* Section II.C *infra*. *See also* Exhibit 3.

[8] *See* Section II.C *infra*.

10. ***Fifth***, in the midst of this trend, recent federal legislation, known as FOSTA-SESTA, clarified that internet service providers such as Meta can be held liable for intentionally facilitating sex trafficking on their platforms.[9] Indeed, a June 2021 decision by the Supreme Court of Texas held that Section 230 of the Communications Decency Act ("CDA"), 47 U.S.C. § 230, did not bar claims against Facebook by victims of sex trafficking under the Texas human trafficking statute.[10] The U.S. Supreme Court denied Facebook's petition for writ of certiorari on March 7, 2022.[11]

11. ***Sixth***, during 2018, 2019, and 2020, Mark Zuckerberg ("Zuckerberg")—Meta's co-founder, Chairman, Chief Executive Officer ("CEO"), and controlling shareholder—repeatedly testified before Congress and publicly discussed the subject of sex trafficking connected to Meta. The Company (and its Board) thus has been well aware of the increasing use of its platforms by sex traffickers and the devasting consequences for victims.[12]

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[9] *See* Section I.C *infra*.

[10] *See* Section II.P *infra*.

[11] *See Doe v. Facebook, Inc.*, ("*Facebook Cert.*"), 142 S. Ct. 1087 (2022) (Thomas, J).

[12] *See* Sections II.D, II.E, II.G *infra*.

12. ***Seventh***, on September 16, 2021, *The Wall Street Journal* reported that "[s]cores of internal Facebook documents" revealed that although Facebook employees had flagged human traffickers using its network, the Company's response had been "[w]eak," "inadequate or ***nothing at all***."[13] For example, said employees concluded that "Facebook products facilitated each step" of a "bustling human-trafficking trade in the Middle East," which "criminal networks recruit[ed] people from poor countries, coordinat[ed] their travel and pu[t] them into . . . forced sex work in the United Arab Emirates and other Persian Gulf countries." In another example, Facebook employees discovered a large sex trafficking "ring that used the site to recruit women from Thailand and other countries. They were held captive, denied access to food and forced to perform sex acts in Dubai massage parlors, according to an internal investigation report. Facebook removed the posts but didn't alert local law enforcement."

13. ***Eighth***, on October 3, 2021, former Facebook employee Frances Haugen appeared on the broadcast *60 Minutes*. On October 4, 2021, CBS's *60 Minutes* published eight whistleblower complaints that Ms. Haugen filed with the SEC, one of which alleged that Meta "misled investors and the public about its promotion of human trafficking / slavery / servitude."[14] One of the internal

[13] *See* Section II.Q *infra*.

[14] *See* Section II.R *infra*.

documents that Ms. Haugen provided to the SEC, dated October 2019, discussed "human trafficking" occurring on Meta's various platforms in the form of "domestic servitude" and "human exploitation."

14. ***Ninth***, in response to Plaintiffs' books-and-records demands pursuant to 8 *Del. C.* §220, Meta produced Board-level documents revealing, among other things, that the Board has acknowledged [redacted] as one of the [redacted] the Company did not yet [redacted] and for which [redacted] but did not [redacted] [redacted][15]

15. ***Tenth***, despite publicly stating that "[w]e deploy technology across all of our platforms to proactively surface illegal child exploitative content as we can, including through detection technology, machine learning and artificial intelligence techniques,"[16] Meta's documents reveal that it internally acknowledged to the Board that the [redacted] [redacted] [redacted][17]

[15] *See* Part III *infra*.

[16] *See* Section II.J *infra*.

[17] *See* Section III.J *infra*.

16. ***Eleventh***, in response to Plaintiffs' books-and-records demands pursuant to 8 *Del. C.* § 220, Meta agreed to "search for materials provided to the Board ***and Board minutes*** since January 1, 2017 relating to the two topics of (i) sex and human trafficking and (ii) teen health, including excerpts of minutes of meetings of the Board (or committees of the Board) that reflect discussion of those two subjects" and to "produce … any non-privileged materials and information identified as a result of that search."[19] Meta also "certifie[d]" in writing to Plaintiffs that its "production" of the "materials that Meta agreed to produce" was "now complete."[20] Yet, despite producing other Board-level documents relating to these topics (which are discussed herein), Defendants conspicuously ***failed to produce any minutes whatsoever*** of any meeting of either the Board, the Audit Committee, or any other committee of the Board. The obvious—and only—inference is that neither the

[18] *See* Section III.M *infra*.

[19] Letter from David E. Ross to William S. Norton (Dec. 14, 2021) at 4.

[20] Letter from David E. Ross to Christine M. Mackintosh (May 20, 2022) at 1.

Board nor the Audit Committee have ever even discussed these topics at all—or at least to an extent that merited noting the discussion in any meeting's minutes.

17. ***Twelfth***, while Meta did produce some Board-level documents discussing the Company's [REDACTED] [REDACTED]—conspicuously absent from Meta's § 220 document production was any material evidence or discussion of what, if anything, the Board, its committees, or Meta's management have done to detect, prevent, deter, or address ***sex trafficking*** or ***human trafficking*** as such on the Company's platforms, or what oversight the Board performed as to these mission-critical risks.

18. Rather, Meta's documents suggest it has consciously chosen to avoid defining "human trafficking" as comprising "sex trafficking." Meta's 2021 "Anti-Slavery and Human Trafficking Statement" does not even mention "sex trafficking." And whereas Meta's 2020 "Anti-Slavery and Human Trafficking Statement" had stated that "[w]e define human trafficking as the exploitation of humans in order to force them to engage in commercial sex, labor, or other activities against their will," and claimed that "we remove content on Facebook that facilitates or coordinates the exploitation of humans, including human trafficking"—Meta's Board approved and ***deleted*** this very same language from similar 2021 and 2022 statements. Clearly, the Board gave up even claiming to remove content relating to or discussing sex trafficking.

19. In sum, when the overwhelming evidence of criminal sex/human trafficking on Meta's platforms is considered together with Meta's failure to produce any Board (or committee) minutes discussing sex/human trafficking, alongside Meta's failure to produce any Board-level documents discussing whether or how the Company has sought to detect, disrupt, prevent, or address sex/human trafficking on its platforms—the only logical inference is that the Board has consciously decided to permit Meta's platforms to promote and facilitate sex/human trafficking.

20. A critical tenet of Delaware corporate law is that Delaware corporations may only pursue "lawful business" by "lawful acts." 8 *Del. C.* §§ 101(b), 102.[21] In passing FOSTA-SESTA, Congress reaffirmed that online service providers such as Meta cannot consciously promote or facilitate unlawful sex trafficking, human trafficking, or child sexual exploitation on their interactive computer platforms without themselves breaking the law. And a Delaware fiduciary cannot be loyal to a Delaware company while causing it to break the law—particularly when the category of crimes being facilitated involves commercial sex acts induced by force,

[21] "Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue 'lawful business' by 'lawful acts.' As a result, a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law." *In re Massey Energy Co. Derivative & Class Action Litig.*, 2011 WL 2176479, at *20 (Del. Ch. May 31, 2011) (quoting Del. Code § 101(b) and § 102).

fraud, coercion, and abuse—both of adults and minors; involuntary servitude, peonage, debt bondage, slavery; and child sexual exploitation—all on a mass scale. Meta's Board and management have utterly failed to act in good faith to assure the existence of a functioning Board-level system of monitoring and reporting to prevent such heinous conduct, and by consciously failing to monitor or oversee whether management was addressing the endemic scourge of sex trafficking and human trafficking that has lived *and grown* for years on Meta's platforms.

## JURISDICTION AND VENUE

21. This Court has subject matter jurisdiction pursuant to 10 *Del. C.* § 341 and has personal jurisdiction over Defendants, who are current or former directors and officers of Meta, pursuant to 10 *Del. C.* § 3114. This Court also has jurisdiction over Nominal Defendant Meta, a Delaware corporation, pursuant to 10 *Del. C.* § 3111.

## PARTIES

### A. Plaintiffs

22. Plaintiff Employees' Retirement System of the State of Rhode Island is a Meta shareholder and has continuously owned shares of the Company's common stock since March 31, 2017.

23. Plaintiff Cleveland Bakers and Teamsters Pension Fund is a Meta shareholder and has continuously owned shares of the Company's common stock since October 10, 2016.

24. Plaintiff Kiwi Investment Management Wholesale Core Global Fund is a Meta shareholder and has continuously owned shares of the Company's common stock since July 18, 2017.

25. Plaintiff Kiwi Investment Management Global Quantitative Fund is a Meta shareholder and has continuously owned shares of the Company's common stock since October 25, 2018.

**B. Nominal Defendant**

26. Nominal Defendant Meta is a Delaware corporation with its principal executive offices located at 1601 Willow Road, Menlo Park, California. Meta's common stock is traded on the NASDAQ exchange under the ticker symbol "META." The Company operates various technology and social media products, including Facebook, Instagram, and WhatsApp.

**C. Current Company Director Defendants**

27. Defendant Zuckerberg is Meta's founder and has served as its CEO since 2004 and as Chairman of the Board since 2012. As CEO, Zuckerberg is responsible for Meta's day-to-day operations, overall direction and company strategy. Zuckerberg is also Meta's controlling stockholder; specifically, as of

March 31, 2022, Zuckerberg controlled 54.4% of Meta's "Total Voting Power" through his ownership of 84.7% of Meta's Class B shares.[22]

28. Defendant Sheryl K. Sandberg ("Sandberg") served as the Company's Chief Operating Officer from March 2008 until August 2022. Sandberg has served as a Company director since June 2012.

29. Defendant Peggy Alford ("Alford") has served as a Company director since May 2019. Alford has been a member of the Board's Audit Committee[23] since April 2020, chairman of the Board's Compensation Committee[24] since May 2022, and a member of the Board's Privacy Committee from May 2020 until May 2022.

30. Defendant Marc L. Andreessen ("Andreessen") has served as a Company director since June 2008. Andreessen has been a member of the Board's Compensation Committee at all times relevant to the Complaint, and the Board's Audit Committee from at least 2013 until February 2021.

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[22] Meta, Proxy Statement (Form DEF 14A) at 62 (Apr. 8, 2022).

[23] In June 2018, the Board amended the charter of the Audit Committee and renamed it as the "Audit & Risk Oversight Committee." References to the "Audit Committee" include the Audit & Risk Oversight Committee after June 2018.

[24] In October 2019, the Board amended the charter of the Compensation & Governance Committee and renamed it as the "Compensation, Nominating & Governance Committee." References to the "Compensation Committee" include the Compensation Nominating & Governance Committee after October 2019 and the Compensation & Governance Committee prior to October 2019.

31. Defendant Andrew W. Houston ("Houston") has served as a Company director since February 2020. Houston has served as a member of the Board's Compensation Committee since April 2020.

32. Defendant Nancy Killefer ("Killefer") has served as a Company director since March 2020. Killefer has served as chairman of the Board's Privacy Committee since May 2020, and as a member of the Board's Audit Committee since February 2021.

33. Defendant Robert M. Kimmitt ("Kimmitt") has served as a Company director since March 2020. Kimmitt has served as a member of the Board's Privacy Committee since May 2020.

34. Defendant Tracey T. Travis ("Travis") has served as a Company director since March 2020. Travis has been a member of the Board's Audit Committee since March 2020, and chairman of that committee since at least May 2021.

35. Defendant Tony Xu ("Xu") has served as a Company director since January 2022. Xu has been a member of the Board's Compensation Committee since February 2022.

36. Zuckerberg, Sandberg, Alford, Andreessen, Houston, Killefer, Kimmitt, Travis, and Xu are referred to collectively as "Director Defendants" and the "Demand Board."

**D. Former-Director Defendants**

37. Defendant Erskine B. Bowles ("Bowles") served as a Company director from September 2011 to May 2019. Bowles was chairman of the Board's Audit Committee until May 2019.

38. Defendant Kenneth I. Chenault ("Chenault") served as a Company director from February 2018 to May 2020. Chenault was a member of the Board's Audit Committee from May 2018 until May 2020.

39. Defendant Susan D. Desmond-Hellmann ("Desmond-Hellmann") served as a Company director from March 2013 to October 2019. Desmond-Hellmann served on the Board's Audit Committee from 2014 until May 2019, and as chairman of the Board's Compensation Committee from May 2019 to October 2019.

40. Defendant Reed Hastings ("Hastings") served as a Company director from June 2011 to May 2019. Hastings was chairman of the Board's Compensation Committee from 2016 to May 2019.

41. Defendant Jan Koum ("Koum") is the co-founder and former CEO of WhatsApp, and served as a Company director from October 2014 until April 2018.

42. Defendant Peter Thiel ("Thiel") served as a Company director from April 2005 until May 2022. Thiel served as a member of the Board's Compensation

Committee from 2015 until October 2019, and as that committee's chairman from October 2019 until May 2022.

43. Defendant Jeffrey D. Zients ("Zients") served as a Company director from May 2018 to May 2020. Zients was chairman of the Board's Audit Committee from May 2019 to May 2020.

44. Bowles, Chenault, Desmond-Hellmann, Hastings, Koum, Thiel, and Zients are referred to herein as the "Former-Director Defendants."

**E. Executive Officer Defendants**

45. Defendant Andrew Bosworth ("Bosworth") has been the Company's Chief Technology Officer ("CTO") since March 2022. Bosworth has been with the Company since 2006 when he created Facebook's News Feed. He served as the Company's Vice President for Reality Labs, overseeing the Company's augmented reality, virtual reality, and artificial intelligence products from 2017 until he became CTO in March 2022.

46. Defendant Mike Schroepfer ("Schroepfer") served as the Company's CTO from 2013 until March 2022.

47. Defendant Nick Clegg ("Clegg") is the Company's President of Global Affairs. Clegg joined the Company in October 2018 as Vice President of Global Affairs and Communications and was promoted to his current position in February 2022. Clegg was heavily involved in creating the Company's content oversight

board, and now leads the Meta's efforts on all policy matters and government interactions on policy implementation, according to Zuckerberg's Facebook post announcing Clegg's 2022 promotion.

48. Defendant Christopher K. Cox ("Cox") has served as the Company's Chief Product Officer from 2014 to March 2019 before stepping away to explore various climate change initiatives and contribute to several political causes. Cox resumed his role as Chief Product Officer in June 2020.[25]

49. Defendant Jennifer G. Newstead ("Newstead") has served as the Company's Chief Legal Officer since April 2019.

50. Defendant David M. Wehner ("Wehner") served as the Company's Chief Financial Officer from June 2014 until November 1, 2022, when he became the Chief Strategy Officer.

51. Defendants Bosworth, Schroepfer, Clegg, Cox, Newstead, and Wehner are referred to herein as "Officer Defendants." The term "Officer Defendants" includes Defendants Zuckerberg and Sandberg for purposes of claims asserted against the Officer Defendants, as Defendants Zuckerberg and Sandberg breached fiduciary duties both in their capacities as directors and in their capacities as officers of Meta.

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[25] Cox left the Company to pursue other interests in March 2019 and resumed his role as Chief Product Officer in June 2020.

## PLAINTIFFS' DEMAND TO INSPECT META'S BOOKS AND RECORDS

52. As part of Plaintiffs' thorough pre-suit investigation, Plaintiffs each sought inspection of certain books and records of the Company pursuant to 8 *Del. C.* § 220 ("Section 220").

53. On December 7, 2021, ERSRI served Meta with a demand for the inspection of books and records relating to, *inter alia*, sex trafficking, human trafficking, and content harmful to children and teenagers occurring on Meta's social media platforms.

54. In response to ERSRI's books-and-records demand pursuant to Section 220, Meta agreed by letter dated December 14, 2021, to produce any non-privileged materials and information identified in their search for "materials provided to the Board and Board minutes since January 1, 2017 relating to the two topics of (i) sex and human trafficking and (ii) teen health, including excerpts of minutes of meetings of the Board (or committees of the Board) that reflect discussion of those two subjects. . . ."[26]

55. On May 26, 2022, the Kiwi Funds served Meta with a demand for the inspection of books and records relating to the use of the Company's social media platforms for human trafficking and sex trafficking. Meta agreed to produce to the

[26] *See* Letter from David E. Ross to William S. Norton, *supra* note19, at 4.

Kiwi Funds the same documents as it had provided to ERSRI. By letter dated June 8, 2022, Meta certified that "its production of the non-privileged materials that Meta agreed to produce [to the Kiwi Funds] is ***now complete***."

56. On January 23, 2023, Cleveland Bakers served Meta with a demand for the inspection of books and records relating to the use of the Company's social media platforms for human trafficking and sex trafficking.

57. In response to Cleveland Bakers' books-and-records demand pursuant to Section 220, Meta agreed, by letter dated January 30, 2023, to produce the same materials it had agreed to produce to ERSRI.

58. By letter dated May 20, 2022, Meta certified that "its production of the non-privileged materials that Meta agreed to produce [to ERSRI] is ***now complete***."[27]

59. The Company's own documents—and the lack thereof—show that the Board, including each of its committees, failed to discuss (even once) the use of the Company's social media platforms for sex trafficking and human trafficking. The Board and its committees also failed to discuss the issue of child sexual exploitation occurring on Meta's platforms. These failures were despite global awareness and

[27] *See* Letter from R. Garrett Rice to Christine M. Mackintosh, *supra* note 20, at 1.

concern with these issues as detailed in Plaintiffs' 220 demands, shareholder proposals detailed in Meta's proxy statements, and as alleged herein.

60. Meta's books and records, along with other information obtained by Plaintiffs through their investigation, evidence the fact that Meta's Board failed to engage in any meaningful oversight relating to the harm to the victims of human and sex trafficking through the use of the Company's social media platforms, or the risk to the Company created by such use of its platforms.

## SUBSTANTIVE ALLEGATIONS

## I. LEGAL BACKGROUND ON SEX/HUMAN TRAFFICKING

### A. The Trafficking Victims Protection Act of 2000

61. Sex trafficking and human trafficking are crimes under U.S. federal and state law. The Trafficking Victims Protection Act of 2000 ("TVPA") and its subsequent reauthorizations define two primary forms of human trafficking: "sex trafficking" and "forced labor":

- Sex trafficking is the recruitment, harboring, transportation, provision, obtaining, patronizing, or soliciting of a person for the purpose of a commercial sex act in which a commercial sex act is induced by force, fraud, or coercion, or in which the person induced to perform such act has not attained 18 years of age. (22 U.S.C. § 7102(11)(A)).
- Forced labor is the recruitment, harboring, transportation, provision, or obtaining of a person for labor or services, through the use of force, fraud, or coercion for the purpose of subjection to involuntary servitude, peonage, debt bondage, or slavery. (22 U.S.C. § 7102(11)(B)).

62. To strengthen penalties for those who engage in sex trafficking, the TVPA created 18 U.S.C. § 1591, which makes "sex trafficking" a crime and defines the offense as follows:

> (a) Whoever knowingly—
>
> (1) in or affecting interstate or foreign commerce, or within the special maritime and territorial jurisdiction of the United States, recruits, entices, harbors, transports, provides, obtains, advertises, maintains, patronizes, or solicits by any means a person; or
>
> (2) benefits, financially or by receiving anything of value, from participation in a venture which has engaged in an act described in violation of paragraph (1),
>
> knowing, or, except where the act constituting the violation of paragraph (1) is advertising, in reckless disregard of the fact, that means of force, threats of force, fraud, coercion described in subsection e(2), or any combination of such means will be used to cause the person to engage in a commercial sex act, or that the person has not attained the age of 18 years and will be caused to engage in a commercial sex act, shall be punished as provided in subsection (b).

18 U.S.C. § 1591(a). A violator of Section 1591 is subject to a statutory fine and a term of imprisonment ranging from "not less than 10 years" to "for life." 18 U.S.C. § 1591(b). In 2003, Congress authorized victims of sex trafficking to file civil actions. 18 U.S.C. § 1595.

63. The U.S. Department of Justice ("DOJ") has described human trafficking (as defined in the TVPA) as "a crime involving the exploitation of a person for labor, services, or commercial sex."[28]

64. The U.S. Department of State (the "State Department") has decried human trafficking as "a grave crime and a human rights abuse":

> Human trafficking, also called trafficking in persons, has no place in our world. As both a grave crime and a human rights abuse, it compromises national and economic security, undermines the rule of law, and harms the well-being of individuals and communities everywhere. It is a crime of exploitation; traffickers profit at the expense of their victims by compelling them to perform labor or to engage in commercial sex in every region of the United States and around the world. With an estimated 24.9 million victims worldwide at any given time, human traffickers prey on adults and children of all ages, backgrounds, and nationalities, exploiting them for their own profit.[29]

65. The U.S. Department of Defense ("DOD") states that "[t]raffickers prey on victims with little or no social safety net." Particular vulnerabilities associated with trafficking victims, according to the DOD, include "poverty or economic hardship, political instability or armed conflict, natural disasters, childhood abuse or neglect, children in foster care, runaway and homeless youth, victims of violence, migrant workers, undocumented immigrants, racial, ethnic, and

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[28] https://www.justice.gov/humantrafficking.

[29] https://www.state.gov/humantrafficking-about-human-trafficking/.

other minorities, physical or cognitive abilities, history of substance abuse, and LGBTQ individuals."[30]

66. The U.S. Department of Homeland Security ("DHS") describes human trafficking as conduct involving "the use of force, fraud, or coercion to obtain some type of labor or commercial sex act."[31] The DHS states that traffickers may use the following methods to lure victims into trafficking situations: violence, manipulation, false promises of well-paying jobs, and romantic relationships.

**B. Section 230 of the Communications Decency Act**

67. Since its enactment in 1996, Section 230 of the CDA has often been used by social media companies to avoid liability for the conduct of third parties occurring on its platforms. Section 230 states that "[n]o provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider." (47 U.S.C. § 230). However, Section 230 does ***not*** protect providers from criminal liability if their content violated criminal laws concerning "sex trafficking" or "sexual exploitation of children":

**(e) EFFECT ON OTHER LAWS**

**(1) NO EFFECT ON CRIMINAL LAW**

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[30] https://ctip.defense.gov/What-is-TIP/.

[31] https://www.dhs.gov/blue-campaign/what-human-trafficking.

> Nothing in this section shall be construed to impair the enforcement of section 223 or 231 of this title, chapter 71 (relating to obscenity) or 110 (relating to sexual exploitation of children) of title 18, or any other Federal criminal statute.
>
> ***
>
> **(5) NO EFFECT ON SEX TRAFFICKING LAW**
>
> Nothing in this section (other than subsection (c)(2)(A)) shall be construed to impair or limit –
>
> > **(A)** any claim in a civil action brought under section 1595 of title 18, if the conduct underlying the claim constitutes a violation of section 1591 of that title;
> >
> > **(B)** any charge in a criminal prosecution brought under State law if the conduct underlying the charge would constitute a violation of section 1591 of title 18; or
> >
> > **(C)** any charge in a criminal prosecution brought under State law if the conduct underlying the charge would constitute a violation of section 2421A of title 18, and promotion or facilitation of prostitution is illegal in the jurisdiction where the defendant's promotion or facilitation of prostitution was targeted.

47 U.S.C. § 230(e)(1) and (5); *see also* 18 U.S.C. Chapter 110 (18 U.S.C. §§ 2251-2260A) (Sexual Exploitation and Other Abuse of Children); 18 U.S.C. §§ 1591, 1595.

### C. FOSTA-SESTA (April 11, 2018)

68. On April 11, 2018, the President signed the Fight Online Sex Trafficking Act[32] ("FOSTA") and the Stop Enabling Sex Traffickers Act[33] ("SESTA") (together "FOSTA-SESTA"), which clarified the country's sex trafficking laws by making it illegal to knowingly assist, support, or facilitate sex trafficking. FOSTA-SESTA made changes to three statutory schemes: the CDA, the TVPA (discussed above); and the Mann Act, 18 U.S.C. § 2421 *et seq*.

69. ***First***, the law amended the safe harbor provisions of Section 230 of the CDA, 47 U.S.C. § 230—which courts had previously interpreted as giving internet service providers (like Meta) immunity from civil liability for the actions of their users—to exclude the enforcement of federal or state sex trafficking laws from Section 230's safe harbors.

70. Section 2 of both acts provides, in part, that "[S]ection 230 was never intended to provide legal protection to websites that facilitate traffickers in advertising the sale of unlawful sex acts with sex trafficking victims."[34] Congress

[32] Pub. L. No. 115-164, 132 Stat. 1253 (2018).

[33] S. 1693, 115th Cong. (2018).

[34] FOSTA, § 2(1); S. 1693 § 2. In passing FOSTA, Congress "narrow[ed] Section 230's scope and provide[d] prosecutors with new tools to combat the sex trafficking of ***both minors and adults***." *Woodhull Freedom Found. v. United States*, 948 F.3d 363, 368 (D.C. Cir. 2020).

clarified and amended Section 230 to ensure that it does not "provide legal protection to websites that unlawfully promote and facilitate prostitution and websites that facilitate traffickers in advertising the sale of unlawful sex acts with sex trafficking victims."[35] FOSTA-SESTA amended Section 230 by adding that "[n]othing in [Section 230] (other than subsection (c)(2)(A)) shall be construed to impair or limit any claim in a civil action brought under section 1595 of title 18, if the conduct underlying the claim constitutes a violation of section 1591 of that title." 47 U.S.C. § 230(5). *See* § I.B *supra* (quoting full text of 47 U.S.C. § 230(5)).

71. ***Second***, as to the Mann Act, FOSTA proscribed "own[ing], manag[ing], or operat[ing] an interactive computer service with the intent to promote or facilitate the prostitution of another person," as punishable by a fine and imprisonment for not more than ten years. FOSTA, § 3(a), 132 Stat. at 1253–54 (codified at 18 U.S.C. § 2421A(a)). This provision adopts the definition of "interactive computer service" in Section 230(f) of the CDA. 18 U.S.C. § 2421A(a). When the underlying conduct "promotes or facilitates the prostitution of 5 or more persons" or when the person "acts in reckless disregard of the fact that such conduct contributed to sex trafficking," there is an enhanced penalty of imprisonment for not more than twenty-five years. *Id.* § 2421A(b). An individual injured by such an

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[35] FOSTA, § 2(1).

aggravated violation may sue for money damages. *Id.* § 2421A(c). Specifically, 18 U.S.C. § 2421A provides:

**IN GENERAL.**—

> **(a)** Whoever, using a facility or means of interstate or foreign commerce or in or affecting interstate or foreign commerce, ***owns, manages, or operates an interactive computer service*** (as such term is defined in defined in section 230(f) the Communications Act of 1934 (47 U.S.C. 230(f))), ***or conspires or attempts to do so, with the intent to promote or facilitate the prostitution of another person*** shall be fined under this title, imprisoned for not more than 10 years, or both.
>
> **(b) AGGRAVATED VIOLATION.**—Whoever, using a facility or means of interstate or foreign commerce or in or affecting interstate or foreign commerce, ***owns, manages, or operates an interactive computer service*** (as such term is defined in defined in section 230(f) the Communications Act of 1934 (47 U.S.C. 230(f))), ***or conspires or attempts to do so, with the intent to promote or facilitate the prostitution of another person and***—
>
> > **(1)** ***promotes or facilitates the prostitution of 5 or more persons***; ***or***
> >
> > **(2)** ***acts in reckless disregard of the fact that such conduct contributed to sex trafficking, in violation of [section] 1591(a)***,
>
> ***shall be fined under this title, imprisoned for not more than 25 years, or both***.
>
> **(c) CIVIL RECOVERY**.—
> Any person injured by reason of a violation of section 2421A(b) may recover damages and reasonable attorneys' fees in an action before any appropriate United States district court.
>
> **(d) MANDATORY RESTITUTION**.—
> Notwithstanding sections 3663 or 3663A and in addition to any other civil or criminal penalties authorized by law, the court shall order restitution for any violation of subsection (b)(2). The scope and nature of such restitution shall be consistent with section 2327(b).

18 U.S.C. § 2421A.

72. ***Third***, with respect to the TVPA, FOSTA-SESTA added a provision to 18 U.S.C. § 1595 authorizing state attorneys general to bring *parens patriae* civil actions against any person who violates section 1591. Specifically, 18 U.S.C. § 1595 provides:

> **(a)** An individual who is a victim of a violation of this chapter may bring a civil action against the perpetrator (or whoever knowingly benefits, financially or by receiving anything of value from participation in a venture which that person knew or should have known has engaged in an act in violation of this chapter) in an appropriate district court of the United States and may recover damages and reasonable attorneys fees.
>
> **(b)**
>
> > **(1)** Any civil action filed under subsection (a) shall be stayed during the pendency of any criminal action arising out of the same occurrence in which the claimant is the victim.
> >
> > **(2)** In this subsection, a "criminal action" includes investigation and prosecution and is pending until final adjudication in the trial court.
>
> **(c)** No action may be maintained under subsection (a) unless it is commenced not later than the later of—
>
> > **(1)** 10 years after the cause of action arose; or
> >
> > **(2)** 10 years after the victim reaches 18 years of age, if the victim was a minor at the time of the alleged offense.
>
> **(d)** ***In any case in which the attorney general of a State has reason to believe that an interest of the residents of that State has been or is threatened or adversely affected by any person who violates section 1591, the attorney general of the State, as parens patriae, may bring a civil action against such person on behalf of the residents of the State in an appropriate district court of the United States to obtain appropriate relief.***

18 U.S.C. § 1595.

73. Along with revising section 1595, Section 230(e)(5)(A) of the CDA now provides that nothing within the CDA shall be construed to limit or impair "any claim in a civil action brought under section 1595 of [the TVPA] if the conduct underlying the claim constitutes a violation of section 1591 of that title." 47 U.S.C. § 230(e)(5).

### D. 11 *Del. C.* § 787(b)(2) (Trafficking an Individual)

74. In addition to being a federal crime, "trafficking an individual" is also a crime under the laws of the state of Delaware. *See* 11 *Del. C.* § 787(b)(2). "A person is guilty of trafficking an individual if the person knowingly recruits, transports, harbors, receives, provides, obtains, isolates, maintains, advertises, solicits, or entices an individual in furtherance of ***forced labor*** in violation of paragraph (b)(2) of this section or ***sexual servitude*** in violation of paragraph (b)(3) of this section." 11 *Del. C.* § 787(b).[36]

[36] *See also* 11 *Del. C.* § 787(b)(2) ("A person is guilty of ***forced labor*** if the person knowingly uses coercion to compel an individual to provide labor or services, except where such conduct is permissible under federal law or law of this State other than 79 Del. Laws, c. 276."); 11 *Del. C.* § 787(b)(3) ("Sexual servitude. — a. A person commits the offense of ***sexual servitude*** if the person knowingly: 1. Maintains or makes available a minor for the purpose of engaging the minor in commercial sexual activity; or 2. Uses coercion or deception to compel an adult to engage in commercial sexual activity.").

## II. META HAS FACILITATED AND ENABLED WIDESPREAD SEX TRAFFICKING AND HUMAN TRAFFICKING

### A. 2009-2022 – Reports of Sex/Human Trafficking and Exploitation on Meta's Platforms Permeate the U.S. News

75. Meta's widespread and ubiquitous facilitation of sex trafficking and human trafficking have been reported in more than 175 articles published in U.S. newspapers and other media outlets between 2009 and 2022. This non-exhaustive selection of news articles is summarized (in chronological order) in Exhibit 1. These articles reported how human traffickers have repeatedly used Meta's platforms to commit their crimes against hundreds (and most likely thousands) of victims in the United States alone, and innumerable more victims worldwide. In several articles, Meta's spokespersons commented on these reports of sex trafficking and human trafficking.

76. For example, on October 29, 2012, *The Associated Press* reported that "***[s]o far this year, 27 of the 129 children reported missing to Indonesia's National Commission for Child Protection are believed to have been abducted after meeting their captors on Facebook***" and that "***[t]he 27 Facebook-related abductions reported to the commission this year in Indonesia have already exceed[ed] 18 similar cases it received in all of 2011***."[37] The article described how these "Facebook-related abductions" are committed by "sexual predators" involved in

[37] *See* Exhibit 1 at 5.

"child sex tourism" in which children as young as 14 or 15 are subjected to "kidnap and rape" and are "forced into prostitution." This same article quoted a Facebook "spokesman Andrew Noyes" who "said in an email" that "[w]e take human trafficking very seriously and a number of measures are in place to counter this activity," but Mr. Noyes "declined to give any details on Facebook's involvement in trafficking cases reported in Indonesia or elsewhere."[38]

77. Similarly, on January 8, 2015, the *Grand Forks Herald* reported on "a sex trafficking conference" at which an "Assistant U.S. Attorney" described a case regarding "a Minnesota man now serving 12 years in federal prison" who "engaged in 800 Facebook chat conversations with, most of the time, 14-to 17-year-old girls" with the intent to "sexually exploit them."[39] The same article quoted "Facebook's Monika Bickert" who "acknowledged how sites like hers can be attractive to pimps for recruiting victims and then threatening or coercing them, or to arrange transactions." The article further noted that "Bickert, head of global policy management with [Facebook]" acknowledged that such criminals "feel the Internet is a really powerful tool for them."

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[38] *Id.*

[39] *Connect In A Click*, GRAND FORKS HERALD (Jan. 8, 2015).

78. On October 25, 2021, *Tampa Bay Times* published an article reporting that "[a]fter publicly promising to crack down, Facebook acknowledged in internal documents obtained by The Associated Press that it was 'under-enforcing on confirmed abusive activity.'"[40] The author further states that "[e]ven today, a quick search for 'khadima,' or 'maids' in Arabic, will bring up accounts featuring posed photographs of Africans and South Asians with ages and prices listed next to their images." The author further notes that "[i]n the documents seen by the AP, Facebook acknowledges being aware of both the exploitative conditions of foreign workers and the use of Instagram to buy and trade maids online [but] Facebook acknowledged it only scratched the surface of the problem and that 'domestic servitude content remained on the platform.'"

79. On October 28, 2021, *USA Today* published an article stating that an internal Facebook report uncovered "a U.S. sex trafficking network recruiting women from overseas and advertising illegal sexual services in domestic massage parlors."[41] The article reported that certain individuals "***used dozens of Facebook***

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[40] Associated Press, *Apple once threatened Facebook ban over Mideast maid abuse; Facebook acknowledged some countries across the region have 'especially egregious' human rights issues when it comes to laborers' protection*, TAMPA BAY TIMES (Oct. 25, 2021), available at https://www.tampabay.com/news/nation-world/2021/10/25/apple-once-threatened-facebook-ban-over-mideast-maid-abuse/.

[41] Cara Kelly, *Facebook failed to rid site of sex trafficking; Papers show company knew it was profiting from illicit spas*, USA Today (Oct. 28, 2021).

***pages and accounts to promote [sex work] parlors and relied on two marketing firms, one in the U.S. and one in India, to buy Facebook ads filled with keywords for potential sexual services***." The author quotes Maggy Krell, who worked on sex trafficking cases as a supervising deputy attorney general in California, who said "'Facebook can't stick its head in the sand,' '[o]nce on notice that its site is being used to traffic someone, they must act.'" The article further states that "***[a] review of the internal documents reveals Facebook has known its products were part of the life cycle of human trafficking for more than three years***," but that Meta "focused" on "'soft actions,' or anything short of moving content from Facebook platforms."

80. On August 30, 2022, *FOX – 4 WDAF* in Kansas City, Missouri, published an article reporting that "[a]n alleged sex-trafficker may have preyed upon hundreds of fellow women over the course of a decade," and that "[d]uring their investigation, agents discovered more than 1,600 online ads associated with Gomez allegedly promoting prostitution" on Facebook, dating back ten years.[42]

### B. 2013-2022 – Criminal/Civil Cases Involving Sex/Human Trafficking on Meta's Platforms Are Routine in U.S. Courts

81. Between 2013 and 2023, at least 70 federal and state courts issued written decisions in criminal and civil cases involving sex trafficking and human

[42] Aaron Feis, *Alleged sex-trafficker may have hundreds of victims, FBI says*, FOX – 4 WDAF (Aug. 30, 2022).

trafficking on Meta's platforms. These decisions are listed in reverse chronological order and summarized in Exhibit 2. While these selected cases are believed to be merely a sample of the larger number of incidents of sex trafficking and human trafficking facilitated by Meta's platforms, including a larger number of criminal prosecutions involving sex trafficking linked to the Company, it is clear that such cases have occurred with increasing frequency in recent years. More appear each week.

82. In several cases, courts found that the evidence supported probable cause to issue search warrants to search the Facebook accounts of defendants and/or victims for evidence of sex trafficking occurring on Meta's platforms.[43]

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[43] *See, e.g.*, *United States v. Wilkins*, No. CR 19-390 (RC), 2021 WL 1894990, at *22, *28 (D.D.C. May 11, 2021) (denying motion to suppress evidence obtained from a "warrant issued to Facebook for [an] Instagram account" and finding "that probable cause existed to search the account for evidence of sex trafficking"); *People v. McGraw*, No. F078342, 2020 WL 5569579, at *1 (Cal. Ct. App. Sept. 17, 2020) (finding "evidence . . . was sufficient to establish probable cause that defendant committed human trafficking" where criminal investigator's "testimony . . . was based primarily on text messages and Facebook communications," including "several Facebook profiles linked to defendant"); *United States v. Vines*, No. 1:17-CR-00160-JRS-TAB, 2018 WL 5634361, at *1, *4, *5 (S.D. Ind. Oct. 31, 2018) (following "indictment charging [defendant] with sex trafficking of a child," denying motion to suppress search warrant; finding "probable cause for search of [defendant's] Facebook" account; and noting that "[t]he government routinely checks social media in sex trafficking cases"); *United States v. Mathis*, No. 18-CR-18(1) (DWF/LIB), 2018 WL 4473529, at *1, *9 (D. Minn. July 17, 2018), report and recommendation adopted, No. CR 18-18(1) (DWF/LIB), 2018 WL 4062741 (D. Minn. Aug. 27, 2018) (denying motion to suppress evidence and finding that search warrant was supported by probable cause where search warrant "affidavit set forth

83. Also in several cases, courts admitted the expert testimony of law enforcement officials describing how sex traffickers frequently use Facebook to recruit victims, communicate with victims and co-conspirators, and facilitate their criminal activities.[44]

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that [minor victim] had been trafficked by [defendant], that [minor victim] communicated through facebook with [another minor victim], that [defendant] had a facebook account, and that [minor victim] appeared to be looking for [defendant] through facebook connections. Further, the affidavit set forth [investigator's] professional experience that sex traffickers and the individuals they traffic . . . often communicate through facebook."); *United States v. Blake*, 868 F.3d 960 (11th Cir. 2017) (finding probable cause to search Facebook account linked to the sex-trafficking conspiracy).

[44] *See, e.g.*, *United States v. Lagrone*, No. 4:17-CR-00264-O, 2018 WL 10447374, at *3 (N.D. Tex. Mar. 23, 2018) (admitting expert testimony by detective who "explained that he has extensive experience using Backpage.com as an investigative tool and frequently uses Facebook and other social media sites in a similar manner"; "find[ing] that the law enforcement witnesses are qualified and demonstrate a level of expertise in how criminals use Facebook, Backpage.com, and other websites to run their enterprises and recruit victims"; and noting that "[t]his testimony is admissible because it will be helpful to the jury to understand how these sites are used in sex trafficking organizations . . . ."); *United States v. Jackson*, No. 2:16-CR-00054-DCN, 2017 WL 2362351, at *1 (D.S.C. May 31, 2017) (denying motion to exclude "expert testimony regarding sex trafficking" where defendants "were indicted on multiple counts of trafficking a minor for sex and of sex trafficking by force, fraud, and coercion in connection with a conspiracy to commit sex trafficking," and "indictment charge[d] that the defendants conspired to recruit young women, some of whom were less than 18 years old, to work as prostitutes," and "used Facebook to recruit victims as well as to communicate with other co-conspirators"); *United States v. Brinson*, 772 F.3d 1314, 1319, 1327 (10th Cir. 2014) (affirming conviction for conspiracy to engage in sex trafficking, sex trafficking of children, and attempted sex trafficking of children and finding that court acted within its discretion by allowing "detective qualified as an expert" to testify regarding "how pimps and prostitutes use the internet, including websites such as Facebook.com";

84. Many judicial opinions by federal and state courts in the last several years have discussed how Meta's platforms are used by sex traffickers to recruit and exploit their victims. *See* Ex. 2. For example, in *United States v. Comer*, 5 F.4th 535 (4th Cir. 2021), the defendant "lured women into prostitution via social media and, in at least one case, attempted to use Facebook to force a young woman who had left her trafficking ring to return." *Id.* at 539. The court concluded that the defendant "***indisputably weaponized social networks like Facebook*** to commit her underlying offense" and that these social networks "were the crucial instrumentalities through which she recruited others into prostitution and, at least in the case of [one victim], tried to prevent them from leaving." *Id.* at 546.

85. Similarly, in *United States v. Porter*, No. 2:20-CR-95, 2022 WL 3021646, at *1 (S.D. Ohio July 29, 2022), the court charged the defendant with child sex trafficking conspiracy and sex trafficking by force conspiracy, noting the defendant's use of Facebook and Facebook messenger. *Id.* The court further noted that the defendant communicated with his coconspirators about his crimes on Facebook. *Id.*

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and that "the jury could have relied on the Facebook.com exchange between [defendant] and [minor victim]" and "[f]rom that exchange, the jury could reasonably infer that [defendant] was using the internet to knowingly entice [a minor victim] into the prostitution trade").

### C. 2012-2022 – U.S. Courts and U.S. News Media Report Rampant Child Sexual Exploitation Taking Place on Meta's Platforms

86. Between 2012 and 2023, at least 129 federal and state courts issued written decisions in criminal and civil cases involving cases of child sexual exploitation on Meta's platforms. These decisions—which are merely a sample of a larger trend in which new cases are filed every few days—are summarized in Exhibit 3.

87. A review of merely a few such cases conveys the real-world harm that that has resulted from the Board's failure to provide any meaningful oversight of this growing problem even as Meta's management has abysmally failed to detect, prevent, or slow down the rampant child sexual exploitation that occurs on a daily basis on Meta's platforms. For example:

- *Commonwealth v. Howland*, No. 61 MDA 2022, 2022 WL 16832489, at *1 (Pa. Super. Ct. Nov. 9, 2022) (defendant convicted of "kidnapping and sexual abuse of a 13-year-old child admitted communicating with the child by . . . Facebook").
- *Commonwealth v. Escabal*, No. 1928 EDA 2021, 2022 WL 6643947, at *1 (Pa. Super. Ct. Oct. 11, 2022) (defendant "admitted using Facebook Messenger to disseminate images of child pornography" and that his "Facebook account [was] used to disseminate the pornographic images").
- *United States v. Elliott*, No. 1:19-CR-00152-TWP-MJD, 2022 WL 2046342, at *1 (S.D. Ind. June 7, 2022) (defendant "possessed Child Sexual Abuse Material ('CSAM') of Minor Victim 1 and distributed it on Facebook, thereafter, he attempted to hire a hitman . . . to kill Minor Victim 1 and Witness Victim 1 to prevent them from testifying against him in various state and federal cases").

- *United States v. Isip*, No. CR 19-64-RGA, 2022 WL 1120111, at *2 (D. Del. Apr. 14, 2022) ("Defendant knowingly received a sexually explicit picture from the [minor] victim via Facebook Messenger.").

- *United States v. Ashmore*, No. ACM 40036, 2022 WL 678895, at *1 (A.F. Ct. Crim. App. Mar. 8, 2022) (defendant "used 16 different Instagram accounts" and "5 Facebook accounts" that were "populat[ed] . . . with photos" of "his [minor] victims").

- *Cuddihe v. United States*, No. 17-CR-04091-SRB-1, 2021 WL 1972208, at *1-2 (W.D. Mo. May 17, 2021) (defendant exchanged "pictures and videos via Facebook Messenger" and used "Facebook" and "Facebook Messenger" to "converse[] with over 150 people, many of whom appeared to be minors between the ages of eleven and fifteen").

- *United States v. Galvan*, No. 3:20-CR-00019, 2020 WL 4604502, at *1, *3, *5 (S.D. Tex. Aug. 11, 2020) (defendant "arrested and charged in state court with three counts of possession of child pornography" after "posing as a 13-year-old boy on Instagram" and authorities discovered "over 8,000 pages of Instagram conversations during the approximate month-and-a-half period the Instagram account was active," and "[a] review of the less-than-two-month-old Instagram account revealed 8,185 pages of conversations, including sexually explicit messages between [defendant] and at least ten separate minor victims").

- *United States v. Bjerknes*, No. 17-CR-0234 (WMW), 2020 WL 1989393, at *1 (D. Minn. Apr. 27, 2020) ("[Defendant's] convictions arise from his scheme, executed between 2014 and 2017, to use 'various social media applications, including Facebook to solicit images and videos constituting child pornography from minor females, engage in sexually explicit conversations with minor females, and distribute sexually explicit images and videos to minor females and males.' [Defendant's] scheme involved at least 55 minors.").

88. U.S. news media has similarly reported on the ubiquitous, openly occurring, and unchecked child sexual exploitation that occurs every day on Meta's

platforms and which currently has no end in sight. For example, on March 13, 2022, *WIRED*, an online and print magazine, published an article by Professor Lara Putnam, a history professor at the University of Pittsburg, titled "Facebook Has a Child Predation Problem."[45] In the article, Professor Putnam recounted how her attempt to research "the 10th, 11th, or 12th wards of the city of Pittsburgh" on Facebook quickly led her to dozens of Facebook "groups targeting children of those ages" with "over 81,000 members" who openly solicited children for sexual exploitation.[46]

89. For example, one such "group [was] named 'Buscando novi@ de 9,10,11,12,13 años'" [i.e., "[l]ooking for a 9-year-old girlfriend"] and had "7,900 members."[47] Yet, when Professor Putnam "used Facebook's on-platform system" to "tag[] it as containing 'nudity or sexual activity' which 'involves a child,'" an "automated response came back days later" (by which time the group had grown to "9,000" members) saying that "[t]he group had been reviewed and did not violate any 'specific community standards'" and that if Professor Putnam "continued to encounter content 'offensive or distasteful' [she] should report that specific content,

[45] Lara Putnam, *Facebook Has a Child Predation Problem*, WIRED (Mar. 13, 2022), available at https://www.wired.com/story/facebook-has-a-child-predation-problem/.

[46] *Id.*

[47] *Id.*

not the group as a whole."[48] And despite her repeated efforts to report these groups to Facebook, due to Facebook's implacable "AI-driven algorithms," "new child sexualization groups began getting recommended to [her] as 'Groups You May Like.'" A partial excerpt of the article states as follows:

> WHILE TRYING TO map the extent and impact of place-based Facebook groups where QAnon and allied disinformation spread, I went looking for Facebook groups with names including 10, 11, or 12. This was part of my work with the Pitt Disinformation Lab, and ***I was thinking of the 10th, 11th, or 12th wards of the city of Pittsburgh. What appeared instead was a group named "Buscando novi@ de 9,10,11,12,13 años." Looking for a 9-year-old girlfriend? What?***
>
> The page's aesthetic was cartoon cute: oversized eyes with long lashes, hearts, and pastels. The posts that made explicit references to photographed genitalia were gamified and spangled with emoticons: "See your age in this list? Type it into the replies and I'll show 'it' to you."
>
> Most often posts were just doorways to connection, the real danger offstage. "Looking for a perverted girlfriend of 11," read one post, with purple background and heart emojis. Replies asked for friend requests to continue via Messenger, or offered entry to private groups or WhatsApp chats—away from the eyes of even a digital passerby.
>
> This was not some outlaw 8Chan message board. ***It was cheerfully findable on Facebook***. And, I began discovering in alarm, it was not the only one. ***Indeed, as late as January 2022—three months into my efforts to get action taken against them—if I searched 11, 12, 13 on the platform, 23 of the first 30 results were groups targeting children of those ages, with group names that included the words boyfriend/girlfriend, novio/a, or niños/niñas, sometimes along with 'pervertidos,' 'hot,' etc. They totaled over 81,000 members***.

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[48] *Id.*

> Surely due diligence would dictate proactive steps to prevent the creation of such groups, backed up by quick action to remove any that get through once they are flagged and reported. I would have thought so. Until I stumbled into these groups and began, with rising disbelief, to find it ***impossible to get them taken down***.
>
> ***
>
> ***OF COURSE I reported the group I had accidentally uncovered. I used Facebook's on-platform system, tagging it as containing "nudity or sexual activity" which (next menu) "involves a child." An automated response came back days later. The group had been reviewed and did not violate any "specific community standards." If I continued to encounter content "offensive or distasteful to you"—was my taste the problem here?—I should report that specific content, not the group as a whole***.
>
> ***"Buscando novi@ de 9,10,11,12,13 años" had 7,900 members when I reported it. By the time Facebook replied that it did not violate community standards, it had 9,000.***
>
> So I tweeted at Facebook and the Facebook newsroom. I DMed [i.e., Direct Messaged] people I didn't know but thought might have access to people inside Facebook. I tagged journalists. And ***I reported through the platform's protocol a dozen more groups, some with thousands of users***: groups I found not through sexually explicit search terms but just by typing "11 12 13" into the Groups search bar.
>
> What became ever clearer as I struggled to get action is that technology's limits were not the problem. ***The full power of AI-driven algorithms was on display, but it was working to expand, not reduce, child endangerment***. ***Because even as reply after reply hit my inbox denying grounds for action, new child sexualization groups began getting recommended to me as "Groups You May Like."***

### D. April 10, 2018 – Zuckerberg Testifies Before the U.S. Senate Regarding Sex/Human Trafficking on Meta's Platforms

90. On at least three separate occasions, Zuckerberg has testified before Congress and publicly discussed the subject of sex trafficking tied to Facebook. His

testimony makes clear that Facebook, its Board, and Zuckerberg specifically, have been put on notice for years that more had to be done to address the improper facilitation of sex trafficking on Meta's platforms.

91. On April 10, 2018, Zuckerberg testified for the first time before Congress, appearing before the U.S. Senate Committee on the Judiciary and the U.S. Senate Committee on Commerce, Science and Transportation. Below are excerpted comments that U.S. Senators John Thune and Ben Sasse made to Zuckerberg during that hearing.

> [**Senator Thune:**] Just last month, in overwhelming bipartisan fashion, ***Congress voted to make it easier for prosecutors and victims to go after websites that knowingly facilitate sex trafficking. This should be a wake-up call for the tech community***. We want to hear more, without delay, about what Facebook and other companies plan to do to take greater responsibility for what happens on their platforms. . . . (p. 3)
>
> ***
>
> [**Senator Sasse:**] I think violence has no place on your platform. ***Sex traffickers and human traffickers have no place on your platform***. (p. 103)

**E. October 23, 2019 – Zuckerberg Testifies Before the House Regarding Sex Trafficking and Exploitation on Meta's Platforms**

92. On October 23, 2019, Zuckerberg testified before the U.S. House Financial Services Committee. Below are excerpted comments that U.S. Congresswoman Ann Wagner made to Zuckerberg during that hearing, and certain of his responses.

[**Congresswoman Wagner:**] So, let me move on to something that is near and dear to my heart. As you may know, I wrote and passed HR 1865, the Fight Online Sex Trafficking Act. Together with the Senate's Stop Enabling Sex Traffickers Act, the package is widely known as FOSTA-SESTA. I am committed to rooting out online sex trafficking, and I believe that what is illegal offline should, indeed, be illegal online.

[**Congresswoman Wagner:**] Three weeks ago, the New York Times ran a report entitled, "The Internet is Overrun with Images of Child Sex Abuse." And I would like this submitted for the record.

***

[**Congresswoman Wagner:**] 16.8 million, as confirmed by the Department of Justice, of the 18.4 million worldwide reports of child sexual abuse material are on Facebook. 16.8 of the 18.4 million. These 18.4 million reports from last year included a record 45 million photos and videos. These are absolutely shocking numbers. Moreover, it is estimated that 70 percent of Facebook's valuable reporting to NCMEC, the National Center on Missing and Exploited Children, would be lost if Facebook implements its end to end encryption proposal. Mr. Zuckerberg, how much is this figure growing year after year, and if you enact end – to - end encryption, what will become of the children who will be harmed as a result that they are not reported?

[**Zuckerberg:**] Congresswoman, thanks. Child exploitation is one of the most serious threats that we focus on.

[**Congresswoman Wagner:**] What is Facebook doing? Sixteen–point–eight of the 18.4 million.

[**Zuckerberg:**] Congresswoman, those reports come from Facebook. The reason why the vast majority come from Facebook is because I think we work harder than any other company to identify this behavior and report it to NCMEC and the FBI.

[**Congresswoman Wagner:**] ***What are you doing to shut this down? These accounts peddle horrific illegal content that exploits women and children. What are you doing, Mr. Zuckerburg, to shut this down?***

> [**Zuckerberg:**] ***Congresswoman, we build sophisticated systems to find this behavior.***
>
> [**Congresswoman Wagner:**] Sixteen–point–eight million and growing of the 18.4 images?
>
> [**Zuckerberg:**] Absolutely. Congresswoman, I don't think Facebook is the only place on the internet where this behavior is happening. I think the fact that the vast majority of those reports come from us reflects the fact that we actually do a better job than everyone else at finding it and acting on it. And you are right that in an end–to–end encrypted world, one of the risks that I am worried about, among others, to safety is that it will be harder to find some of this behavior.
>
> [**Congresswoman Wagner:**] But you have said you want end–to–end encryption. What is going to happen to these children? They won't be reported then. And you are responsible. Facebook is responsible for 16.8 million of the 18.4 million that are out there last year alone.
>
> [**Zuckerberg:**] Congresswoman, again I believe that there are probably a lot more than 18 million out there, and I think we're doing a good job of finding this, but I think you're right that an end to–
>
> [**Congresswoman Wagner:**] ***What are you going to do to shut it down, Mister Zuckerberg?***
>
> [**Zuckerberg:**] ***We are working with law enforcement and building technical systems to identify and report this hard before it–***
>
> [**Congresswoman Wagner:**] ***Well, you are not working hard enough, sir, …***

### F. October 2019 – BBC Reports "Hundreds of Women Being Sold" in "Slave Markets" on "Instagram"; Apple Threatens to Pull Meta from the App Store; and Meta Internally Admits "Our Platform Enables All Three Stages of the Human Exploitation Life Cycle"

93. On October 31, 2019, *BBC News Arabic* published an article detailing "[a]n undercover investigation" revealing that "[i]n Saudi Arabia, ***hundreds of***

***women [were] being sold on Instagram, which is owned by Facebook***."[49] The article stated that "at the time of publication, ***hundreds of domestic workers were still being traded on Instagram*** which the BBC [British Broadcasting Company] has seen."[50] *BBC* quoted "Urmila Bhoola, the UN special rapporteur on contemporary forms of slavery," who said, "***[t]his is the quintessential example of modern slavery***[.]"[51] "***What they are doing is promoting an online slave market***," Ms. Bhoola said, "If Facebook or any other companies are hosting apps like these, they have to be held accountable."[52]

94. On October 23, 2019, according to internal documents,[53] Meta "received [a] communication from Apple" in which Apple "threatened to pull

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[49] *See* Owen Pinnell & Jess Kelly, *Slave markets found on Instagram and other apps*," BBC NEWS ARABIC (Oct. 31, 2019), available at https://www.bbc.com/news/technology-50228549.

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] Apple's confrontation with Meta was revealed in internal documents obtained by Frances Haugen and filed with her whistleblower complaints to the SEC, which were published in *60 Minutes'* website. *See* Keith Zubrow, Maria Gavrilovic, and Alex Ortiz, Whistleblower's SEC Complaint: Facebook Knew Platform Was Used to "Promote Human Trafficking and Domestic Servitude," 60 MINUTES (Oct. 4, 2021), available at https://www.cbsnews.com/news/facebook-whistleblower-sec-complaint-60-minutes-2021-10-04/ ("[Meta's] failure to solve human trafficking and servitude on its platforms threatened its distribution on the Apple App Store."). *60 Minutes* posted Haugen's SEC complaint concerning trafficking at: https://drive.google.com/file/d/1ItiZR_n1_xB3gzkJZ9uvd6pUOYRMGIex/view.

[Facebook and Instagram] apps from its App Store due to [Apple's] identifying content promoting 'domestic servitude'" on Facebook and Instagram. "Apple['s] escalation was linked to the findings of the BBC investigation into Domestic Servitude content on [Instagram and Facebook], which identified [Meta's] apps (and Apple's platform, Apps Store) being used to buy and sell domestic workers in the Gulf Region."[54]

95. In response to this "Apple escalation," Meta undertook a "Deep Dive" on "Domestic Servitude and Tracking in the Middle East," and as a result, internally acknowledged that it had been "***underreporting this behaviour***"; suffered from an "***absence of proactive detection***"; that "***newly created and existing [domestic servitude] content [was] not captured***" which "***meant that domestic servitude content remained on the platform***"; Meta had been "***under-enforcing on confirmed abusive activity with a nexus to the platform***"; and that Meta's own "***investigative findings demonstrate that our platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks***."[55] Specifically, Meta's internal documents stated:[56]

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[54] *Id.*

[55] *Id.*

[56] *Id.* (quoting "Internal Facebook documents" titled "Apple Escalation – How we made it through this SEV," "Domestic Servitude and Tracking in the Middle East – a SEV Deep Dive," and "Domestic Servitude") (internal footnotes and citations omitted).

"On 23rd October [2019] ***we received communication from Apple where the company threatened to pull FB & IG apps from its App Store due to them identifying content promoting 'domestic servitude'***

Apple escalation was linked to the findings of the BBC investigation into Domestic Servitude content on IG & FB, which identified our apps (and Apple's platform, Apps Store) being used to buy and sell domestic workers in the Gulf Region. At the time, BBC approached Facebook in relation to the investigation prior to the Apple escalation and shared violating hashtags . . .

***However, due to the underreporting of this behaviour and absence of proactive detection, newly created and existing content not captured in the IG [i.e., Instagram] sweep meant that domestic servitude content remained on the platform***."

"***Was this issue known to Facebook before BBC enquiry and Apple escalation? Yes***."

"[W]e found users did discover the IG domestic servitude accounts using Search currently we aren't logging the information to determine how users found the IG accounts."

"***FB is the primary vehicle that domestic workers from the Philippines - - probably the most significant source country - - use to communicate with recruitment agencies about off-platform exploitation . . . 89% . . . were undetectable for scaled review***. . . Our best opportunity to reduce this type of human exploitation on the platform is a preventive educational campaign . . . We also propose several recommendations to improve our enforcement . . . by using our current approach, ***we are under-enforcing on confirmed abusive activity with a nexus to the platform.***"

"***Our investigative findings demonstrate that our platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks. The traffickers, recruiters and facilitators from these 'agencies' used FB profiles, IG profiles, Pages, Messenger and WhatsApp***."

"Human Trafficking Unresolved model for investigative flows led to ambiguity on responsibilities . . . Understand exercise for Hex [human exploitation] deprioritized." "***encryption will preclude investigators'***

> ***access to inboxes and potentially make it impossible to accurately evaluate the violating status of recruitment-related agencies*** . . . [but a] preventative approach could lead to a significant reduction in real-world domestic servitude abuse via the Facebook platform.

96. In the same internal documents (as quoted in a September 16, 2021 article by *The Wall Street Journal*[57]), Meta internally acknowledged in that "***domestic servitude manifests on our platform across its entire life cycle: recruitment, facilitation, and exploitation***," and "***recognised the risks resulting from mitigation strategy based on user reports: similarly to other human exploitation abuses, domestic servitude has been highly underreported by the platform users***."[58]

### G. November 17, 2020 – Zuckerberg Testifies Before U.S. Senate Regarding Human Trafficking on Meta's Platforms

97. On November 17, 2020, Zuckerberg testified before the U.S. Senate Committee on the Judiciary. Below are excerpted comments that Senator Richard Blumenthal made to Zuckerberg during that hearing.

> [**Senator Blumenthal:**] There are real harms and real victims here. And in some ways, this hearing is a betrayal of those real harms and the real victims of them. Those harms have been caused by big tech because you have failed your responsibility as have others in this industry. ***I want to see real reform that will enable these abuses to be reformed***

[57] Justin Scheck, Newley Purnell, Jeff Horwitz, *Facebook Employees Flag Drug Cartels and Human Traffickers. The Company's Response Is Weak, Documents Show*, THE WALL STREET JOURNAL (Sept. 16, 2021), available at https://www.wsj.com/articles/facebook-drug-cartels-human-traffickers-response-is-weak-documents-11631812953?mod=article_inline.

[58] *Id.*

***because your platforms have embraced abuse and weaponized child predators, violent white supremacists and human traffickers.***

**H. 2020 – Polaris – "Human Trafficking Trends in 2020"**

98. The Polaris Project is a nonprofit that was founded in 2002 that has operated the U.S. National Human Trafficking Hotline, which provides 24/7 support and a variety of options for survivors of human trafficking to get connected to help and stay safe. Polaris released its report – Human Trafficking Trends in 2020 – detailing an analysis of data obtained from the U.S. National Human Trafficking Hotline.[59]

99. The investigation found that "[o]nline recruitment increased a significant 22%. During the lockdowns, as the proportion of victims from common recruitment sites such as strip clubs (-46%), foster homes (-70%) and schools (-38%) went down drastically, the Internet was reported as the top recruitment location for all forms of trafficking."[60]

100. Notably, "the analysis found a significant increase in the proportion of potential victims for whom Facebook and Instagram were the sites for recruitment into trafficking." There was a "125% increase in reports of recruitment on Facebook

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[59] https://polarisproject.org/2020-us-national-human-trafficking-hotline-statistics/.

[60] https://polarisproject.org/wp-content/uploads/2022/01/Human-Trafficking-Trends-in-2020-by-Polaris.pdf.

over the previous year" and a "95% increase in reports of recruitment on Instagram over the previous year."[61]

### I. March 3, 2020 – Tech Transparency Project – "Broken Promises: Sexual Exploitation of Children on Facebook"

101. In March of 2020, the Tech Transparency Project ("TTP") published its analysis which found hundreds of U.S. cases in which suspected pedophiles used Facebook to groom minors and trade images of their sexual abuse.[62]

102. The review identified 366 federal criminal cases over seven years that featured suspects using Facebook for child exploitation. TTP's report also found such cases are becoming more frequent, from as many as 10 per quarter in 2013 to as many as 23 per quarter in 2019.

103. The report further concluded that Facebook's systems are failing to eliminate such abuse. In the vast majority of cases, Facebook did not provide the initial tip-off to authorities, despite this conduct occurring on its platforms. In fact, "[o]nly 9% of the cases were initiated because Facebook or the National Center for Missing and Exploited Children (which receives cyber tips from Facebook) reported them to authorities, raising questions about the effectiveness of Facebook's

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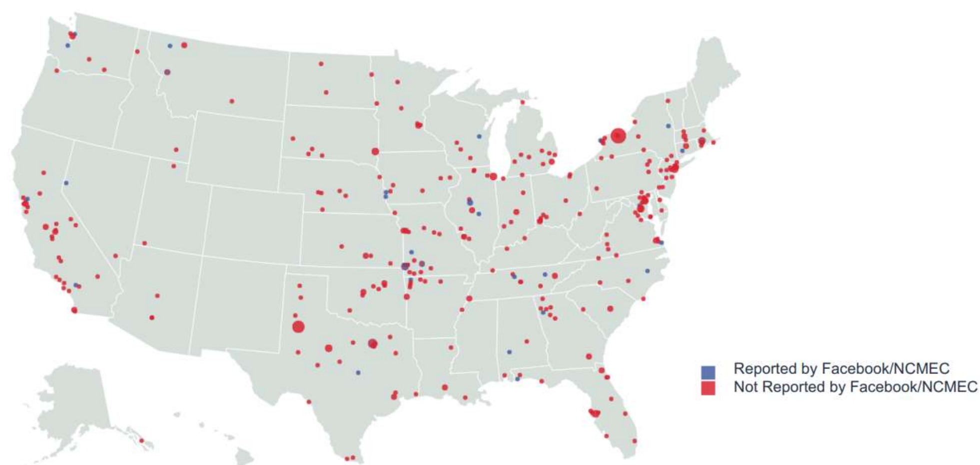
[61] *Id.*

[62] https://www.techtransparencyproject.org/articles/sexual-exploitation-children-facebook.

monitoring of criminal activity targeting children."[63] The report concluded therefore that "[t]he cases reviewed represent the tip of the iceberg of a far larger problem that remains unsolved by Facebook in the U.S. and around the world."[64]

104. The TTP report also emphasized how Zuckerberg told lawmakers in October 2019 that Facebook "build[s] sophisticated systems to find this behavior," yet the map below illustrates how Meta has failed to detect and/or report the vast majority of cases:



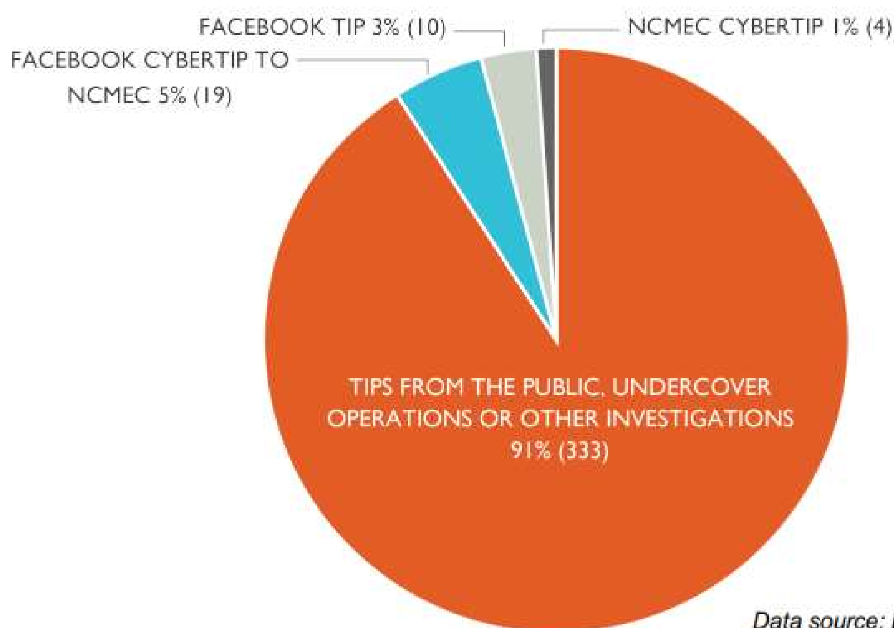

*Federal criminal cases across the country have shown suspected pedophiles targeting or abusing children on Facebook. Facebook reported the activity to authorities in less than 10 percent of the cases.*

105. The report further stated that "[a]ll of the examples of suspects using Facebook for child exploitation fell into 366 cases (which sometimes covered

[63] https://www.techtransparencyproject.org/sites/default/files/Facebook-Child-Exploitation.pdf.

[64] *Id.*

multiple defendants). The Justice Department's press releases on those cases included information on how the investigation was initiated. The majority of the cases (91%) were initiated by tips from the public, undercover operations or information obtained in ongoing investigations. The remaining 9% state that investigations were the result of cyber tips from Facebook or NCMEC."[65]




106. TTP's report further explains that "[a]fter [FOSTA-SESTA's] final passage, however, the press releases show child exploitation cases involving

[65] *Id.*

Facebook began to increase, as did Facebook and NCMEC's reporting of such activity to authorities."[66]

107. "In the five years before the passage of FOSTA-SESTA, Facebook and NCMEC averaged less than one cyber tip per quarter, according to the TTP analysis. Since the bill was passed in March 2018, they have averaged more than three reports per quarter. In total, they reported more cases in the nearly two years since FOSTA-SESTA than they did in the prior five years combined."[67]

108. "Th[is] trend … suggests the threat of legal liability under FOSTA-SESTA may be motivating Facebook to increase tips to authorities. But even with the upswing, ***the number of Facebook tips detailed in the DOJ press releases remains relatively low, and they're limited to child sexual abuse images.***"[68]

### J. April 10, 2020 – Meta's Board Opposes a "Stockholder Proposal Regarding Child Exploitation" by Making False Statements

109. On April 10, 2020, Meta filed its annual proxy statement in which it published a "Stockholder Proposal Regarding Child Exploitation" which stated, among other things, that "Facebook [was] being sued in a Texas court for facilitating

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[66] *Id.*

[67] *Id.*

[68] *Id.*

sex trafficking of minors," and that "Instagram [was] being linked to 'rampant sex trafficking'":[69]

> Facebook and its subsidiaries have faced other recent controversies of child sexual exploitation, including:
>
> - ***Facebook being sued in a Texas court for facilitating sex trafficking of minors***;[70]
> - ***Instagram being linked to "rampant sex trafficking***, child sexual abuse grooming, as well as adult fetishization of young girls…," "sexually graphic comments on minor's photos," and allowing strangers to "direct message minors";[71] and
> - Pedophiles "sharing Dropbox links to child porn via Instagram[.]"[72]

110. Based on these and other observations, the "Shareholders request[ed] that the Board of Directors issue a report by February 2021 assessing the risk of increased sexual exploitation of children as the Company develops and offers additional privacy tools such as end-to-end encryption."[73]

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[69] Meta, Proxy Statement (Schedule 14A) at 77 (Apr. 10, 2020).

[70] https://www.nytimes.com/2019/12/03/technology/facebook-lawsuit-section-230.html.

[71] https://endsexualexploitation.org/articles/statement-instagram-is-predators-paradise-says-international-groupof-human-rights-ngos/; https://endsexualexploitation.org/articles/senate-hearing-uncovers-sexploitation-in-appsand-social-media/

[72] https://www.dailymail.co.uk/news/article-6574015/How-pedophiles-using-Instagram-secret-portal-apparentnetwork-child-porn.html

[73] Meta, Proxy Statement (Schedule 14A) at 77 (Apr. 10, 2020).

111. Meta's Board opposed this request and "**recommend[ed] a vote AGAINST the stockholder proposal**."[74] In its "Opposing Statement," Meta claimed that "[w]e use sophisticated technology and other techniques not only to detect child exploitation imagery and remove it, but also to detect and prevent grooming or potentially inappropriate interactions between a minor and an adult," and told shareholders that "[w]e deploy technology across all of our platforms to proactively surface as much illegal child exploitative content as we can, including through detection technology, machine learning and artificial intelligence techniques, and open-sourcing photo- and video-matching technology."[75] As discussed below, Meta's statements in opposing this stockholder proposal were materially misleading because in fact Meta did not use its "machine learning" technology [redacted] Furthermore, although Meta was ***publicly*** claiming that it could successfully "detect child exploitation imagery and remove it" and "detect and prevent grooming or potentially inappropriate interactions between a minor and an adult"—***internally*** Meta was acknowledging that [redacted]

[74] *Id.* at 79.

[75] *Id.*

### K. June 2020 – 2020 Trafficking in Persons Report

112. In June 2020, the U.S. Department of State published its Trafficking in Persons Report (June 2020, 20th Ed.).[76] The report notes how "[t]he media reported in 2018 that trafficking gangs increasingly used social media sites, particularly Facebook, to buy and sell women and girls for sex and labor exploitation." *Id.* at 269. The report further notes that "[t]raffickers use social media websites, including dating apps, online forums and chat rooms, and Facebook groups, to exploit girls in sex trafficking." *Id.* at 275.

### L. April 9, 2021 – Meta's Board Opposes a "Shareholder Proposal Regarding Child Exploitation" by Making False Statements

113. On April 9, 2021, Meta filed its annual proxy statement in which it published a "Shareholder Proposal Regarding Child Exploitation" which stated, among other things, that "[c]hild sexual exploitation online (and Child Sexual Abuse Material—CSAM) is an escalating threat to children worldwide. The exponential growth of CSAM is directly tied to the growth of social media and the increasing number of children online. In 2019, the National Center for Missing and Exploited

[76] https://www.state.gov/reports/2020-trafficking-in-persons-report/.

Children (NCMEC) received nearly 17 million reports of CSAM. Of these, nearly 16 million reports–or ***94 percent–stem from Facebook and its platforms, including Messenger and Instagram***."[77]

114. Just as they had in 2020, the "Shareholders request[ed] that the Board of Directors issue a report by February 2022 assessing the risk of increased sexual exploitation of children as the Company develops and offers additional privacy tools such as end-to-end encryption."[78]

115. As it had in 2020, Meta's Board opposed this request and "**recommend[ed] a vote AGAINST the shareholder proposal**."[79] In its "Opposing Statement," Meta claimed to have "dedicated teams to help ***find and remove more harmful content - increasingly before people even see it***"; touted "***our progress and effectiveness in combating these issues***"; and stated that "[w]e deploy technology across all of our platforms to proactively surface illegal child exploitative content and activity, including through detection technology, ***machine learning*** and artificial intelligence techniques."[80]

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[77] Meta, Proxy Statement (Schedule 14A) at 74 (Apr. 9, 2021).

[78] *Id.*

[79] *Id*. at 76.

[80] *Id.* at 75.

116. As discussed below, Meta's statements in opposing this shareholder proposal were materially misleading because in fact Meta did not use its "machine" learning technology [redacted] *See* Section II.L *supra*. And although Meta was ***publicly*** touting its "progress and effectiveness in combating these issues" and how it could "find and remove more harmful content - increasingly before people even see it"—***internally*** Meta was acknowledging that [redacted] *See* Section II.L *supra*.

**M. June 8, 2021 – 2020 Federal Human Trafficking Report**

117. On June 8, 2021, the Human Trafficking Institute published its 2020 Federal Human Trafficking Report.[81] The report provided numerous statistics concerning human trafficking in the United States and internationally. One of the "key takeaways from 2020" was that 59% of online victim recruitment (and 65% of

[81] https://traffickinginstitute.org/wp-content/uploads/2022/01/2020-Federal-Human-Trafficking-Report-Low-Res.pdf.

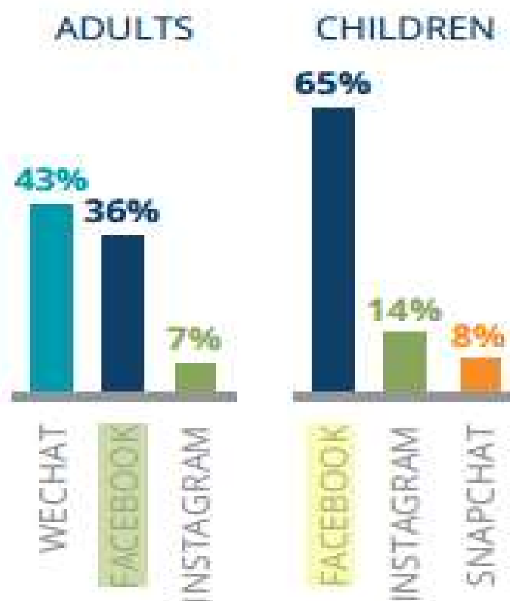
child victim recruitment) in active sex trafficking cases occurred on the Facebook and Instagram social media platforms:

> Although traffickers in 2020 active cases recruited their victims from a variety of physical locations, the internet was the most common (41%, 244) location for recruitment, as has been the case every year since 2013. ***In 2020, 59% (78) of online victim recruitment in active sex trafficking cases occurred on Facebook, making [Facebook] by far the most frequently referenced website or app in public sources connected with these prosecutions, which was also true in 2019***.
>
> Surprisingly, despite Facebook's reputation as a less popular platform among teenagers, it was a more common platform for recruiting child victims than adult victims in 2020 active sex trafficking cases. In fact, ***65% (68) of child victims recruited on social media were recruited through Facebook*** compared to just 36% (10) of adults. After Facebook, Instagram and Snapchat were the most frequently cited social media platforms for recruiting child victims, accounting for 14% (15) and 8% (8) of child recruitment, respectively. Among adults, other top platforms were WeChat (43%, 12) and Instagram (7%, 2). Overall, when examining websites and apps used to recruit victims irrespective of age, the most common sites in active sex trafficking cases—after Facebook—were Instagram (13%, 17), WeChat (9%, 12), and SnapChat (7%, 9).

*Id.* at 44 (emphases added) (internal citations omitted).

118. The report depicted the percentages of "active criminal sex trafficking cases by age" which involved Facebook or one of Meta's other platforms, Instagram, as follows: [82]

[82] *Id.*




119. Thus, in 2020, 79% of child victims in active criminal sex trafficking cases were recruited by their predators from Facebook and Instagram.

**N. June 2021 – 2021 Trafficking in Persons Report**

120. In June 2021, the State Department publicly released its annual Trafficking in Persons Report.[83] The State Department reported that COVID-19 mitigation efforts forced many people to shift online, including human traffickers. Online grooming and recruitment of children has increased, and reports from several

[83] https://www.state.gov/reports/2021-trafficking-in-persons-report/.

different countries demonstrated drastic increases in online commercial sexual exploitation and sex trafficking, including online sexual exploitation of children (OSEC), and demand for distribution of child sexual exploitation material (CSEM), including content that involved human trafficking victims. The report noted that in Israel, women, transgender adults, and children were vulnerable to sex trafficking, and that traffickers "use social media websites, including dating apps, online forums and chat rooms, and Facebook groups, to exploit girls in sex trafficking."[84] The report further noted that "[i]n cases of sexual exploitation of children, WhatsApp chats . . . are used to attract children and exploit them."[85]

### O. June 10, 2021 – Meta Falsely Tells *CBS* that It "Take[s] Down Any Content that Violates [Its] Rules" Against "Sex Trafficking and Child Exploitation"

121. On June 10, 2021, Meta issued a statement to *CBS News*, claiming that it "take[s] down any content that violates" the Company's rules prohibiting "sex trafficking and child exploitation" on its platforms:

> ***Sex trafficking and child exploitation are abhorrent and we don't allow them on Facebook. We have policies and technology to prevent these types of abuses and take down any content that violates our rules***. We also work with safety groups, anti-trafficking organizations and other technology companies to address this and we report all apparent instances of child sexual exploitation to the National Center for Missing and Exploited Children.

[84] *Id.* at 310.

[85] *Id.* at 216.

122. Meta's statement above to *CBS News* on June 10, 2021, was materially false and misleading because although Meta claimed to "take down any content that violates" it rules against "[s]ex trafficking and child exploitation"—Meta had already internally acknowledged in December 2020 that (1) [redacted]; (2) [redacted]; (3) the [redacted] and that the [redacted]; and (4) the Company lacked [redacted].[86]

123. Indeed, Meta failed to "fix[] the systems that allowed" traffickers to operate despite having extensive information concerning their activities and opportunities to remove that content. For example, as *The Wall Street Journal* reported on September 16, 2021, a Meta team spent more than one year in 2018/2019 investigating human trafficking on its platforms in the Middle East, and therefore already knew it had an unresolved problem with human trafficking before the issue was raised by *BBC* and Apple. Yet, an internal document warned the Company to be cautious with statements against human trafficking in order to not "alienate

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[86] META220_0006468 and META220_0006471.

buyers" of enslaved domestic workers who used Meta's platforms. As *The Wall Street Journal* reported, and Meta's internal documents noted, Meta was often more concerned with retaining users and "placating authoritarian governments" than it was with preventing human trafficking on its platforms.[87]

### P. June 25, 2021 – the Texas Supreme Court Upholds a Lawsuit Against Meta by Victims of Sex Trafficking Despite Section 230

124. On June 25, 2021, the Supreme Court of Texas issued an opinion in *In re Facebook, Inc.*,[88] which held that Section 230 of the CDA, 47 U.S.C. § 230, did not bar claims against Meta by three victims of sex trafficking under the Texas human trafficking statute.[89] In so holding, the court reviewed these victims' allegations that Facebook engaged in "overt acts" that "encourag[ed] the use of [the Company's] platforms for sex trafficking" including that:

> Facebook "creat[ed] a breeding ground for sex traffickers to stalk and entrap survivors"; that "Facebook . . . knowingly aided, facilitated and assisted sex traffickers, including the sex trafficker[s] who recruited [Plaintiffs] from Facebook" and "knowingly benefitted" from rendering such assistance; that "Facebook has assisted and facilitated the trafficking of [Plaintiffs] and other minors on Facebook"; and that Facebook "uses the detailed information it collects and buys on its users to direct users to persons they likely want to meet" and, "[i]n doing so,

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[87] https://www.wsj.com/articles/facebook-drug-cartels-human-traffickers-response-is-weak-documents-11631812953.

[88] No. 20-0434, 2021 WL 2603687 (Tex. June 25, 2021).

[89] Tex. Civ. Prac. & Rem. Code Ann. § 98.002(a).

> . . . facilitates human trafficking by identifying potential targets, like [Plaintiffs], and connecting traffickers with those individuals."[90]

125. The court found that "[r]ead liberally in Plaintiffs' favor, these statements may be taken as alleging affirmative acts by Facebook to encourage unlawful conduct on its platforms."[91] The court concluded that "[t]he available precedent indicates that Facebook enjoys no CDA immunity from claims founded on such allegations" and therefore held that "[t]he plaintiffs' statutory human-trafficking claims may proceed . . . ."[92]

126. In the same case, on March 7, 2022, the U.S. Supreme Court denied Meta's petition for writ of certiorari. *See Facebook Cert.,* 142 S. Ct. 1087 (2022). In his concurring opinion, Justice Thomas wrote that "***Facebook allegedly 'knows its system facilitates human traffickers in identifying and cultivating victims,' but has nonetheless 'failed to take any reasonable steps to mitigate the use of Facebook by human traffickers' because doing so would cost the company users and the advertising revenue those users generate***." *Id.* at 1088. Justice Thomas observed that "[i]t is hard to see why the protection of § 230(c)(1) grants publishers against being held strictly liable for third parties' content should protect Facebook from liability for its own 'acts and omissions.'" *Id.*

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[90] *In re Facebook*, 2021 WL 2603687, at *13.

[91] *Id.*

[92] *Id.* at *13, *1.

### Q. September 16, 2021 – *The Wall Street Journal* Reports that Meta "Allow[s] Users to Post … Advertisements for Human Trafficking" and "Treats Harm" as the "Cost of Doing Business"

127. In September 2021, *The Wall Street Journal* began publishing a series of articles that the newspaper dubbed its "Facebook Files Investigation." The articles were based on "internal documents," many provided by Frances Haugen, and "interviews with dozens of current and former employees" of Facebook.[93]

128. Of particular relevance to this case, on September 16, 2021, *The Wall Street Journal* published an article titled "***Facebook Employees Flag Drug Cartels and Human Traffickers. The Company's Response Is Weak, Documents Show***."[94] The article stated that "[s]cores of internal Facebook documents reviewed by The Wall Street Journal show employees raising alarms about how its platforms are used in some developing countries, where its user base is already huge and expanding. They also show the company's response, which in many instances is inadequate or

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[93] Jeff Horwitz, *Facebook Says Its Rules Apply to All. Company Documents Reveal a Secret Elite That's Exempt*, THE WALL STREET JOURNAL (Sept. 13, 2021), available at https://www.wsj.com/articles/facebook-files-xcheck-zuckerberg-elite-rules-11631541353?mod=article_inline.

[94] Justin Scheck, Newley Purnell, Jeff Horwitz, *Facebook Employees Flag Drug Cartels and Human Traffickers. The Company's Response Is Weak, Documents Show*, THE WALL STREET JOURNAL (Sept. 16, 2021), available at https://www.wsj.com/articles/facebook-drug-cartels-human-traffickers-response-is-weak-documents-11631812953.

nothing at all."[95] Rather, "[w]hen problems have surfaced publicly, Facebook has said it addressed them by taking down offending posts. But it hasn't fixed the systems that allowed offenders to repeat the bad behavior."[96] Much of the misconduct reported in the article to which Meta exhibited an inadequate or nonexistent response involved sex trafficking, human trafficking, and human exploitation on Meta's platforms. Among other things, the article stated:

> Scores of internal Facebook documents reviewed by The Wall Street Journal show employees raising alarms about how its platforms are used in some developing countries, where its user base is already huge and expanding. They also show ***the company's response***, which in many instances ***is inadequate or nothing at all***.
>
> ***Employees flagged that human traffickers in the Middle East used the site to lure women into abusive employment situations in which they were treated like slaves or forced to perform sex work***.
>
> Facebook removes some pages, though ***many more operate openly***, according to the documents.
>
> In some countries where Facebook operates, it has few or no people who speak the dialects needed to identify dangerous or criminal uses of the platform, the documents show.
>
> When problems have surfaced publicly, Facebook has said it addressed them by taking down offending posts. But ***it hasn't fixed the systems that allowed offenders to repeat the bad behavior. Instead, priority is given to retaining users, helping business partners and at times placating authoritarian governments***, whose support Facebook sometimes needs to operate within their borders, the documents show.

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[95] *Id.*

[96] *Id.*

***Facebook treats harm in developing countries as "simply the cost of doing business" in those places***, said Brian Boland, a former Facebook vice president who oversaw partnerships with internet providers in Africa and Asia before resigning at the end of last year.

"There is very rarely a significant, concerted effort to invest in fixing those areas," he said.

***

The documents reviewed by the Journal are reports from employees who are studying the use of Facebook around the world, including ***human exploitation*** and other abuses of the platform. ***They write about their embarrassment and frustration, citing decisions that allow users to post . . . advertisements for human trafficking***.

***

from the files

How FB Family of Apps were exploited/ misused

| Stages of Human Trafficking Network Lifecycle | | |
|---|---|---|
| **Recruitment** | **Coordination** | **Exploitation** |
| 1. Fake FB accounts<br>2. Fake IG accounts<br>3. Messenger<br>4. Search to identify other local massage parlors for women to recruit<br>5. Other websites and social media / internet presence | 1. Messenger<br>2. WhatsApp | 1. Pages for massage parlors<br>a. Suspicious hashtags<br>2. Ads targeting men in Dubai<br>a. Fake names sharing credit card/ad accounts<br>3. Other websites and social media / internet presence |

Source: 2019 'Case Briefs and Insights report' on how human traffickers and criminal networks use Facebook platforms

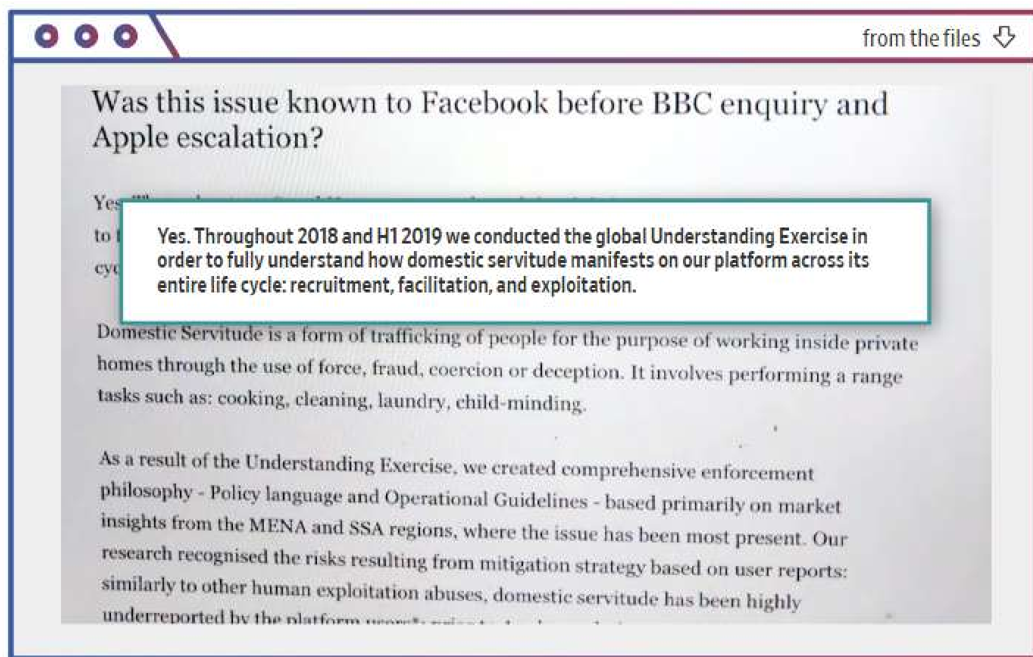
***The investigation team spent more than a year documenting a bustling human-trafficking trade in the Middle East taking place on its services***. On Facebook and Instagram, unscrupulous employment agencies advertised workers they could supply under coercive terms, using their photos and describing their skills and personal details.

The practice of signing people to restrictive domestic employment contracts and then selling the contracts is widely abused and has been defined as human trafficking by the U.S. State Department.

The company took down some offending pages, but ***took only limited action to try to shut down the activity until Apple Inc. threatened to remove Facebook's products from the App Store unless it cracked down on the practice. The threat was in response to a BBC story on maids for sale***.

In an internal summary about the episode, a Facebook researcher wrote: ***"Was this issue known to Facebook before BBC enquiry and Apple escalation?"***

***The next paragraph begins: "Yes."***


from the files

Was this issue known to Facebook before BBC enquiry and Apple escalation?

Yes. Throughout 2018 and H1 2019 we conducted the global Understanding Exercise in order to fully understand how domestic servitude manifests on our platform across its entire life cycle: recruitment, facilitation, and exploitation.

Domestic Servitude is a form of trafficking of people for the purpose of working inside private homes through the use of force, fraud, coercion or deception. It involves performing a range tasks such as: cooking, cleaning, laundry, child-minding.

As a result of the Understanding Exercise, we created comprehensive enforcement philosophy - Policy language and Operational Guidelines - based primarily on market insights from the MENA and SSA regions, where the issue has been most present. Our research recognised the risks resulting from mitigation strategy based on user reports: similarly to other human exploitation abuses, domestic servitude has been highly

Source: 2019 internal report titled 'Apple Escalation on Domestic Servitude - how we made it through this SEV'

***One document from earlier this year suggested the company should use a light touch with Arabic-language warnings about human trafficking so as not to "alienate buyers"—meaning Facebook users who buy the domestic laborers' contracts, often in situations akin to slavery***.

***

**Language gap**

The company's internal communications show it doesn't have enough employees who speak some of the relevant languages to help monitor the situation. For some languages, Facebook also failed to build automated systems, called classifiers, that could weed out the worst abuses. ***Artificial-intelligence systems that form the backbone of Facebook's enforcement don't cover most of the languages used on the site***.

***

***Facebook's team of human-exploitation investigators***, which in addition to the former police officer included a Polish financial expert who previously investigated trafficking finances at HSBC bank and a Moroccan refugee expert who formerly worked at the United Nations High Commissioner for Refugees, ***gathered evidence of human trafficking***.

***By looking across Facebook products, they found criminal networks recruiting people from poor countries, coordinating their travel and putting them into domestic servitude or into forced sex work in the United Arab Emirates and other Persian Gulf countries. Facebook products facilitated each step, and the investigators followed communications across platforms to identify perpetrators and victims***.

***Facebook in 2018 didn't have a protocol for dealing with recruiting posts for domestic servitude. In March 2018, employees found Instagram profiles dedicated to trafficking domestic servants in Saudi Arabia. An internal memo says they were allowed to remain on the site because the company's policies "did not acknowledge the violation***."

***The investigation team identified multiple trafficking groups in operation, including one with at least 20 victims, and organizers who spent at least $152,000 on Facebook ads for massage parlors***.

The former police officer recommended that Facebook disable WhatsApp numbers associated with the rings, put in new policies about ads purchased anonymously and improve its artificial intelligence to better root out posts related to human trafficking, according to the

documents. He added that ***Facebook should develop a network to prevent trafficking*** by sharing findings with other tech companies.

In another memo, the Polish trafficking expert wrote that ***18 months after it first identified the problem, Facebook hadn't implemented systems to find and remove the trafficking posts***.

The BBC and Apple flagged concerns in 2019. With the threat posing ***"potentially severe consequences to the business,"*** the trafficking expert wrote, Facebook began moving faster. A proactive sweep using the investigation team's prior research found more than 300,000 instances of potential violations and disabled more than 1,000 accounts.

***The team continued finding posts of human trafficking***, and Facebook struggled to put effective policies in place. One document says ***Facebook delayed a project meant to improve understanding of human trafficking***.

Another memo notes: "***We know we don't want to accept/profit from human exploitation. How do we want to calculate these numbers and what do we want to do with this money?***"

from the files

IV - RECOMMENDED ACTION ITEMS

****If you see your name below, it means that we believe that you're probably the best person/ team POC that could help FB move forward on tackling sex trafficking in respective areas post this investigation. Please help loop in additional people or redirect if we've misidentified you (nonetheless thank you for reading!).* ***Master Task:*** T53526763

| ACTION ITEM | RISK/ IMPACT | AI TYPE | OWNER | TASK |
|---|---|---|---|---|
| Clarify Ads Account policy why/when payment methods related to ad credit accounts are allowed with no names/ info | Prevent traffickers from using multiple CC with nameless payment methods linked to the ad credit accounts & close any policy gap | Policy | ad-policy | T53526846 |
| Clarify policies how FB currently handles accrued ad revenues associated with HT | Prevent reputational risk for the company (not to profit from ads spent for HT) | Policy | | T53526954 |

Note: Names have been redacted on this document.

Source: 2019 'Case Briefs and Insights report' on how human traffickers and criminal networks use Facebook platforms

***At the end of 2020, following three months in which Facebook investigated a dozen networks suspected of human trafficking, a system for detecting it was deactivated. The trafficking investigators said that hurt their efforts***, according to the documents.

***"We found content violating our domestic servitude policy that should have been detected automatically"*** by a software tool called the Civic Integrity Detection pipeline, wrote an employee in a document titled "***Domestic Servitude: This Shouldn't Happen on FB and How We Can Fix It***." She recommended the company reactivate that pipeline.

***

The investigation team also struggled to curb sex trafficking. In 2019, they discovered a prostitution ring operating out of massage parlors in the U.S. Facebook gave the information to police, who made arrests.

***Facebook discovered a much larger ring that used the site to recruit women from Thailand and other countries. They were held captive, denied access to food and forced to perform sex acts in Dubai massage parlors***, according to an internal investigation report.

Facebook removed the posts but ***didn't alert local law enforcement***. The investigation found traffickers bribed the local police to look away, according to the report.

### R. October 3-4, 2021 – Former Meta Employee Frances Haugen Appears on *60 Minutes* and Publishes Her Complaints to the SEC

129. On October 3, 2021, Frances Haugen, one of the key sources of information for *The Wall Street Journal's* series of September 2021 news articles, appeared on *60 Minutes*. In the broadcast, *60 Minutes* reported that "[l]ast month, Haugen's lawyers filed at least 8 complaints with the [SEC] which enforces the law in financial markets."[97] Ms. Haugen's disclosures to the SEC included some of the

[97] Scott Pelley, *Whistleblower: Facebook Is Misleading the Public on Progress*

"tens of thousands of pages of Facebook internal research" that Ms. Haugen "secretly copied" while an employee at Facebook. *Id.*[98]

130. The next day, on October 4, 2021, *60 Minutes* published on its website each of Ms. Haugen's eight complaints to the SEC.[99] One of Ms. Haugen's complaints to the SEC was titled "Facebook misled investors and the public about its promotion of human trafficking / slavery / servitude."[100] This complaint quoted an internal Meta document titled "28/27 Domestic Servitude Global Analysis document" which stated that "***[w]e have observed increasing number*** [*sic*] ***of***

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*Against Hate Speech, Violence, Misinformation*, 60 MINUTES (Oct. 4, 2021), available at https://www.cbsnews.com/news/facebook-whistleblower-frances-haugen-misinformation-public-60-minutes-2021-10-03/.

[98] The "thousands of documents" that Ms. Haugen obtained were available on Facebook's intra-company network called "Facebook Workplace," and included "presentations to Chief Executive Mark Zuckerberg – sometimes in draft form, with notes from top company executives included" and which "[v]irtually any of Facebook's more than 60,000 employees could have accessed." Jeff Horwitz, "*The Facebook Whistleblower, Frances Haugen, Says She Wants to Fix the Company, Not Harm It*," THE WALL STREET JOURNAL (Oct. 3, 2021), available at https://www.wsj.com/articles/facebook-whistleblower-frances-haugen-says-she-wants-to-fix-the-company-not-harm-it-11633304122.

[99] *See* Keith Zubrow, Maria Gavrilovic, and Alex Ortiz, Whistleblower's SEC Complaint: Facebook Knew Platform Was Used to "Promote Human Trafficking and Domestic Servitude," 60 MINUTES (Oct. 4, 2021), available at https://www.cbsnews.com/news/facebook-whistleblower-sec-complaint-60-minutes-2021-10-04/.

[100] Available at https://drive.google.com/file/d/1ItiZR_n1_xB3gzkJZ9uvd6pUOYRMGIex/view.

***reported content that indicates that the platform is being used to coordinate and promote domestic servitude … real world harm caused by domestic servitude as well as risk to the business due to potential PR [i.e., public relations] … fires***."[101]

131. The same complaint quoted further internal Meta documents which stated (as noted above in Section II.F) that: "***[D]ue to the underreporting of this behaviour and absence of proactive detection, newly created and existing content not captured in the IG [i.e., Instagram] sweep meant that domestic servitude content remained on the platform***"; "***we are under-enforcing on confirmed abusive activity with a nexus to the platform***"; and "***[o]ur investigative findings demonstrate that*** … ***our platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks***… ***The traffickers, recruiters, and facilitators from these 'agencies' used FB profiles, IG profiles, Pages, Messenger, and WhatsApp***…."[102]

### S. October 5, 2021 – Ms. Haugen Testifies Before Congress that Meta's "AI Systems Only Catch a Very Tiny Minority of Offending Content" and Explains that the Company "Has No Oversight"

132. On October 5, 2021, Ms. Haugen testified before the U.S. Senate's Sub-Committee on Consumer Protection, Product Safety, and Data Security. In her

[101] *Id.* at 3.

[102] *Id.* at 4-5.

written statement, Ms. Haugen testified that Facebook's "leadership keeps vital information from the public, the U.S. government, its shareholders, and governments around the world. The documents I have provided prove that ***Facebook has repeatedly misled us about what its own research reveals about the safety of children***, its role in spreading hateful and polarizing messages, and so much more."[103] Ms. Haugen further testified that "***Facebook's closed design means it has no oversight—even from its own Oversight Board, which is as blind as the public***." *Id.*

133. During the hearing, Senator Marsha Blackburn stated that "***Facebook also turned a blind eye toward blatant human exploitation taking place on its platform - trafficking, forced labor cartels, the worst possible things one can imagine***."[104]

134. Furthermore, during the hearing, Senator Mike Lee brought up prior testimony of a different witness who testified before the committee (Ms. Davis) claiming that Facebook has sexually suggestive ads that are targeted to children. Ms.

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[103] Statement of Frances Haugen (Oct. 4, 2021), available at https://www.commerce.senate.gov/services/files/FC8A558E-824E-4914-BEDB-3A7B1190BD49.

[104] Marsha Blackburn, *Blackburn Asks Whistleblower To Detail Facebook's Practice of Endangering Children Online*, (2021), available at https://www.blackburn.senate.gov/2021/10/blackburn-asks-whistleblower-to-detail-facebook-s-practice-of-endangering-children-online.

Haugen responded that "It is very possible that none of those ads were seen by a human. The reality is that we've seen from repeated documents within my disclosures is that ***Facebook's AI systems only catch a very tiny minority of offending content*** … [i]t's likely if they rely on computers and not humans, they will also likely never get more than 10 to 20% of those ads."[105]

### T. October 25, 2021 – Ms. Haugen Testifies Before the U.K. Parliament

135. On October 25, 2021, Frances Haugen testified before the Parliament of the United Kingdom to discuss her concerns about Facebook's monitoring of the conduct on its platform.

136. In particular, Ms. Haugen pointed out Facebook's deficiencies in moderating online posts written in languages other than English, saying "I want to be clear: bad actors have already tested Facebook. They have tried to hit the rate limits. They have tried experiments with content. They know Facebook's limitations. The only ones who do not know Facebook's limitations are good actors. Facebook needs to disclose what its integrity systems are and which languages it works in, and the performance per language or per dialect, because I guarantee you

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[105] Clare Duffy, et al., *Facebook whistleblower testifies in Congress*, (Oct. 5, 2021), https://www.rev.com/blog/transcripts/facebook-whistleblower-frances-haugen-testifies-on-children-social-media-use-full-senate-hearing-transcript.

that, safety systems designed for English probably do not work as well on UK English versus American English."[106]

### U. April 8, 2022 – Meta's Board Opposes a "Shareholder Proposal Regarding Child Exploitation" by Making False Statements

137. On April 8, 2022, Meta filed its annual proxy statement in which it published a "Shareholder Proposal Regarding Child Sexual Exploitation Online" which stated, among other things, that "[i]n 2020, 79 percent of U.S. underage sex trafficking victims recruited online were recruited through Facebook or Instagram."[107]

138. Just as they had in 2020 and 2021, the "Shareholders request[ed] that the Board of Directors issue a report by February 2023 assessing the risk of increased sexual exploitation of children as the Company develops and offers additional privacy tools such as end-to-end encryption."[108]

139. As it had in 2020 and 2021, Meta's Board "**recommend[ed] a vote AGAINST the shareholder proposal**."[109] In support of its recommendation, Meta claimed that "[f]or years ***we have been tackling this issue*** using the most advanced technologies"; "[w]e continue to increase our investment in people and technology

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[106] Available at https://committees.parliament.uk/oralevidence/2884/pdf/ at 19.

[107] Meta, Proxy Statement (Schedule 14A) at 80 (Apr. 8, 2022).

[108] *Id*.

[109] *Id*. at 83.

with ***dedicated teams to help find and remove more harmful content – increasingly before people even see it***"; and that "***[w]e deploy technology to proactively surface illegal child exploitative content and activity***, including through detection technology, ***machine learning*** and artificial intelligence techniques."[110]

140. As discussed below, Meta's statements to shareholders in its April 8, 2022 proxy were materially misleading because in fact Meta did not use its "machine learning" technology [REDACTED] *See* Section II.U *supra*. And while Meta ***publicly*** claimed to have been "tackling this issue" for "years" including by "remov[ing] more harmful content – increasingly before people even see it"—***internally*** Meta was acknowledging that [REDACTED] *See* Section II.U *supra*.

[110] *Id.* at 82.

## V. July 2022 – 2022 Trafficking in Persons Report

141. In July 2022, the State Department again released its annual Trafficking in Persons Report.[111] This report states that more than 175 nations have ratified or acceded to the UN TIP Protocol, which defines trafficking in persons and contains obligations to prevent and combat the crime. The TVPA and the UN TIP Protocol contain similar definitions of human trafficking. The elements of both definitions can be described using a three-element framework focused on the trafficker's 1) acts; 2) means; and 3) purpose. It is also important to note that neither U.S. nor international law requires that a trafficker or victim move across a border for a human trafficking offense to take place.

142. The 2022 Trafficking in Persons Report stated that "[t]raffickers have increasingly lured potential victims through social media, including Facebook, Instagram, TikTok, and mobile messages," and that "[t]he media [in Iraq, Iran, and Syria reported] trafficking gangs increasingly use social media sites, particularly Facebook, to buy and sell women and girls for sex and labor exploitation." The report also noted that in Israel, "[t]raffickers use social media websites, including dating apps, online forums and chat rooms, and Facebook groups to exploit girls in sex trafficking." Furthermore, in Kuwait, reports of "employers allegedly selling

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[111] https://www.state.gov/reports/2022-trafficking-in-persons-report/.

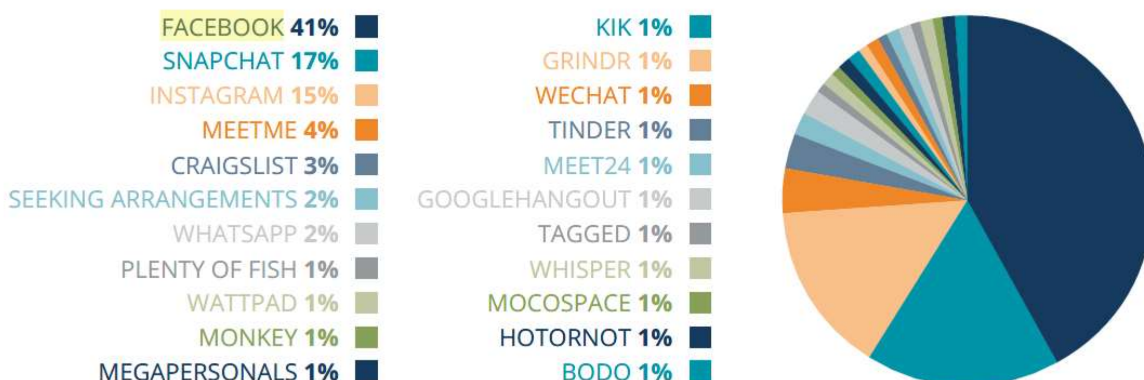
their workers to other employers on social media and online platforms like Instagram, Twitter, Facebook … increased."

### W. June 16, 2022 – 2021 Federal Human Trafficking Report

143. On June 16, 2022, the Human Trafficking Institute publicly released the 2021 Human Trafficking Report ("2021 HTI Report").[112] The 2021 HTI Report found that since 2000, traffickers have recruited 55% of sex trafficking victims online, usually through social media platforms, web-based messaging apps, online chat rooms, classified advertisements, or job boards. Defendants in federal sex trafficking cases used the internet as their primary method of soliciting buyers in 85% of the cases filed in 2021.

144. The 2021 HTI Report further found that when an online platform was used to recruit victims for criminal sex trafficking in new cases filed in 2019, 2020, and 2021, Facebook was used in 41% of the cases (more than twice as much than any other platform) and Instagram was used in 15% of the cases. In other words, based on these statistics the 2021 HTI Report concluded that more sex trafficking has occurred on Meta's two largest platforms ***than on every other platform in the world <u>combined</u>***.

[112] https://traffickinginstitute.org/2021-fhtr-is-now-available/.




## III. BOARD-LEVEL DOCUMENTS CONFIRM THAT THE BOARD HAS KNOWN THAT META HAS UTTERLY FAILED TO PREVENT, DETECT, OR RESPOND TO RAMPANT SEX TRAFFICKING ON ITS PLATFORMS—YET FAILED TO EXERCIZE OVERSIGHT

145. Despite committing to Plaintiffs that they would produce Board minutes, including committee minutes, related to sex and human trafficking and teen health, there was a complete lack of Board minutes produced by Defendants. The materials presented to the Board, however, demonstrate that the Board knew about Meta's problems with trafficking and related issues.[113] Defendants woefully

[113] *See, e.g.*, 1850 ( ), 2229 (same), 2671 (same), 2726 ( ), 3134 ( ); *see also* 5069 (noting to address and including ), 5919 (noting a ).

neglected their duty to respond to and address human trafficking on Meta's platforms.

146. As background, when Meta identifies a [114] The materials provided to the Board on February 14, 2019 indicate the Board was [115] In addressing problems, Meta stated, [116] Meta also has stated that [117]

147. In the same document, Meta

[114] META220_0003179.

[115] *Id.*

[116] *Id.*

[117] *Id.*

respectively. *Id.* Hence, Meta

### A. December 2017 – the Board Acknowledges the

148. On December 7, 2017, the Board received a presentation titled "Board Updates & Approvals" for "*Directors Only*"[118] which discussed Meta's "2017 DECEMBER – POLICY RISKS & OPPORTUNITIES."[119] The presentation reported the following:

[120]

### B. March 2018 – the Board Is Informed that

149. On March 1, 2018, the Board received a presentation on and was specifically warned that and noted that

[118] META220_0003014.

[119] META220_0003132.

[120] META220_0003134.

such [121]

### C. 2019 – the Board Acknowledges and Admits that in Addressing

150. A recognizes that Meta's [122]

151. In evaluating [123] As to Meta's progress in addressing these problems, Meta coded [124] Meta noted that its included [125]

### D. February 2019 – the Board Acknowledges

121 META220_0002955

122 META220_0002885.

123 *Id.*

124 *Id.*

125 META220_0002890.

**—Yet Does Not Prioritize Solving It**

152. On February 13, 2019, the Audit Committee held a meeting during which it received a presentation which discussed "Law Enforcement Compliance."[126] The presentation further discussed the [.]"[127]

153. On February 14, 2019, the Board received a "H1 2019 Board Update"[128] for the Facebook Board of Directors[129] which stated that Meta needed to regarding ; noted that ; and set forth the of Meta's regarding the [130] The update categorized Meta's progress as

[126] META220_0006220, 6233.

[127] META220_0006233.

[128] META220_0003172.

[129] *Id.*

[130] META220_0003178.

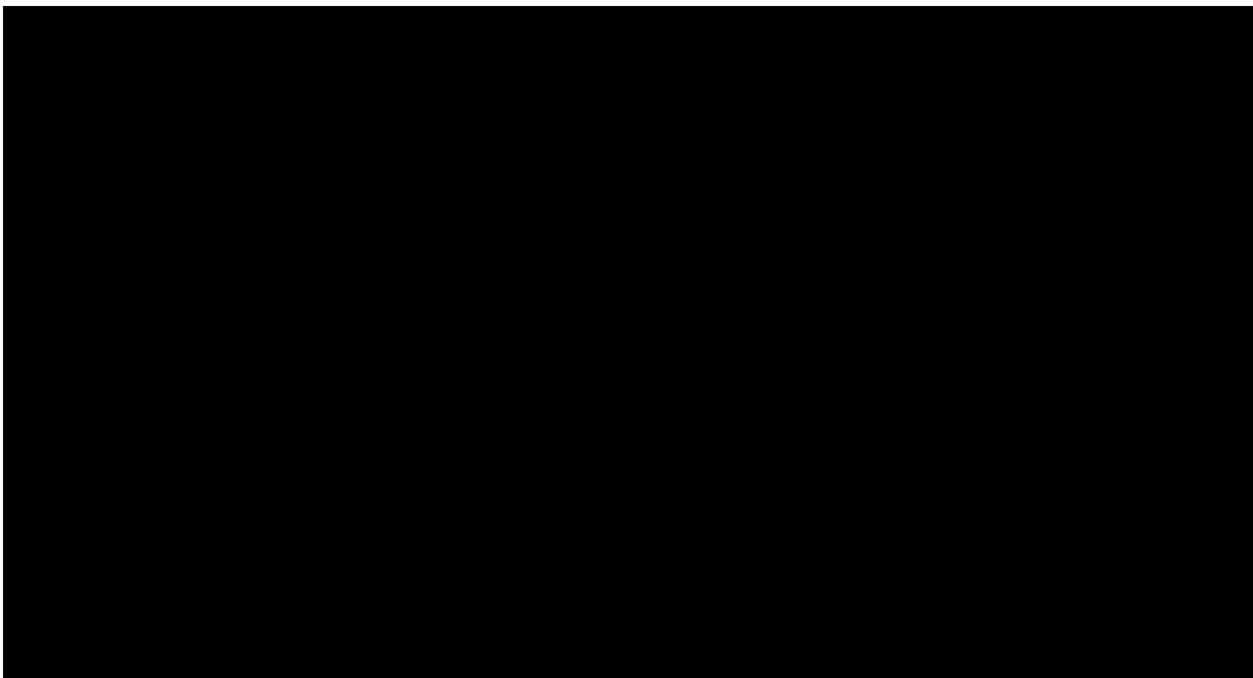
—and again noted that [131]

154. The update stated that Meta's progress addressing [132]

155. The update also stated that Meta's progress in addressing However, the update did not even mention sex/human trafficking as being an issue that Meta was even trying to address, nor did it state whether Meta had made any progress (or if it was even trying to make progress) addressing sex/human trafficking.

[131] *Id.*

[132] *Id.*



156. Next, the update reviewed Meta's

[133] In that regard, the update predicted that

[134] Regarding how Meta classified the

the update included a

[135]

[133] META220_0003179.

[134] *Id.*

[135] *Id.* (emphasis in original).

157. The update stated that Meta's [136] Thus, because Meta's , as of the date of this update (December 2018), Meta had only to address this problem.

158. In contrast, the update stated that Meta's [137] In other words, Meta's Stated differently, whereas Meta at least sought to

[136] *Id.*

[137] *Id.*

Meta was content in ***not*** making any progress

159. On another page, the update stated, and listed purported [138] Yet, noticeably absent from this page is any reference to Meta

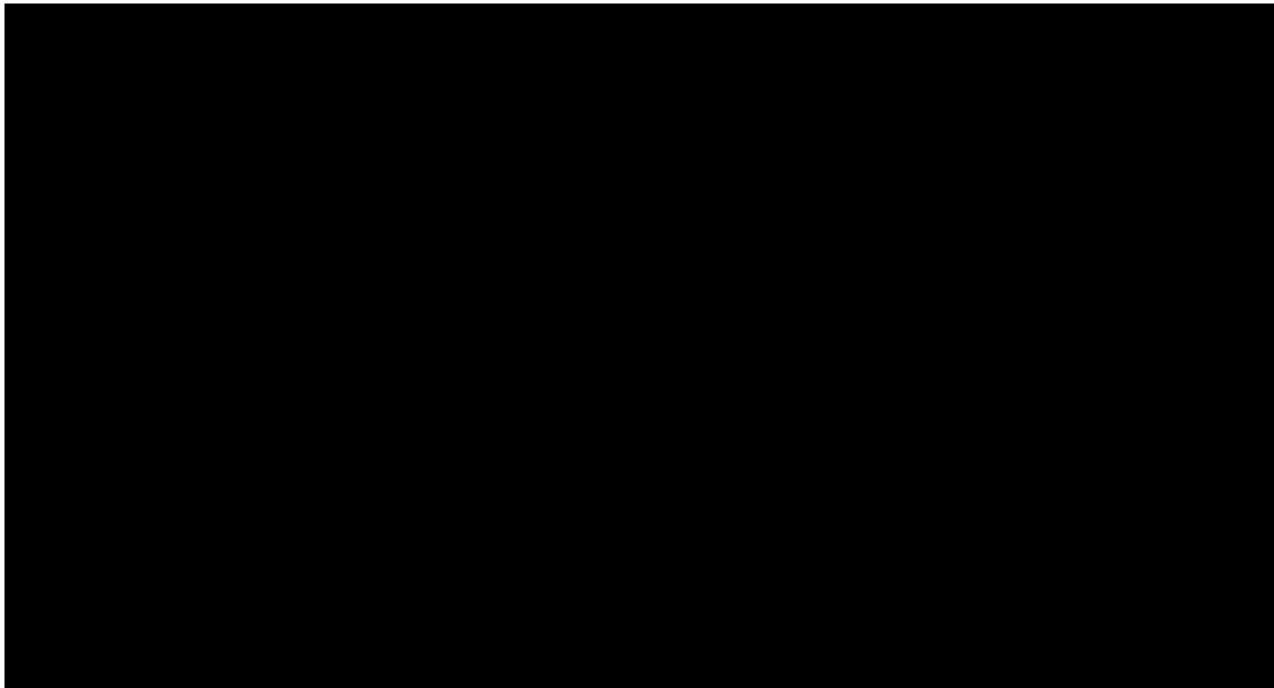
[138] META220_0003181. Inexplicably, Meta had no *Id.*

using its [redacted] [139] This is despite the fact that, just pages earlier, Meta had acknowledged that it had only [redacted] [140] on [redacted], had also acknowledged that this problem would [redacted], and had made clear that it had no [redacted] [141]

[139] *Id.*

[140] META220_0003178.

[141] META220_0003179.



### E. May 2019 – Meta Fails to Remove "Posts of Sexually Explicit or Exploitative Content" Despite Alerts from the BBC and Opposes a Shareholder Proposal for a Report Regarding Child Exploitation

160. On May 30, 2019, Meta held its Annual Meeting of Shareholders. In connection with this meeting, the Board met and received a "PROXY PAPER"[142] from Glass, Lewis & Co., LLC ("Glass Lewis"), a proxy advisory firm, which recommended that Company shareholders vote "FOR" a shareholder proposal "[t]hat the Company report on the efficacy of its content policy enforcement."[143] Glass Lewis reasoned that "[a]dditional disclosure of financial and reputational risks

[142] META220_0000754.

[143] META220_0000785.

on account of recent content management controversies is warranted" and noted that "we believe support for this proposal would provide disclosure of an important area that we do not believe is being satisfactorily addressed by the Company[.]"[144] As support, the paper detailed how in 2016, Facebook had failed to remove "posts of sexually explicit or exploitative content" despite repeated reports and notifications regarding that content by the BBC:[145]

> In 2016, ***the BBC reported that the Company's platform contained posts of sexually explicit or exploitative content and images, as well as "secret" groups used by pedophiles to connect and interchange images***. In response to these reports, the Company stated that it had improved its reporting and take-down measures. However, to test these claims, the *BBC* subsequently used the Company's reporting mechanisms to alert it to 100 images which appeared to violate the Company's guidelines. ***Of these 100 images of what appeared to be child pornography, only 18 were removed***. The Company claimed the others had not violated its Community Standards. The *BBC* also discovered five accounts maintained by convicted sex offenders, specifically pedophiles, despite the Company's rules which deny access to its platform by these individuals. The *BBC* notified the Company of the accounts via its platform's notification system, but ***none were disabled***. Pursuant to a follow-up investigation by the *BBC* one year later, the Company recognized the nature of the content and stated that it removed the items from its platform and reported them to the Child Exploitation & Online Protection Centre (Angus Crawford. 'Facebook Failed to Remove Sexualised Images of Children." *BBC*. March 7, 2017).

[144] *Id.*

[145] META220_0000789.

### F. September 2019 – the Board Receives a

161. On September 5, 2019, the Board received a presentation titled "Board Approvals & Updates" for "*Directors Only*" which discussed "Political Narratives and Our Response" and noted that one such narrative was that and that [146]

162. Later in the same presentation, Meta stated that

[146] META220_0003252, 3364, 3366-67.

[147]

163. Yet noticeably absent from the above statement was any mention of any policy against sex/human trafficking or any effort or progress in identifying or taking down content related to sex/human trafficking, or any ability of Meta (including its ) to or take down content related to either child exploitation, prostitution, sexual solicitation, or sex/human trafficking.[148]

164. A presentation dated December 5, 2019, noted that . . ."[149]

[147] META220_0003376.

[148] *Id.*

[149] META220_0003508.

### G. 2020 – Meta Acknowledges that It Lacks [redacted] and that Meta [redacted]

165. A document titled "Policy 2020 H1/H2 Strategy"[150] discussed Meta's [redacted] and detailed certain [redacted][151] This [redacted][.]"[152] The document stated that [redacted][153] The document stated that [redacted][154] The document further noted that [redacted]

[150] META220_0003006.

[151] META220_0003011.

[152] META220_0003012.

[153] *Id.*

[154] *Id.*

[155]

166. Importantly, by acknowledging that [157]—Meta was simultaneously acknowledging that such that Meta's [158] The document further acknowledged that [159]

**H. February 2020 – the Board Opposes a "Stockholder Proposal Regarding Child Exploitation" Warning that "Instagram" Is "Linked to 'Rampant Sex Trafficking" and "Child Sexual Abuse"**

167. On February 13, 2020, a presentation to the Board's Compensation Committee[160] attached a "Stockholder Proposal Regarding Child Exploitation" that

[155] *Id.*

[156] *Id.*

[157] META220_0003011.

[158] META220_0003012.

[159] META220_0003011.

[160] META220_0001663.

noted that "Facebook [is] being sued in a Texas court for facilitating sex trafficking of minors"; that "Instagram [is] being linked to 'rampant sex trafficking [and] child sexual abuse grooming'"; and that "Facebook may face significant regulatory risk if it cannot curb child sexual abuse on existing platforms":[161]

> Facebook and its subsidiaries have faced other recent controversies of child sexual exploitation, including:
>
> - Facebook being sued in a Texas court for ***facilitating sex trafficking of minors***;[162]
> - Instagram being linked to "***rampant sex trafficking***, ***child sexual abuse grooming***, as well as adult fetishization of young girls...", "sexually graphic comments on minor's photos" and allowing strangers to "direct message minors."[163]
> - Pedophiles "sharing Dropbox links to child porn via Instagram";[164]
>
> Facebook may face significant regulatory risk if it cannot curb child sexual abuse on existing platforms or on encrypted messaging. Senate Judiciary Committee member Marsha Blackburn stated in a December 2019 hearing that Facebook and peers need to "get your act together, or

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[161] META220_0001850-1851.

[162] https://www.nytimes.com/2019/12/03/technology/facebook-lawsuit-section-230.html.

[163] https://endsexualexploitation.org/articles/statement-instagram-is-predators-paradise-says-international-group-of-human-rights-ngos/; https://endsexualexploitation.org/articles/senate-hearing-uncovers-sexploitation-in-apps-and-social-media/.

[164] https://www.dailymail.co.uk/news/article-6574015/How-pedophiles-using-Instagram-secret-portal-apparentnetwork-child-porn.html.

we will gladly get your act together for you.[165] Most of the Committee supported that sentiment.[166]

168. The presentation noted that this stockholder proposal "[r]equest[ed] that the Board issue a report by February 2021 assessing the risk of increased sexual exploitation of children as the company develops and offers additional privacy tools such as end-to-end encryption."[167] The same proposal was discussed in another presentation on the same day (February 13, 2020) titled "Board Updates & Approvals" for *"Directors Only*."[168]

### I. May 2020 – Glass Lewis Recommends Voting "FOR" the Shareholder Proposal and Notes that "366 Federal Criminal Cases Over Seven Years Featured Suspects Using Facebook for Child Exploitation"

169. On May 27, 2020, Meta held its Annual Meeting of Shareholders. In connection with this meeting, the Board met and reviewed the "Proxy Analysis & Benchmark Policy Voting Recommendations" by Institutional Shareholder Services Inc. ("ISS"), a proxy advisory firm, in which ISS discussed the above-referenced stockholder proposal for a "Report on Online Child Sexual Exploitation" and ISS

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[165] https://www.politico.com/news/2019/12/10/tech-companies-bipartisan-congress-encryption-080704.

[166] https://www.judiciary.senate.gov/meetings/encryption-and-lawful-access-evaluating-benefits-and-risks-to-public-safety-and-privacy.

[167] META220_0001690.

[168] META220_0000001, META220_0000016.

recommended that the Board vote "FOR" the proposal and stated that "[a] vote FOR this proposal is warranted, as additional information on risks related to potential sexual exploitation of children through the company's platforms would give shareholders more information on how well the company is managing related risks."[169] ISS noted that "the board states that the requested report is unnecessary and recommends that stockholders vote against it."[170] However, ISS noted that in March 2020, the TTP had released a study identifying "366 federal criminal cases over seven years that featured suspects using Facebook for child exploitation":[171]

> In March 2020, the not-for-profit investigative group Tech Transparency Project [(TTP)] released a study called "Broken Promises: Sexual Exploitation of Children on Facebook." Results of the study have been published in The Guardian and elsewhere. By analyzing Department of Justice news releases from January 2013 through December 2019, the study finds that Facebook failed to catch hundreds of cases of child exploitation on its platform. The "top findings" section of the analysis states:
>
> - "The review identified ***366 federal criminal cases over seven years that featured suspects using Facebook for child exploitation***.
> - Only 9 percent of the cases were initiated because Facebook or the National Center for Missing and Exploited Children (which receives cyber tips from Facebook) reported them to authorities,

[169] META220_0002627, 2671.

[170] META220_0002672.

[171] META220_0002674.

> raising questions about the effectiveness of Facebook's monitoring of criminal activity targeting children."

170. Based on the above, ISS stated that "the company has experienced some recent controversy related to its alleged failure to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019."[172] Accordingly, ISS concluded that "[g]iven the potential financial and reputational impacts of potential controversies related to child exploitation on the company's platforms, shareholders would benefit from additional information on how the company is managing the risks related to child sexual exploitation, including risks associated with end-to-end encryption technologies. Therefore, this proposal merits shareholder support."[173]

171. Also in connection with the Board's May 27, 2020 Annual Meeting, Glass Lewis similarly recommended that the Board vote "FOR" the same shareholder proposal "[t]hat the Company report on the risk of increased sexual exploitation of children due to end-to-end encryption."[174] As it had in May of 2019 (*see* § III.I *supra*), Glass Lewis reminded the Board that the *BBC* had alerted Meta that "the Company's platform contained posts of sexually explicit or exploitative

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[172] *Id.*

[173] *Id.*

[174] META220_0002725.

content and images" and "accounts maintained by convicted sex offenders, specifically pedophiles," and that of "100 images" reported, "only 18 were removed" and "none" of the "pedophiles[']" accounts "were disabled."[175] Glass Lewis also reminded the Board—like ISS's May 14, 2020 report—of the TTP's March 2020 report which "review identified 366 federal criminal cases over seven years that featured suspects using [Meta's] platform for child exploitation."[176] Glass Lewis further reminded the Board that the "passage of the FOSTA-SESTA law, which for the first time made [Meta] liable to civil penalties for sex trafficking on its platform," created "the potential for litigation."[177]

172. Glass Lewis noted how "[i]n October 2018, the Company announced work that it had done over the prior year to develop new technology to fight child exploitation, including photo-matching technology, and ***artificial intelligence and machine learning*** to proactively detect child nudity and previously unknown child exploitative content when it is uploaded."[178]

173. Glass Lewis further noted that "recent regulation has increased the level of legal and reputational risk related to this issue. Further, numerous investigations

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[175] META220_0002728.
[176] *Id.*
[177] META220_0002729.
[178] *Id.*

by the media have demonstrated the wide extent of this problem on the platforms maintained by the largest tech companies, including the Company. As such, management of this issue is of critical importance for companies involved in the distribution of digital media and messaging over the internet."[179]

174. Glass Lewis concluded: "Accordingly, we do not believe that [Meta] has provided sufficient disclosure to demonstrate to shareholders that these risks will be managed as [Meta] expands its encrypted messaging services, nor do we have any reason to be assured that [Meta] will act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services." [180]

175. On May 28, 2020, the Board received a presentation titled "Board Updates & Approvals" for "*Directors Only*," which reviewed "Investor Feedback re: Governance Matters" and stated that "Investors were also interested i[n] . . . . Proposal 10 (Child Exploitation)."[181]

[179] *Id.*

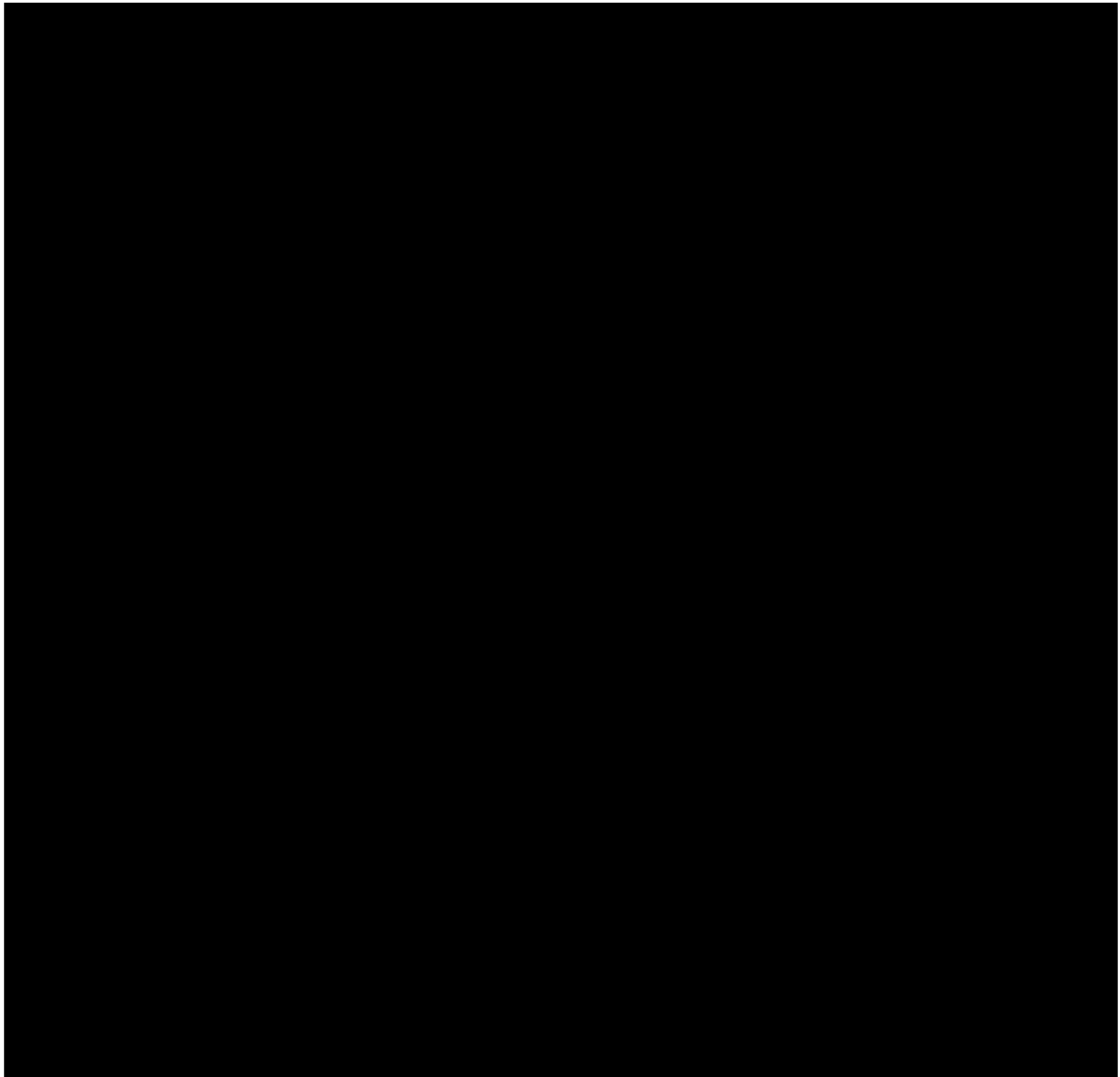
[180] META220_0002729-30.

[181] META220_0000159, 0252.

**J. December 2020 – the Audit Committee Learns that [redacted]**

176. On December 2, 2020, the Board's Audit Committee held a meeting at which they received an "Agenda" presentation that informed them of several [redacted][182]

[182] META220_0006395, 6468, 6471, 6599, 6672, 6675.



177. As noted above, one [redacted] and in particular that the [redacted]

[184] In other words, despite frequently touting Meta's technological capabilities to use artificial intelligence ("AI") to detect harmful content,[185] the Company internally acknowledged to the Audit Committee that for

Even worse, the Company also acknowledged that

[183] Meta's website defines "ground truth data" as "***the foundation upon which we build models, generate inferences, and make decisions***. What is ground truth data? We define it as a dataset that contains the values we want to infer for a particular population of interest (the data could be human labels, survey data, behavioral data, etc.). Whether it is modeling user characteristics to ensure appropriate and personalized user experiences, ***detecting and removing harmful misinformation and hate speech***, or executing other data-driven tasks, the underlying ***machine learning processes*** rely on models trained and validated on some ground truth data." *See* https://research.facebook.com/blog/2022/8/-introducing-the-ground-truth-maturity-framework-for-assessing-and-improving-ground-truth-data-quality/.

[184] META220_0006468.

[185] *See, e.g.*, "F8 2018: Using Technology to Remove the Bad Stuff Before It's Even Reported" (May 2, 2018), available at https://about.fb.com/news/2018/05/removing-content-using-ai/; "Community Standards report" (Nov. 13, 2019) ("We have been making consistent progress in increasing the effectiveness of our AI systems to detect harmful content."), available at https://ai.facebook.com/blog/community-standards-report/; "Our New AI System to Help Tackle Harmful Content" (Dec. 8, 2021), available at https://about.fb.com/news/2021/12/metas-new-ai-system-tackles-harmful-content/.

[1][186]

178. Confronted with their utter failure to communicated to the Audit Committee that [187]

179. Simply put, not only did Meta not use its to address but it did not use This appears to be the same failure that was eventually revealed and corroborated on October 25, 2021, by *USA Today*, which reported that "[i]n at least one case, Facebook deactivated a tool that was proactively detecting exploitation, according to internal documents."[188]

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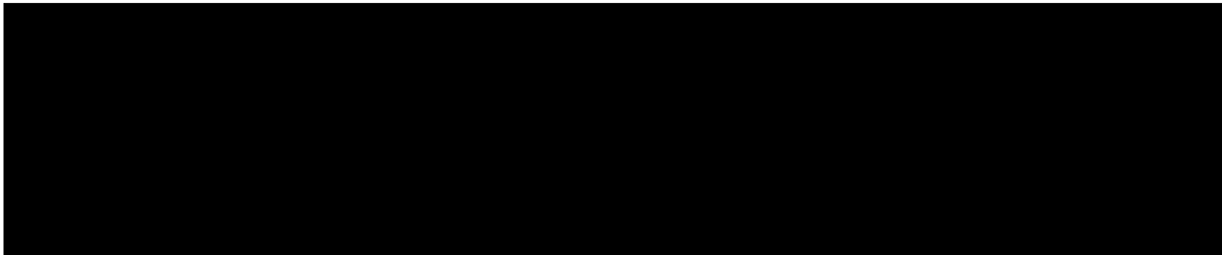
[186] META220_0006468.

[187] *Id.*

[188] Terry Collins et al., *Live updates: Facebook papers whistleblower Frances Haugen testifies at Parliament*, USA TODAY (Oct. 25, 2021), available at https://www.usatoday.com/story/tech/2021/10/25/facebook-papers-whistleblower-testimony-frances-haugen/6120082001/.

180. Meta's internal admission to the Audit Committee that it did not [REDACTED] is remarkable given that the Company's 2020, 2021, and 2022 proxy statements, in recommending that shareholders vote "against"[189] the shareholder proposal for a report on Meta's "detection technologies and strategies" to prevent "sexual exploitation of children,"[190] the Company repeatedly claimed that "[w]e deploy technology across all of our platforms to proactively surface as much illegal child exploitative content as we can, including through detection technology, ***machine learning and artificial intelligence techniques*** . . . ."[191]

181. The same presentation identified a further [REDACTED] with respect to Meta's [REDACTED][192]

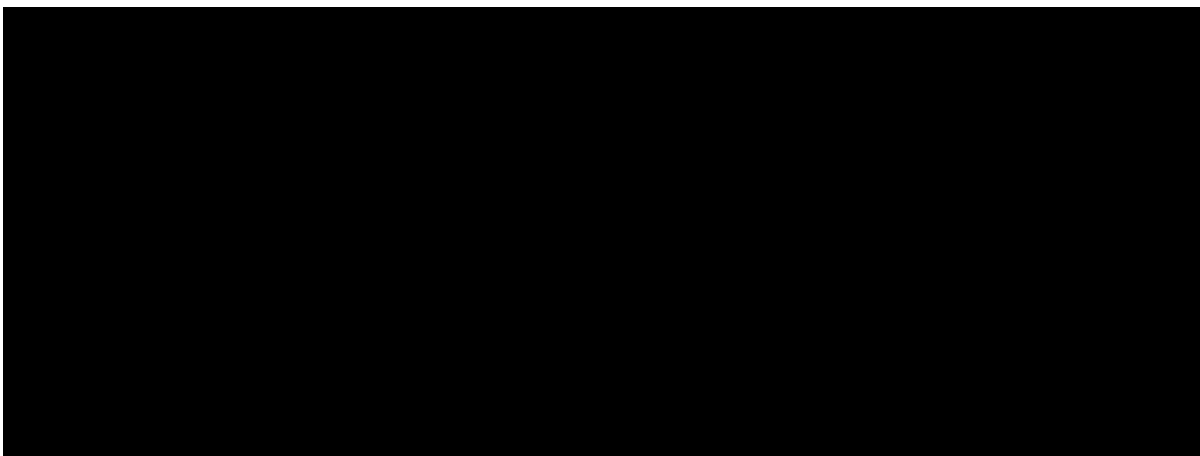


[189] *See* Meta, Proxy Statement (DEF 14A) at 79 (Apr. 10, 2020); Meta, Proxy Statement (DEF 14A) at 76 (Apr. 9, 2021); Meta, Proxy Statement (DEF 14A) at 83 (Apr. 8, 2022).

[190] *See* Meta, Proxy Statement (DEF 14A) at 77 (Apr. 10, 2020); Meta, Proxy Statement (DEF 14A) at 74 (Apr. 9, 2021); Meta, Proxy Statement (DEF 14A) at 80 (Apr. 8, 2022).

[191] *See* Meta, Proxy Statement (DEF 14A) at 79 (Apr. 10, 2020); Meta, Proxy Statement (DEF 14A) at 75 (Apr. 9, 2021); Meta, Proxy Statement (DEF 14A) at 82 (Apr. 8, 2022).

[192] META220_0006471, 6675.



182. Specifically, the Audit Committee was informed that [193] [194] In other words, Meta's management were unable to and therefore they had been unable to

[193] *Id.*

[194] *Id.*

[195] And Meta's management lacked

[196]

183. On December 3, 2020, the Board received a presentation titled "Board Updates & Approvals" for "*Directors Only*"[197] which attached a letter from Harrington Investments Inc.,[198] regarding a "Shareholder Proposal Follow-up."[199] The letter stated that "Facebook is the world's #1 hub of reported child sexual abuse material" and that "94 percent" of online material "came from the Facebook platform":[200]

> ***Facebook is the world's #1 hub of reported child sexual abuse material (CSAM). In 2019, there were more than 16.9 million reports***

[195] *Id.*

[196] *Id.*

[197] META220_0000344.

[198] Harrington Investments, Inc., describe themselves as "a leader in Socially Responsible Investing and Shareholder Advocacy since 1982, dedicated to managing portfolios for individuals, foundations, non-profits, and family trusts to maximize financial, social and environmental performance." https://www.harringtoninvestments.com/.

[199] META220_0000467-0471.

[200] META220_0000469. The letter appears to have quoted statements made by shareholders in support of the shareholder resolutions that ISS and Glass Lewis recommended in May 2020 that the Board support. *See, e.g.*, https://www.iccr.org/shareholders-raise-alarm-facebook-agm-failure-address-encryption-concerns-will-boost-child-sexual#:~:text=They%20noted%20that%20Facebook%20is,came%20from%20the%20Facebook%20platform.

> ***of child sexual abuse material online and, of that, 15.8 million — or 94 percent — came from the Facebook platform. . . .*** Reported incidents of child sexual exploitation and grooming . . . increased dramatically from year to year over the past decade. The bottom line is that Facebook's efforts are not stopping these crimes against children -- including infants and toddlers -- on its platforms.

### K. February 2021 – the Board Opposes the Renewed Stockholder Proposal and Learns that the Supreme Court Had Declined to Hear Meta's Appeal of the Texas Lawsuit by Victims of Trafficking

184. On February 11, 2021, the Board's Compensation Committee received a presentation regarding Meta's "2021 Annual Meeting of Stockholders Agenda."[201] The presentation attached and discussed a "Stockholder Proposal" which "[r]equest[ed] that the Board issue a report by February 2022 assessing the risk of increased sexual exploitation of children as the company develops and offers additional privacy tools such as end-to-end encryption. The report should address potential adverse impacts to children (18 years and younger) and to the company's reputation or social license and assess the impact of limits to detection technologies and strategies."[202] The shareholder proposal stated that "[t]he Facebook brand has been diminished in recent years due to the platform's use as a tool for gross disinformation, hate speech, and to incite racial violence. What was envisioned as a tool to connect people . . . . has led to many instances of human suffering and death.

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[201] META220_0001010, 1063.

[202] META220_0001068; *see also* META220_0001156.

Management and the board have failed to take effective action to stem these abuses, which has resulted in a series of negative impacts including: . . . [o]ver 45 million images of child pornography and torture made public."[203]

185. The same presentation also attached a ████████ ████████ dated February 5, 2021, by ████.[204] The ████ informed the Committee that ████████████████████████████████████████████████████████████████████████.[205]

186. The same ████ further informed the Committee that ████████████████████████████████████████.[206]

[203] META220_0001162.

[204] META220_0001219.

[205] *Id.*

[206] META220_0001319.

187. Also on February 11, 2021, the Board received a presentation titled "Board Updates & Approvals" for "*Directors Only*"[207] that informed the Board of the same "Stockholder Proposal" discussed above requesting "that the Board issue a report by February 2022 assessing the risk of increased sexual exploitation of children as the company develops and offers additional privacy tools such as end-to-end encryption."[208] The same presentation set forth a [redacted] [redacted] which stated:[209]

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

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[207] META220_0004201.

[208] META220_0004214.

[209] *Id.*

188. Yet, as discussed herein, Meta's supposed [REDACTED] were not necessarily being used for [REDACTED] and therefore this statement was misleading to investors. *See supra* Section II.U; *see also infra* Section III.O.

189. The same February 11, 2021 presentation included a section titled [REDACTED] which acknowledged that Meta [REDACTED] and that its [REDACTED] in that regard [REDACTED]:[210]

[REDACTED]

[210] META220_0004246.

### L. May 2021 – the Board Learns that "Shareholder Proposals" Regarding "Child Exploitation" Had "Garnered the Most Attention" and Meta Issues a "2021 Anti-Slavery and Human Trafficking Statement" that Fails to Mention Sex Trafficking

190. On May 26, 2021, Meta held its Annual Meeting of Shareholders. In connection with the meeting, the Board met and reviewed a shareholder proposal similar to one it had received in 2020 seeking the Company to issue a report concerning child exploitation on Meta's platforms and providing supporting facts. The Board also reviewed similar recommendations by ISS and Glass Lewis, proxy advisors who each recommended (as they had in 2020) that shareholders vote "FOR" the proposal.[211]

191. On May 27, 2021, the Board received a presentation titled "Board Updates & Approvals" for "*Directors Only*"[212] which discussed "Investor Feedback re: Governance Matters" and noted that "Shareholder proposals . . . . that garnered the most attention were: Proposals 6 (Child Exploitation)."[213]

192. Also on May 27, 2021, the Compensation Committee received a presentation that similarly discussed "Investor Feedback re: Governance Matters"

[211] META220_0000885-886, 897, 916-920, 923-924, 926-927, 933, 938, 962-968, 991.

[212] META220_0003530.

[213] META220_0003595.

which noted that "Shareholder proposals . . . . that garnered the most attention were: Proposals 6 (Child Exploitation)."[214]

193. The May 27, 2021 "Board Updates & Approvals" presentation included a discussion of "Key Policies Applicable to Directors" which listed Meta's "Anti-Slavery and Human Trafficking Statement" and noted that "[c]hanges/updates to policies marked in RED are being proposed for approval at the 5/26 [Audit Committee] meeting or 5/27 [Compensation Committee] meeting. Redlined versions of these policies have been included in the following slides for reference."[215] As indicated, the presentation included a "redlined" version of "Facebook's Anti-Slavery and Human Trafficking Statement," in which deletions were indicated in red in strikethrough font and additions were indicated in blue underlined font.[216]

194. Meta's 2021 Anti-Slavery and Human Trafficking Statement was also notable in that it ***did not*** discuss, focus on, or even comment on whether sex trafficking or sexual exploitation had been occurring on Meta's platforms. Instead, this statement focused on whether "modern slavery and human trafficking" were

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[214] META220_0001380, 1385.

[215] META220_0003530, 3605.

[216] META220_0003625-30.

occurring within Meta's own business operations or in Meta's supply chains.[217] In this latter regard, Meta concluded, "[w]e consider the risks of modern slavery and human trafficking to be ***relatively low*** in our direct business operations as our direct workforce is largely comprised of professionally qualified or skilled personnel. However, we are aware that inherent and potential risks of modern slavery and human trafficking could be present in our supply chains."[218]

195. Meta's 2021 "Anti-Slavery and Human Trafficking Statement" is perhaps most noticeable in the language that the Board approved to be deleted and which had been in the earlier 2020 version of that statement. Specifically, Meta deleted the portion of language which stated that they remove content related to human trafficking:[219]

> ~~In an effort to disrupt and prevent harm, ***we remove content on Facebook that facilitates or coordinates the exploitation of humans, including human trafficking. We define human trafficking in our Community Standards as the business of depriving someone of liberty for profit. It is the exploitation of humans in order to force them to engage in commercial sex, labor, or other activities against their will***. It relies on deception, force and coercion, and degrades humans by depriving them of their freedom while economically or materially benefiting others.~~

[217] *Id.*

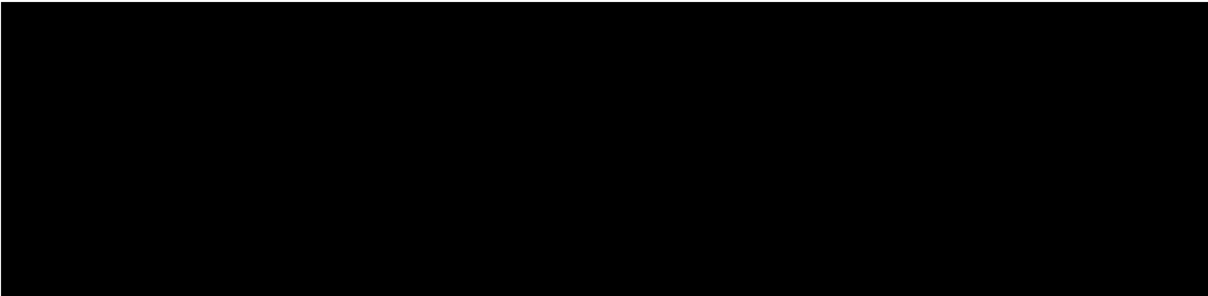
[218] META220_0003625.

[219] META220_0003629.

196. The final, published versions of Meta's 2020, 2021, and 2022 "Anti-Slavery and Human Trafficking Statement" remain available online and reflect Meta's deletions of the above language from the 2021 and 2022 versions.[220]

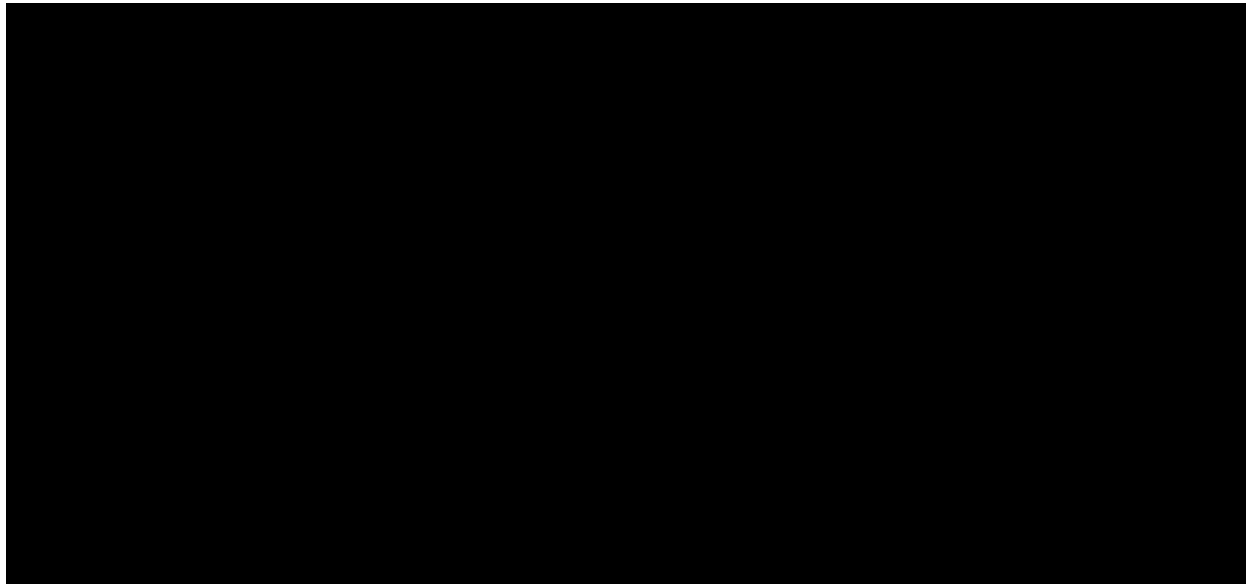
**M. September 2021 – the Audit Committee Learns that [REDACTED] Including a [REDACTED] and [REDACTED]**

197. On September 1, 2021, the Audit Committee held a "Zoom Meeting" during which the Board reviewed a presentation reviewing several [REDACTED] which concluded, among other things, that [REDACTED][221]



[220] Neither Meta's 2021 or 2022 Anti-Slavery and Human Trafficking Statements make any mention of "sex trafficking" or provide any attempt to define or refer to human trafficking as involving commercial sex or sexual exploitation. Instead, Meta blithely noted that "[w]e consider the risks of modern slavery and human trafficking to be relatively low in our direct business operations as our direct workforce is largely comprised of professionally qualified or skilled personnel." *See* ANTI-SLAVERY AND HUMAN TRAFFICKING STATEMENT 2021 available at https://s21.q4cdn.com/399680738/files/doc_downloads/2021/06/2021-Facebook's-Anti-Slavery-and-Human-Trafficking-Statement.pdf; ANTI-SLAVERY AND HUMAN TRAFFICKING STATEMENT 2022 available at https://s21.q4cdn.com/399680738/files/doc_downloads/2022/06/30/2022-Anti-Slavery-and-Human-Trafficking-Statement.pdf.

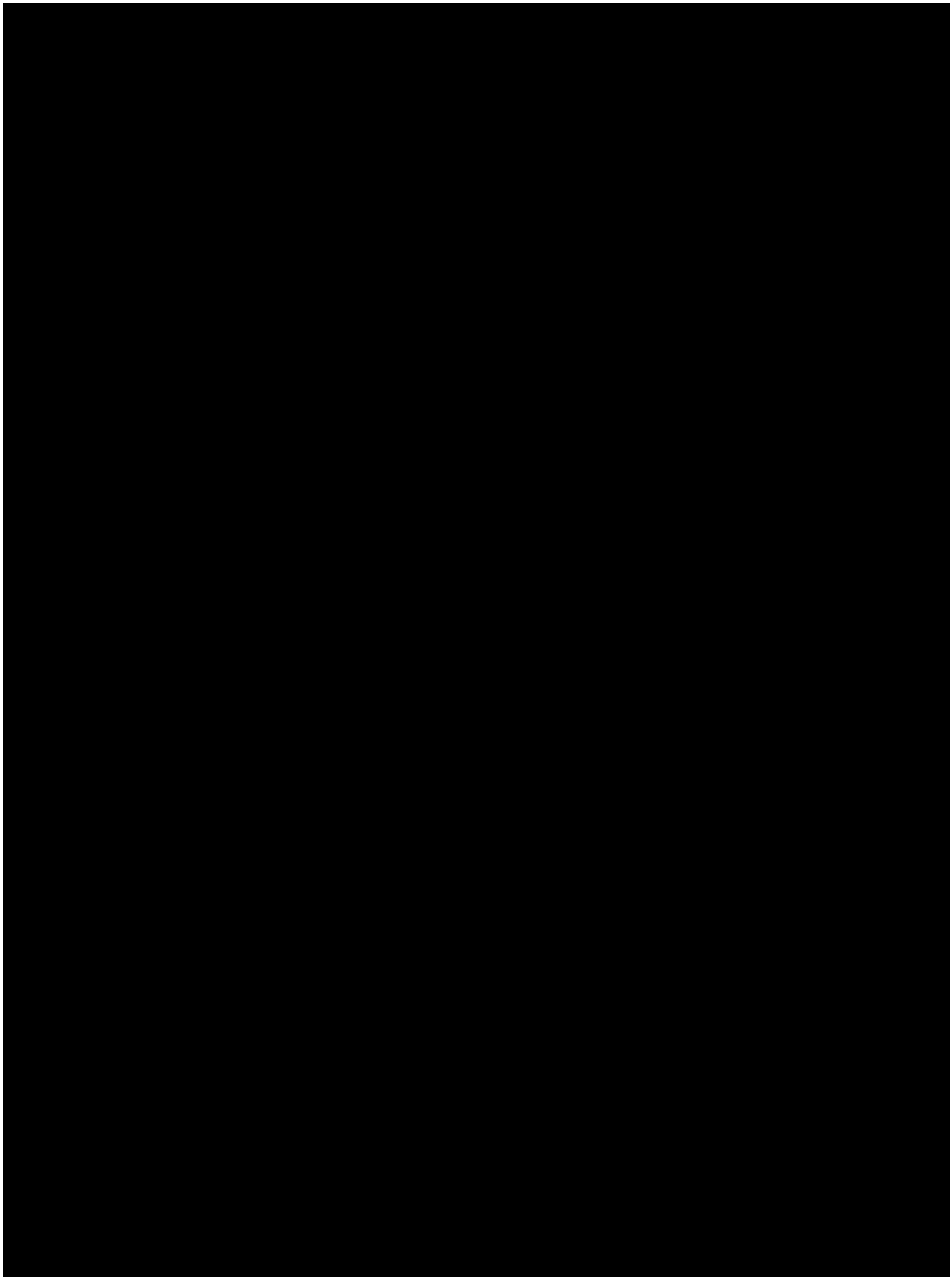
[221] META220_0004766, 4867; *see also* META220_0004968, 5069.

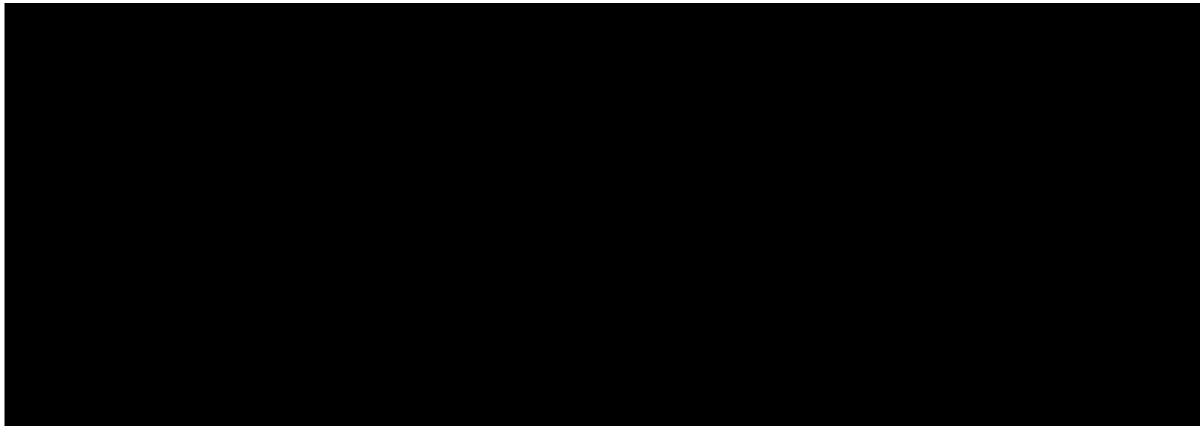


198. On another slide, the presentation identified several [REDACTED] [REDACTED], including that [REDACTED] [REDACTED].[222]

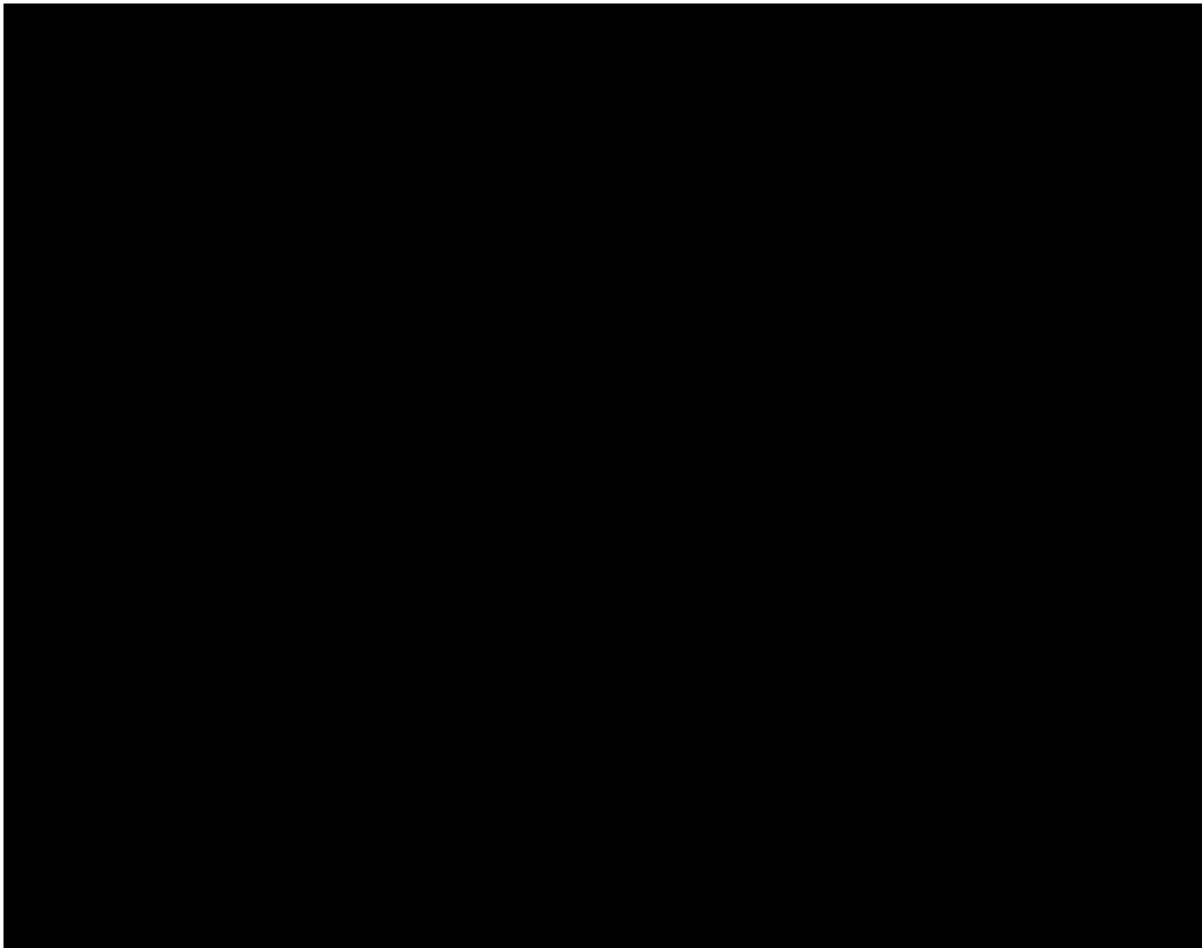
[REDACTED]

[222] META220_0004907.

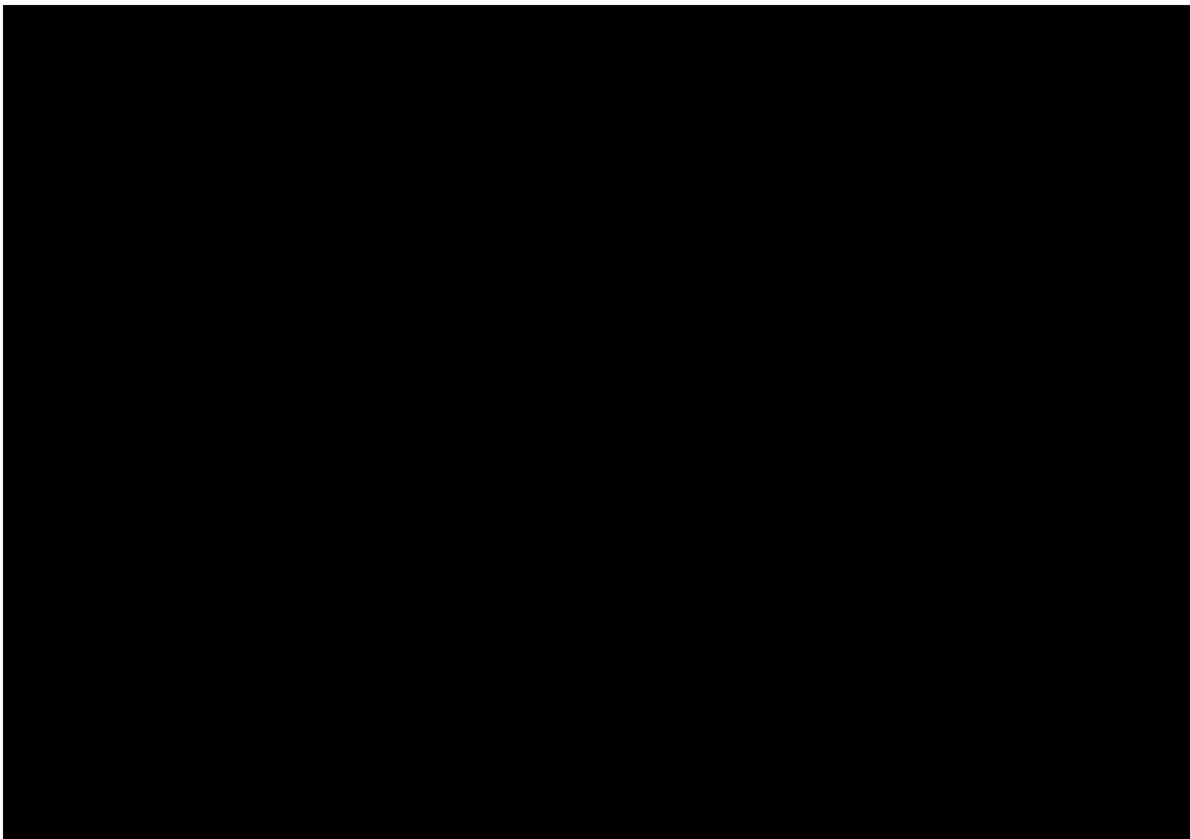




199. On another slide, the presentation identified the additional [REDACTED] [REDACTED]:[223]



[223] META220_0004908.



200. On September 2, 2021, the Board received a presentation titled "Board Updates & Approvals" for "*Directors Only*."[224] The documents attached to the September 2, 2021 Board update included a letter dated May 25, 2021, from Matt Crossman of Rathbone Investment Management Ltd. to Defendant Zuckerberg.[225] In the letter, Mr. Crossman wrote:[226]

> With regard to the AGM [i.e., annual general meeting] planned for the 26th May 2021, we wish to formally notify the board of our intention to

[224] META220_0004350.

[225] META220_0004433-34.

[226] *Id.*

> voting against the recommendation of management on the following items:
>
> ***
>
> - Item 6: Report on Online Child Sexual Exploitation: We have determined to vote FOR this resolution.
>
> ***
>
> With regard to item 6, we have determined to vote against management by providing our support for the request that the company report on risks related to the sexual exploitation of children as it develops additional privacy tools, such as end-to-end encryption. Additional information on risks related to potential sexual exploitation of children through the company's platforms would give shareholders more information on how well the company is managing related risks, and we are generally in favour of improved disclosure.

201. Also on September 2, 2021, the Compensation Committee received a presentation[227] attaching the "ISS Proxy Analysis & Benchmark Policy Voting Recommendations" in which ISS stated, "[s]upport for the shareholder proposal requesting a report assessing risks related to the potential sexual exploitation of children through the company's platforms (Item 6) is warranted, as additional information would aid investors in assessing the company's management of related risks."[228]

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[227] META220_0000813.

[228] META220_0000885.

### N. December 2021 – the Board Learns that Meta's [REDACTED] and Meta Is "Wracked by Management Missteps and Lack of Board Oversight" and "Subject to Unparalleled Regulatory Scrutiny"

202. On December 8, 2021, the Audit Committee received a presentation [REDACTED][229]

203. The presentation stated that [REDACTED] and that [REDACTED][230] The presentation also noted that [REDACTED][231] The presentation further noted that [REDACTED][232]

[229] META220_0005477, 5529.

[230] META220_0005529.

[231] *Id.*

[232] *Id.*

204. On December 9, 2021, the Board received a presentation marked for "DIRECTORS ONLY"[233] that included a shareholder proposal stating that "***[t]he Meta (formerly Facebook) brand has continued to be wracked by management missteps and lack of Board oversight, resulting in continued harm by its platform including . . . . [l]ack of cooperation with authorities to prevent and detect child exploitation and abuse***."[234]

205. The proposal also told the Board that "[a] whistleblower complaint filed with the SEC argues that the Company has failed to adequately warn investors about the material risks of dangerous and criminal behavior . . . on its sites," and that Meta's "failure to control these activities reflects a grave lack of oversight by management and the board."[235]

206. The proposal also criticized and sought information regarding "the effectiveness of Meta's algorithms to locate and eliminate content that violates the Community Standards" and "the effectiveness of Meta's staff and contractors in locating and eliminating content that violates the Community Standards[.]"[236]

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[233] META220_0004573.

[234] META220_0004673 (citing https://www.theguardian.com/technology/2021/jan/21/facebook-admits-encryption-will-harm-efforts-to-prevent-child-exploitation).

[235] META220_004673 (citing https://www.washingtonpost.com/technology/2021/10/22/facebook-new-whistleblower-complaint/).

[236] META220_0004674.

207. The proposal concluded that Meta's "enforcement of 'Community Standards' . . . has proven ineffective at controlling the dissemination of user content that . . . incites violence and/or harm to public health or personal safety."[237]

### O. February 2022 – the Audit Committee Learns that Meta's [redacted] Have [redacted] and that [redacted]

208. On February 9, 2022, the Audit Committee held a meeting and reviewed a presentation titled "Audit & Risk Oversight Committee Agenda."[238] The presentation discussed Meta's [redacted][239] and, as part of that discussion, reviewed [redacted][.][240] One such [redacted] concerned Meta's [redacted] and found that Meta had [redacted][241]

209. In the same presentation, another [redacted] concerning Meta's [redacted] found that Meta had [redacted][.]"[242]

[237] META220_0004673.

[238] META220_0005786.

[239] META220_0005902.

[240] META220_0005919-5920, 5922.

[241] META220_0005919.

[242] META220_0005920.

210. Yet another concerning Meta's found, among other things, that (1) Meta's ; (2) Meta had an ; (3) ; and (4) [.]"[243]

211. With regard to , the presentation stated that [244] In other words, Meta internally acknowledged to the Audit Committee not only that ," but that at the same time, Meta did not have any system that it could use for . And while Meta was

[243] META220_0005922.

[244] *Id.*

[245]

212. With regard to , the presentation stated that [246] In other words, Meta internally acknowledged to the Audit Committee that a " but that this [.]"[247] Even worse, while Meta had developed a Meta had not yet even [248]

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245 *Id.*

246 *Id.*

247 *Id.*

248 *Id.*

213. Meta's acknowledgement to the Audit Committee that as of January 20, 2022, the Company did not yet have [249] is notable when considered alongside Meta's prior acknowledgement to the Audit Committee that as of December 2, 2020, the Company did not yet have a to [250] Hence, in December 2020, Meta could not , and in January of 2022, Meta had no —and apparently as a consequence, Meta had a

214. On February 10, 2022, the Board held a "Q1 2022 Board of Directors Meeting"[251] during which the Board reviewed a presentation which described a "Shareholder Proposal" the Board had received and a

[249] *Id.*

[250] META220_0006395, 6468.

[251] META220_0000481.

[252] On the same day, the Compensation Committee received the same slide, which is recreated below.[253]

**Shareholder Proposals (cont.)**

| **Shareholder Proposal** | |
|---|---|
| Report on child exploitation:<br>Requests that the Board prepare a report assessing the risk of increased sexual exploitation of children as we implement privacy such as E2EE [i.e., end-to-end encryption]. | |

215. The February 10, 2022 Board presentation also contained the text of the 2022 Shareholder Proposal regarding "Child Sexual Exploitation Online"[254] and the [255] In its the

[252] META220_0000535.

[253] META220_0006803, 6848.

[254] META220_0000608-0609.

[255] META220_0000610-0612.

Board stated, [redacted][256]

# IV. FIDUCIARY DUTIES OF THE DEFENDANTS

## A. Defendants' Fiduciary Duties Under *Caremark*

216. By reason of their positions as directors, officers, and/or fiduciaries of Meta and because of their ability to control the business and corporate affairs of Meta, Defendants at all relevant times owed fiduciary duties to Meta and its stockholders, including the duties of care, loyalty, and good faith.

217. Under *Caremark* and its progeny, a board of directors of a Delaware corporation, as well as its officers, have the specific fiduciary duties to: (a) implement an information and reporting system and controls of compliance; and (b) oversee and monitor the operations of that information and reporting system.[257] Under the second prong of *Caremark*, directors and officers breach their fiduciary duty of loyalty if, having implemented a reporting and information system and

[256] META220_0000611.

[257] *In re Caremark Int'l. Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

controls, they consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.[258]

218. The *Caremark* duty is especially heightened with respect to the monitoring of fraudulent or criminal conduct, as opposed to other, more general business risks. As the Delaware Court of Chancery has stated, "[d]irectors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct."[259]

219. Moreover, the Delaware Court of Chancery has recently confirmed that *Caremark* duties extend to corporate officers. As Vice Chancellor Laster noted, "[t]he same policies that motivated Chancellor Allen to recognize the duty of oversight for directors apply equally, if not to a greater degree, to officers. The Delaware Supreme Court has held that under Delaware law, corporate officers owe

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[258] *Stone v. Ritter*, C.A. No. 1570-N, 2006 WL 302558, at *1-2 (Del. Ch. 2006), *aff'd sub nom. Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370, (Del. 2006).

[259] *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 131 (Del. Ch. 2009).

the same fiduciary duties as corporate directors, which logically include a duty of oversight."[260]

220. As noted above, it is an axiomatic tenet of Delaware corporate law that Delaware corporations may only pursue "lawful business" by "lawful acts." 8 *Del. C.* §§ 101(b), 102(a)(3). "Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue 'lawful business' by 'lawful acts.' As a result, a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law."[261]

221. Here, one of the most significant risks Meta faced was legal and regulatory compliance. Defendants were well aware that Meta was at a heightened risk for running afoul of these requirements because of multiple governmental departments' keen focus on sex/human trafficking and child exploitation on Meta's online platforms and those platforms' roles in promoting and facilitating the recruitment of trafficking victims. Accordingly, Defendants were required to be

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[260] *In re McDonald's Corp. S'holder Deriv. Litig.*, --- A.3d ---, 2023 WL 407668, at *1 (Del. Ch. Jan. 26, 2023).

[261] *In re Massey Energy Co. Derivative & Class Action Litig.*, C.A. No. 5430-VCS, 2011 WL 2176479, at *20 (Del. Ch. May 31, 2011) (quoting 8 *Del. C.* §§ 101(b), 102(a)(3), (b)(7)).

especially vigilant that the proper systems were in place to detect and deter such illegal conduct.

222. As set forth in greater detail below, Defendants breached their fiduciary duties by both failing to implement any adequate information reporting systems or controls to detect, prevent, and address sex/human trafficking and child exploitation (under the first prong of *Caremark*); and, to the extent any such ostensible systems or controls may have existed (if only nominally), by failing to oversee and monitor such systems or controls (under the second prong of *Caremark*). As alleged in Sections IV.A to IV.C *infra*, Defendants owed very specific responsibilities to monitor their information and reporting systems for fraudulent and criminal conduct and to ensure that the Company's business practices complied with all legal and regulatory requirements. Moreover, these responsibilities indisputably were known by Defendants. In conscious disregard of these responsibilities, Defendants failed to monitor or oversee the operations of Meta's information and reporting system, thereby disabling themselves from being informed of the non-compliance and fraudulent/unlawful sales practices. By failing to act in the face of a known duty to act, and by demonstrating a conscious disregard for their responsibilities, Defendants failed to act in good faith and breached their fiduciary duty of loyalty.

### B. The Audit Committee's Charter Gave the Audit Committee Defendants the Specific Duty to Oversee Legal and Regulatory Compliance, Community Safety and Security, and Content Governance

223. In June 2018, Facebook announced that it changed its Audit Committee Charter to cover risk oversight responsibilities like data privacy, community safety, and cybersecurity. Defendant Bowles, Chair of the Audit Committee at that time, made the statement that "Facebook has grown significantly since going public, and so has the role of the audit committee, especially its role managing risk oversight. To reflect this, the Board updated the Audit Committee's charter to clarify how its role has grown, as well as to address other evolving issues, particularly in the areas of privacy and data use, community safety and security, and cyber-security."[262] At that time, the Audit Committee was renamed the Audit & Risk Oversight Committee (which is referred to herein as the "Audit Committee").

224. The Charter of the new Audit Committee (effective June 14, 2018) (the "2018 Charter") stated that the purpose of the Audit Committee was "to oversee (A) the independence, qualifications, and performance of the independent auditor, (B) the accounting and financial reporting processes of the Company and the audits of the financial statements of the Company, (C) the Company's internal audit function, and (D) certain risk exposures of the Company." Because the

[262] https://www.axios.com/2018/06/14/facebooks-board-expands-role-of-a-1529004696.

responsibilities and duties of the Audit Committee are set forth in its Charter, the members of the Board indisputably were aware of these duties.

225. The Audit Committee is required to meet no less frequently than once each quarter, "or more frequently, as determined appropriate by the Committee." Furthermore, the Committee, "in discharging its responsibilities, may conduct, direct, supervise or authorize studies of, or investigations into, any matter that the Committee deems appropriate, with full and unrestricted access to all books, records, documents, facilities and personnel of the Company." Further, the Committee "has the sole authority and right, at the expense of the Company, to retain legal and other consultants, accountants, experts and advisers of its choice to assist the Committee in connection with its functions, including any studies or investigations." In other words, the Audit Committee is provided the necessary access to management and to the internal auditor in order to fulfill the Committee's responsibilities.

226. Among its responsibilities, the Audit Committee is required to oversee the internal audit function. As part of this responsibility, the Audit Committee is required to "oversee the activities of the Company's internal audit function, including review of any process of appointment and/or replacement of the senior employee in charge of the internal audit function." Further, the "Committee will periodically meet separately with the internal audit function out of the presence of the Company's management."

227. A key responsibility assigned to the Audit Committee under the 2018 Charter is to oversee risk. As part of this responsibility, the Audit Committee is responsible for overseeing the management of the below major risk exposures set forth in the 2018 Charter:

1. *Financial and Enterprise Risk*. The Committee will review with management, at least annually, the Company's major financial risk and enterprise exposures and the steps management has taken to monitor or mitigate such exposures, including the Company's procedures and any related policies with respect to risk assessment and risk management.

2. **Legal and Regulatory Compliance.** ***The Committee will review with management, at least annually, (a) the Company's program for promoting and monitoring compliance with applicable legal and regulatory requirements, and (b) the Company's major legal and regulatory compliance risk exposures and the steps management has taken to monitor or mitigate such exposures, including the Company's procedures and any related policies with respect to risk assessment and risk management.***

3. *Privacy and Data Use*. The Committee will review with management, at least annually, (a) the Company's privacy program, (b) the Company's compliance with its consent order with the U.S. Federal Trade Commission, as well as the laws, and (c) the Company's major privacy and data use risk exposures and the steps the Company has taken to monitor or mitigate such exposures, including the Company's procedures and any related policies with respect to risk assessment and risk management.

4. **Community Safety and Security.** ***The Committee will review with management, at least annually, the Company's assessment of the major ways in which its services can be used to facilitate harm or undermine public safety or the public interest, as well as the steps the Company has taken to monitor or mitigate such abuse, including the Company's procedures and any related policies with risk to risk assessment and risk management.***

5. *Cybersecurity*. The Committee will review with management, at least annually, the Company's cybersecurity risk exposures and the steps the Company has taken to monitor or mitigate such exposures, including the Company's procedures and any related policies with respect to risk assessment and risk management.

6. *Other Risk Oversight*. The Committee will periodically review with management the Company's risk exposures in other areas, as the Committee deems necessary or appropriate from time to time.

228. In December 2020, section *(d) Community Safety and Security* was amended to reference Meta's monitoring of "content": "The Committee will review with management, at least annually, the Company's assessment of the major ways in which its services can be used to facilitate harm or undermine public safety or the public interest, ***including through the sharing of <u>content</u> on its services that violate the Company's policies***, as well as the steps the Company has taken to monitor, mitigate, and prevent such abuse."

229. In 2021, Meta changed the title of this section from "Community Safety and Security" to "Social Responsibility," stating that:

> The Committee will review with management, (a) at least annually, the Company's assessment of the major ways in which its services can be used to facilitate harm or undermine public safety or the public interest, including through the sharing of content on its services that violate the Company's policies, as well as the steps the Company has taken to monitor, mitigate, and prevent such abuse, and (b) from time to time, such other program, policies, and risk exposures related to social responsibility as the Committee deems necessary or appropriate.

230. These responsibilities are affirmed in Meta's proxy statement disclosures. According to Meta's 2022 Annual Proxy Statement filed with the SEC

on April 8, 2022,[263] the "Principal Responsibilities" of the Audit Committee include "[r]eviewing our program for promoting and monitoring compliance with applicable legal and regulatory requirements," and "[o]verseeing our major risk exposures (including in the areas of financial and enterprise risk, legal and regulatory compliance, environmental sustainability, social responsibility (including content governance, community safety and security, human rights, and civil rights), and cybersecurity) and the steps management has taken to monitor and control such exposures, and assisting our board of directors in overseeing the risk management of our company."[264]

231. Under the Audit & Risk Oversight Committee Charter, effective as of September 8, 2022 ("2022 Charter"),[265] one of the Audit Committee's principal duties is to monitor the Company's financial statements and disclosures. As part of this responsibility, the Audit Committee is required to:[266]

a. Meet to review and discuss with the independent auditor and the Company's management the Company's quarterly financial statements and annual audited financial statements, including the Company's specific disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

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[263] https://www.sec.gov/Archives/edgar/data/1326801/000132680122000043/meta2022definitiveproxysta.htm.

[264] *Id.* at 21.

[265] https://s21.q4cdn.com/399680738/files/doc_downloads/governance_documents/2022/09/Audit-and-Risk-Oversight-Committee-Charter-(9.8.2022).pdf.

[266] *Id.* at 3-4.

b. The Committee will be responsible for recommending to the Board whether the annual audited financial statements should be included in the Company's annual report on Form 10-K.

c. The Committee will cause to be prepared and review a report to the Company's stockholders for inclusion in the Company's proxy statement as required by the Commission Rules.

d. The Committee will discuss with the independent auditors and they Company's management any items appropriate or required to be discussed in accordance with applicable PCAOB standards in connection with the preparation of financial statements of the Company.

232. The responsibilities set forth above in the 2022 Charter, and affirmed in the Company's proxy statement disclosures, clearly encompass oversight of the Company's compliance with criminal laws, regulatory compliance, and community safety and security.

### C. Additional Duties Imposed by Meta's Corporate Governance Guidelines and Code of Conduct

233. All of the Director Defendants became fully aware of their responsibilities and duties to oversee and monitor the Company for compliance risks when they joined the Board. Meta's Corporate Governance Guidelines state that "these Corporate Governance Guidelines . . . reflect the Board's strong commitment to sound corporate governance practices and . . . encourage effective policy and decision making at both the Board and management level, with a view to enhancing long-term value for Meta shareholders."[267] The Corporate Governance Guidelines

[267] Meta, Corporate Governance Guidelines (Amended as of Apr. 3, 2022) at 1,

also provide that "[e]ach member of the Board is expected to spend the time and effort necessary to properly discharge such director's responsibilities." *Id.*

234. According to the Company's Code of Conduct one of the five principles that guide Meta's work includes "[k]eep[ing] people safe and protect[ing] privacy—we are committed to protecting our communities from harm."[268] The Code of Conduct specifically applies to "[m]embers of the Board of Directors, officers, and employees of Meta, as well as contingent workers (including vendor workers, contractors and independent contractors)[.]"[269]

235. The Code of Conduct specifically exhorts employees to:

- Consider a broad range of potential impacts on people, communities and society, looking across different dimensions of responsibility, such as inclusion, safety, privacy and others[.]
- Raise and address potential harms early and often throughout the product development process[.]

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available at https://s21.q4cdn.com/399680738/files/doc_downloads/governance_documents/2022/04/Meta-Corporate-Governance-Guidelines-(April-3-2022).pdf;

*see also* Facebook, Corporate Governance Guidelines (Amended as of Dec. 3, 2020) at 1.

[268] Meta, Keep Building Better: The Meta Code of Conduct [effective September 7, 2022] at 5, available at file:///L:/S&CF/471%20-%20Derivative/Facebook%20Human%20Trafficking%20(1000380.000)/Hickey/220%20Cx/Cited%20or%20Quoted/20220907_Meta_Code_of_Conduct.pdf; *see also* Facebook, Keep Building Better: The Facebook Code of Conduct at 5, available at 5 https://s21.q4cdn.com/399680738/files/doc_downloads/governance_documents/2021/06/FB-Code-of-Conduct.pdf.

[269] *See* sources cited *supra* note 269, at 6.

- Seek out expert voices, diverse perspectives and the resources and tools we have at Meta to inform our decisions[.]
- Engage in necessary reviews, such as Privacy Review and Integrity XFN review[.]
- Work quickly to identify and remove harmful content from Meta platforms, such as hate speech, harassment, child exploitation, threats of violence and terrorism[.]
- Design and build products that prioritize safety, privacy, provide appropriate warnings where necessary and articulate instructions for safe and responsible use[.]

236. The Code of Conduct specifically states that "we have a legal obligation to report to the National Center for Missing and Exploited Children any apparent violation of laws pertaining to child exploitation imagery."[270] The Code of Conduct further states that "[w]e have teams that are specially trained to review, escalate and report this [CEI] content, which must be done in a secure manner exposing the fewest people to this material." *Id.* In contrast, Meta's Code of Conduct fails to recognize any legal obligation to address human trafficking, nor does Meta list any teams that are specially trained to review, escalate, or report content related to human trafficking.

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[270] *Id.* at 30.

## V. DEFENDANTS' BREACHES OF FIDUCIARY DUTY

### A. Meta's Rampant Promotion and Facilitation of Sex/Human Trafficking and Child Exploitation Is a Mission-Critical Risk that Exposes Meta, Its Board, and Its Executives to Criminal/Civil Liability, Regulatory Risk, and Reputational Harm

237. The fact that Meta's platforms promote and facilitate rampant sex/human trafficking and child exploitation is a mission-critical risk that exposes the Company, its executives, and its Board to criminal and civil liability, regulatory risk, as well as monetary and reputational harm.

238. ***First***, as noted above (*see* Sections I.A to I.D *supra*), numerous federal and state statutes make sex/human trafficking a crime. *See, e.g.*, 18 U.S.C. § 1591(a); 11 *Del. C.* § 787(b). In that regard, in response to the same sort of rampant sex trafficking that has occurred and continues to occur on Meta's platforms, Congress passed FOSTA-SESTA, which makes it a crime to "own[], manage[], or operate[] an interactive computer service . . . with the intent to promote or facilitate the prostitution of another person" as well as to "act[] in reckless disregard of the fact that such conduct contributed to sex trafficking, in violation of [section] 1591(a)" and subjects violators to statutory fines and/or up to 25 years in prison. 18 U.S.C. § 2421A(a), (b)(2).

239. ***Second***, federal law exposes internet service providers who facilitate trafficking to civil liability. In that regard, FOSTA-SESTA states that "[a]ny person injured by reason of a violation of section 2421A(b) may recover damages and

reasonable attorneys' fees in an action before any appropriate United States district court" and that "in addition to any other civil or criminal penalties authorized by law, the court shall order restitution for any violation of subsection (b)(2)." 18 U.S.C. § 2421A(c)-(d).

240. ***Third***, the extent of Meta's facilitation of, and reckless disregard toward, trafficking on its platforms, as revealed by Ms. Haugen's whistleblower complaints, led to a securities fraud class action titled *Ohio Public Employees Retirement System v. Meta Platforms, Inc.*,[271] as a result of which Meta and its officers and directors face substantial risk of liability and as a result of which the Company is incurring substantial legal costs.

241. ***Fourth***, also as a result of Meta's promotion and facilitation of sex/human trafficking on its platforms—as revealed by Ms. Haugen's whistleblower complaints, federal and state case law, reports by the news media, and Congressional and Parliamentary hearings and other negative publicity—Meta has faced substantial reputational damages, and as a result, declining users, declining revenue, increased regulatory risk, and a declining stock price.

[271] No. 21-cv-08812-JST (N.D. Cal. filed Nov. 12, 2021), consol. sub nom. *In re Meta Platforms, Inc. Sec. Litig.*, No. 21-cv-08812-JST (N.D. Cal. filed Oct. 28, 2022).

242. ***Fifth***, numerous federal and state laws also make the sexual exploitation and abuse of children a crime. *See, e.g.*, 18 U.S.C. §§ 2251-2260A. Internet service providers who commit such crimes are not protected by Section 230 of the CDA. *See* 47 U.S.C. § 230(e)(1). Yet, an accumulating mass of federal and state case law and news reports shows a raging epidemic of child sexual exploitation occurring—openly and unchecked—on Meta's platforms. Meta's internal documents demonstrate the Board and management's utter failure to provide the oversight necessary to address this growing problem. As a result, Meta has faced substantial reputational damages, and as a result, declining users, declining revenue, increased regulatory risk, and a declining stock price.

243. Thus, for all the reasons set forth above, Meta's compliance with federal and state laws prohibiting sex/human trafficking, as well as the sexual exploitation and abuse of children—and particularly by internet service providers—was and is an essential mission-critical risk; the Board thus has had an imperative duty to make a good faith effort to put in place a reasonable board-level system of monitoring and reporting, and having implemented such a system, not to consciously fail to monitor or oversee its operations in the face of waving red flags.

### B. Meta's Complete Lack of Any Board or Committee Minutes Discussing Sex/Human Trafficking or Child Exploitation Demonstrates the Board's Utter Failure to Implement Any Board-Level Monitoring, Reporting, or Oversight for These Risks

244. As noted above,[272] in responses to Plaintiffs' books-and-records demands, Meta agreed that "[t]he Company will search for materials provided to the Board and Board minutes since January 1, 2017 relating to the two topics of (i) sex and human trafficking and (ii) teen health, including excerpts of minutes of meetings of the board of directors (or committees of the board) that reflect discussion of those two subjects . . . ."[273] Yet, in responses to Plaintiffs' books-and-records demands—and despite this promise—Defendants produced no minutes whatsoever of any meeting by either the Board, the Audit Committee, or any other committee of the Board.

245. As reflected by the complete lack of minutes discussing sex/human trafficking, child sexual exploitation (or any other subject), it is evident that the Board and the Audit Committee consciously failed to monitor or oversee Meta's operations insofar as they concern sex/human trafficking or child sexual exploitation.

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[272] *See* ¶¶ 16, 56-60 *supra*.

[273] Letter from David E. Ross to William S. Norton (Dec. 14, 2021) at 4.

246. This failure is even more notable when one considers how many times the Board met between 2017 and 2021. In 2017, the Board met five times and the Audit Committee met ten times. In 2018, the Board met twelve times and the Audit Committee met eleven times. In 2019, the Board met 13 times and the Audit Committee met ten times. In 2020, the Board met 15 times and the Audit Committee met nine times. In 2021, the Board met 12 times and the Audit Committee met ten times.

247. Throughout these many meetings, the Board and the Audit Committee had ample opportunity to discuss the fact that sex/human trafficking, and child sexual exploitation had been running rampant on Meta's platforms—yet, they utterly failed to do so.

### C. Ignoring Glaring Red Flags, the Board Utterly Failed to Implement Any System or Controls to Address the Rampant Sex/Human Trafficking on Meta's Platforms or Consciously Failed to Monitor or Oversee Whatever Controls May Have Existed

248. ***First***, the Board and management saw glaring red flags—in the form of shareholder proposals published in Meta's proxy statements—that put the Board on actual notice that, among other things: "Facebook . . . facilitate[ed] sex trafficking of minors"; "Instagram [was] linked to 'rampant sex trafficking'"; that "94 percent" of "Child Sexual Abuse Material" online "stem[s] from Facebook and its platforms, including Messenger and Instagram"; and that "[i]n 2020, 79 percent of U.S.

underage sex trafficking victims recruited online were recruited through Facebook or Instagram." *See* ¶¶ 111, 169, 115, 139 *supra*.

249. Moreover, two of the Board's proxy advisors, ISS and Glass Lewis, informed the Board—in recommending that the Board support the shareholder proposals mentioned above—that, among other things, that a TTP study identified "366 federal criminal cases over seven years that featured suspects using Facebook for child exploitation," and in May of 2019, although the *BBC* had alerted Meta that "the Company's platform contained posts of sexually explicit or exploitative content and images" and "accounts maintained by convicted sex offenders, specifically pedophiles," and that of "100 images" reported, "only 18 were removed" and "none" of the "pedophiles[']" accounts "were disabled." *See* ¶¶ 162, 171, 173 *supra*.

250. In addition, between 2013 and 2023, at least 70 federal and state courts have issued written decisions in criminal and civil cases involving sex trafficking on Meta's platforms. Likewise, Meta's widespread and ubiquitous facilitation of sex trafficking and human trafficking was reported in more than 175 articles published in U.S. newspapers and other media outlets between 2009 and 2022. *See* Sections II.B & II.A *supra*.

251. ***Second***, that the Board did not monitor, discuss, or address sex/human trafficking is demonstrated by the fact that, as discussed above, Meta has absolutely

no minutes from any meeting of the Board, the Audit Committee, or any other committee discussing sex/human trafficking or child sexual exploitation.

252. ***Third***, the Board had no regular process or protocols requiring management to apprise the Board of issues relating to sex trafficking, human trafficking, or even child safety or exploitation; instead, the Audit Committee only received intermittent, *ad hoc*, management-initiated communications regarding child safety—but no reports whatsoever regarding the extent of sex trafficking or human trafficking on Meta's platforms, and no reports or indications whatsoever of any efforts or initiatives to detect, prevent, or address such trafficking.

253. ***Fourth***, Meta's management saw glaring red flags that Meta's platforms facilitated widespread sex/human trafficking and child sexual exploitation but those additional red flags apparently never reached the Board due to the lack of reporting structure or oversight. In that regard, on October 23, 2019, Meta "received communication from Apple where the company threatened to pull FB & IG apps from its App Store due to them identifying content promoting 'domestic servitude.'" In response, according to Meta's records, Meta's management concluded that that "Facebook's statements about human trafficking were false" because, among other things, Meta internally acknowledged that Meta suffered from an "absence of proactive detection"; Meta had been "under-enforcing on confirmed abusive activity with a nexus to the platform"; and that Meta's own "investigative findings

demonstrate that our platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks."

## VI. META HAS SUFFERED SIGNIFICANT DAMAGE AS A RESULT OF DEFENDANTS' BREACHES

254. As a result of Defendants' breaches, Meta has suffered significant reputational harm as the Company has failed to address the widely known and publicized use of its social media platforms for human and child sex trafficking as described above. TechCrunch reported that in February 2022, the Company announced it had lost daily active users for the first time in the Company's history. In addition, *Bloomberg* reported in October 2021 in the wake of Frances Haugen's whistleblower revelations that U.S. teenagers were spending less time on Facebook, and the number of new teens signing up for Facebook accounts was also declining.

255. Because of Defendants' failures to address the ongoing criminal trafficking activity via the use of Meta's social media products, the severity of which was at least partially revealed by Frances Haugen's, *The Wall Street Journal's*, and *CBS News's* disclosures in September and October 2021, the Company is also exposed to significant potential liability in the pending securities class action styled *In re Meta Platforms, Inc. Securities Litigation*.[274]

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[274] No. 21-cv-08812-JST (N.D. Cal.).

256. On October 28, 2022, the Lead Plaintiffs in *In re Meta* filed a detailed, 195-page consolidated amended complaint.[275] The *In re Meta* complaint alleges, among other things, that "[t]hroughout the Class Period, Meta made statements that the Company was able to, and in fact did, stop its platforms from being used to facilitate and promote human trafficking" but "in truth, Meta failed to 'fix[] systems that allowed' traffickers to operate despite extensive information concerning their activities and opportunities to remove that content" and that "as *The Wall Street Journal* reported, after a Meta team spent more than one year [in 2018/2019] investigating human trafficking in the Middle East, an internal document [from 2021] warned Meta to be cautious with statements against human trafficking in order to not 'alienate buyers' [i.e., buyers of enslaved domestic workers] who used Meta's platforms."[276]

257. As a result of these and other misrepresentations by Meta about its policies and practices concerning human trafficking and sex trafficking (and other forms of harmful content) and the eventual revelation of the truth regarding Meta's true policies and practices, the *In re Meta* complaint alleges that "[f]rom the date of

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[275] Lead Pls.' Consol. Am. Class Action Compl. for Violations of the Federal Securities Laws, *In re Meta*, No. 4:21-cv-08812-JST (N.D. Cal. Oct. 28, 2022) (ECF No. 97).

[276] *Id.* at ¶¶ 413-14.

the first article published by *The Wall Street Journal* on September 13, 2021, to the final disclosures on October 21, 2021, Meta's stock price declined by $54.08 per share, or over 14%, representing ***a total decline of more than <u>$130 billion</u> in Meta's market capitalization***[.]"[277]

258. Of particular relevance to this case, the *In re Meta* complaint alleges that as a result of *The Wall Street Journal's* September 16, 2021 article, which revealed that "human traffickers used Facebook to facilitate their criminal enterprises, and that content violating the Company's domestic servitude policy routinely makes its way on to Meta's platforms without deletion,"[278] Meta's stock price suffered a "***single-day drop [that] erased over <u>$2 billion</u> of Meta's market capitalization***."[279]

259. Similarly, the *In re Meta* complaint also alleges that Meta stock dropped from a closing price of $343.01 on October 1, 2021, to a closing price of $326.23 on October 4, 2021, a steep decline of $16.78 or more than 4%—a stock "drop [that] ***eliminated nearly <u>$40 billion</u> of Meta's market capitalization in a single business day***,"[280] following the revelations (1) on October 3, 2021, that

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[277] *Id.* at ¶ 514.

[278] *Id.* at ¶ 318.

[279] *Id.* at ¶ 319.

[280] *Id.* at ¶ 349.

"Facebook whistleblower, Frances Haugen, [gave] two in-depth interviews with *60 Minutes* and *The Wall Street Journal* in advance of her congressional testimony";[281] and (2) that "on October 4, 2021, *CBS News* released the eight whistleblower complaints that Frances Haugen filed with the SEC,"[282] which included Haugen's complaint detailing how Meta "misled investors and the public about its promotion of human trafficking / slavery / servitude."

260. As a result of the Board's utter failure of oversight, leading to the Company's widespread facilitation of human trafficking and sex trafficking, and misrepresentations to its shareholders and the marketplace about its policies and practices concerning human/sex trafficking, Meta now faces massive liability to its shareholders in *In re Meta*, and has already began incurring substantial legal costs of its defense.

261. In addition to *In re Meta*, the Company also faces liability and has been incurring legal costs as a result of *In re Facebook, Inc.*, 2021 WL 2603687, a case brought against Meta by three victims of sex trafficking who alleged that Meta "'knows its system facilitates human traffickers in identifying and cultivating victims,' but has nonetheless 'failed to take any reasonable steps to mitigate the use

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[281] *Id.* at ¶ 514.

[282] *Id.* at ¶ 351.

of Facebook by human traffickers' because doing so would cost the company users and the advertising revenue those users generate."[283] Meta's costs include at least two state court appeals and one attempted appeal to the U. S. Supreme Court, which have thus far proved unsuccessful in dismissing the victims' case against Meta.

## VII. DERIVATIVE ALLEGATIONS

262. Plaintiffs bring this action derivatively to redress injuries suffered by the Company as a direct result of the breaches of fiduciary duty and other breaches by Defendants.

263. Plaintiffs have owned Meta stock continuously during the time of the wrongful course of conduct by the Defendants alleged herein and continue to hold Meta stock.

264. Plaintiffs will adequately and fairly represent the interests of Meta and its stockholders in enforcing and prosecuting the Company's rights.

## VIII. DEMAND ON THE BOARD IS EXCUSED BECAUSE IT IS FUTILE

265. Plaintiffs have not made a demand on Meta's Board to bring suit asserting the claims set forth herein because pre-suit demand is excused as a matter of law.

266. Meta's Demand Board consists of nine directors: Defendant Zuckerberg, Defendant Sandberg, Defendant Alford, Defendant Andreessen,

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[283] *Facebook Cert.*, 142 S. Ct. at 1088 (2022).

Defendant Houston, Defendant Killefer, Defendant Kimmitt, and Defendant Travis. As set forth below, with respect to the claims for relief asserted by Plaintiffs, at least half the Board is not disinterested and independent.

### A. At Least Half of Meta's Demand Board Faces a Substantial Risk of Liability

267. Every one of the Demand Board members is a Defendant and faces a substantial risk of liability as a result of their failure to conduct oversight concerning, and to address, the use of Meta's social media platforms for human trafficking and child exploitation.

268. Each of the Demand Board members knew that significant criminal activity involving sexual exploitation and human trafficking was taking place on Facebook and Instagram. The evidence of such activity was everywhere. As described in Section II.A, the involvement of both platforms in such activity was well publicized by the media, with over 175 articles published in the past decade in the United States detailing how sex/human traffickers have systematically used Facebook to commit their heinous crimes. Hundreds of criminal cases have been filed against criminals who conducted their crimes using the platforms. In presentations to the Board, Facebook's management signaled that the problems were persistent and growing more severe. Facebook's own founder and CEO was repeatedly questioned about Facebook's lack of response by members of Congress. And in October 2021, a whistleblower went public to make clear that Facebook—

despite its representations—did *not* have controls in place sufficient to control human trafficking. The members of the Demand Board were well aware that the Company did not have the controls in place to halt such activity.

269. The misconduct that gives rise to this action was perpetrated both by management and the Board and constitutes knowingly and consciously presiding over rampant criminal activity within Meta's products. For years, the Board has consciously turned a blind eye to systemic evidence of sex/human trafficking and child sexual exploitation. Because every member of the Demand Board faces a substantial likelihood of liability as Defendants in this action, demand on the Board is excused as futile.

**Zuckerberg**

270. Defendant Zuckerberg is the CEO, chairman, and founder of Facebook and its parent company, Meta. Zuckerberg has served as CEO and as a member of the Board since he created the Company in 2004; he has served as Chairman of the Board since 2012. Zuckerberg is also Meta's controlling shareholder.

271. As CEO and Chairman, Zuckerberg had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities. *See supra* Sections IV.B to IV.C. Zuckerberg was on the Board when it was repeatedly

advised—through the media,[284] by proxy advisors,[285] and by other stockholders—about the pernicious conduct occurring on Meta's platforms.

272. Zuckerberg was also on the Board when it was told by management that:

- Congress would be pushing for Section 230 immunity because of concerns over sex trafficking on internet sites (December 2017);
- Facebook had [REDACTED] (2019);
- A narrative had developed that [REDACTED] (September 2019);
- A stockholder proposal was asserting that Facebook was being sued for "facilitating sex trafficking of minors"; that "Instagram [is] being linked to 'rampant sex trafficking [and] child sexual abuse grooming'"; and that "Facebook may face significant regulatory risk if it cannot curb child sexual abuse on existing platforms" (February 2020);
- Facebook needed to [REDACTED] (2020);
- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and

[284] *See* Exhibit 1 & Section II.A *supra*.

[285] *See* Section V.C *supra*.

- Glass Lewis "d[id not] have any reason to be assured that the Company] w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

273. In addition, multiple reports issued by governmental and non-governmental organizations in 2020, 2021, and 2022 made clear that Facebook was being used for sex and labor exploitation.[286] Zuckerberg was also on the Board in October 2019 when internal Company documents reportedly revealed that Facebook's "platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks" and in 2021 when those internal documents were made public by a whistleblower. In 2018, 2019, and 2020, Zuckerberg testified before Congress and legislators repeatedly confronted him about evidence that human trafficking and sexual exploitation flourished on Facebook.[287] Numerous civil and criminal cases were brought in federal and state courts involving sex trafficking linked to the Company while Zuckerberg was on the Board.[288] And Zuckerberg was on the Board and served as CEO in 2018 when Congress addressed the pernicious sex trafficking in the country, including by eliminating the social media platforms' immunity under Section 230 of

[286] *See supra* Sections II.H, II.I, II.K, II.M, II.N, II.V, and II.W.

[287] *See supra* Sections II.., II.E, and II.G.

[288] *See supra* Sections II.B and II.P.

the CDA. Zuckerberg and the other Demand Board members were well aware of the thriving and systemic predation occurring throughout the Company's products and of the increased risk to Meta as a result of these crimes.

274. Nevertheless, the Board, with Zuckerberg at the helm, failed to act concerning trafficking and exploitation, and in fact affirmatively rejected stockholder proposals that would provide transparency regarding any efforts to arrest these safety concerns. Furthermore, although the Board had in place a policy concerning child exploitation, it failed to put in place a policy concerning human trafficking. Zuckerberg was also on the Board when the Company "deactivated a tool that was proactively detecting exploitation . . ."[289] Zuckerberg therefore faces a substantial likelihood of liability for breaching his fiduciary duties under *Caremark*. Furthermore, Zuckerberg is not an independent director under NYSE listing standards.

**Sandberg**

275. Defendant Sandberg is a director of Meta. Sandberg has served as a director since 2012 and served as COO from 2008 until August 2022.

276. As a director and COO, Sandberg had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and

[289] *See* note 190 *supra*.

Instagram platforms, but consciously disregarded those responsibilities.[290] Sandberg was on the Board when it was repeatedly advised—through the media, by proxy advisors, and by other stockholders—about the pernicious conduct occurring on its platforms. Sandberg also was on the Board in October 2019 when internal Company documents reportedly revealed that Facebook's "platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks" and in 2021 when those internal documents were made public by a whistleblower.

277. Sandberg was also on the Board when it was told by management that:

- Congress would be pushing for Section 230 immunity because of concerns over sex trafficking on internet sites (December 2017);
- Facebook had [redacted] (2019);
- A stockholder proposal was asserting that Facebook was being sued for "facilitating sex trafficking of minors"; that "Instagram [is] being linked to 'rampant sex trafficking [and] child sexual abuse grooming'"; and that "Facebook may face significant regulatory risk if it cannot curb child sexual abuse on existing platforms" (February 2020);
- A narrative had developed that [redacted] (September 2019);

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[290] *See* Sections IV.B to IV.C *supra*.

- Facebook needed to [redacted] (2020);
- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and
- Glass Lewis "d[id not] have any reason to be assured that the Company w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

278. Sandberg therefore faces a substantial likelihood of liability for breaching her fiduciary duties under *Caremark*. Furthermore, Sandberg is not an independent director under NYSE listing standards.

**Alford**

279. Defendant Alford is a director of Meta and has been a director since 2019.

280. As a director, Alford had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities.[291] Alford was on the Board when it was repeatedly advised—through the media, by proxy advisors, and

[291] *See* Sections IV.B to IV.C *supra*.

by other stockholders—about the pernicious conduct occurring on its platforms. Alford also was on the Board in October 2019 when internal Company documents reportedly revealed that Facebook's "platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks" and in 2021 when those internal documents were made public by a whistleblower.

281. Alford was also on the Board when it was told by management that:

- A narrative had developed that [REDACTED] (September 2019);
- Facebook needed to [REDACTED] (2020);
- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and
- Glass Lewis "d[id not] have any reason to be assured that the Company w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

282. Alford has been a member of the Audit Committee since 2019. The Audit Committee also received numerous reports that Facebook was failing to control trafficking and exploitation. For example, in December 2020, the Audit Committee was told that:

- ;
- ;
- The machine learning process ; and
- The Company lacked concerning child exploitative imagery.

283. Additionally, in September 2021, the Audit Committee was told that:

-
-
-
-
- There were ;
- ;
- and
-

284. Then, in February 2022, the Audit Committee was told that:

-

- A [redacted] and
- Meta had not yet [redacted]

285. However, the members of the Audit Committee, including Alford, failed to take steps to put in place such controls.

286. Alford was also a member of the Compensation Committee in February 2021 when it was told by management that:

- A [redacted] indicated that sex trafficking lawsuits filed by survivors [redacted];
- Child advocates had demonstrated outside Facebook headquarters in October 2020; and
- [redacted]

287. Members of the Compensation Committee—including Alford—failed to act in response to these and other red flags.

288. Alford therefore faces a substantial likelihood of liability for breaching her fiduciary duties under *Caremark*.

**Andreessen**

289. Defendant Andreessen is a director of Meta and has been a director since 2008.

290. As a director, Andreessen had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities.[292] Andreessen was on the Board when it was repeatedly advised—through the media, by proxy advisors, and by other stockholders—about the pernicious conduct occurring on its platforms. Andreessen was also on the Board in October 2019 when internal Company documents reportedly revealed that Facebook's "platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks" and in 2021 when those internal documents were made public by a whistleblower.

291. Andreessen was on the Board when it was told by management that:

- Congress would be pushing for Section 230 immunity because of concerns over sex trafficking on internet sites (December 2017);
- Facebook had [redacted] (2019);
- A stockholder proposal was asserting that Facebook was being sued for "facilitating sex trafficking of minors"; that "Instagram

[292] *See* Sections IV.B to IV.C *supra*.

[is] being linked to 'rampant sex trafficking [and] child sexual abuse grooming'"; and that "Facebook may face significant regulatory risk if it cannot curb child sexual abuse on existing platforms" (February 2020);

- A narrative had developed that (September 2019);
- Facebook needed to (2020);
- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and
- Glass Lewis "d[id not] have any reason to be assured that the Company w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

292. Andreessen has been a member of the Audit Committee since 2012. The Audit Committee also received numerous reports that Facebook was failing to control trafficking and exploitation. For example, in December 2020, the Audit Committee was told that:

- 
- 
- The machine learning process and

- The Company lacked [redacted] concerning child exploitative imagery.

293. In addition, in September 2021, the Audit Committee was warned that:

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- There were [redacted]
- [redacted]
- [redacted] and
- [redacted]

294. In addition, in February 2022, the Audit Committee was warned that:

- [redacted]
- A [redacted] and
- Meta had not yet [redacted]

295. However, the members of the Audit Committee, including Andreessen, failed to take steps to put in place such controls.

296. Andreessen therefore faces a substantial likelihood of liability for breaching his fiduciary duties under *Caremark*.

**Houston**

297. Defendant Houston is a director of Meta and has been a director since 2020.

298. As a director, Houston had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities.[293] Houston was on the Board when it was repeatedly advised—through the media, by proxy advisors, and by other stockholders—about the pernicious conduct occurring on its platforms. Houston was also on the Board in 2021 when a whistleblower published internal Facebook documents reportedly revealing that Facebook's "platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks . . . ."

299. Houston was on the Board when it was warned by management that:

- Facebook needed to [redacted] (2020);

[293] *See* Sections IV.B to IV.C *supra*.

- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and
- Glass Lewis "d[id not] have any reason to be assured that the Company] w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

300. Houston therefore faces a substantial likelihood of liability breaching his fiduciary duties under *Caremark*.

**Killefer**

301. Defendant Killefer is a director of Meta and has been a director since 2020.

302. As a director, Killefer had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities.[294] Killefer was on the Board when it was repeatedly advised—through the media, by proxy advisors, and by other stockholders—about the pernicious conduct occurring on its platforms. Killefer was also on the Board in 2021 when a whistleblower published internal Facebook documents reportedly revealing that Facebook's "platform enables all

[294] *See* Sections IV.B to IV.C *supra*.

three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks . . . "

303. Killefer was on the Board when it was warned by management that:

- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and
- Glass Lewis "d[id not] have any reason to be assured that the Company w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

304. Killefer has been a member of the Audit Committee since 2020. The Audit Committee also received numerous reports that Facebook was failing to control trafficking and exploitation. For example, in December 2020, the Audit Committee was warned that:

- 
- 
- The machine learning process and
- The Company lacked concerning child exploitative imagery.

305. In addition, in September 2021, the Audit Committee was told that:

- 
- 
- 
- 
- There were
- 
- and
- 

306. Then, in February 2022, the Audit Committee was warned that:

- 
- A and
- Meta had not yet

307. However, the members of the Audit Committee, including Killefer, failed to take steps to put in place such controls.

308. Killefer therefore faces a substantial likelihood of liability for breaching her fiduciary duties under *Caremark*.

**Kimmitt**

309. Defendant Kimmitt is a director of Meta and has been a director since 2020.

310. As a director, Kimmitt had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities.[295] Kimmitt was on the Board when it was repeatedly advised—through the media, by proxy advisors, and by other stockholders—about the pernicious conduct occurring on its platforms. Kimmitt was also on the Board in 2021 when a whistleblower published internal Facebook documents reportedly revealing that Facebook's "platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks . . . "

311. Kimmitt was on the Board when it was warned by management that:

- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and

[295] *See* Sections IV.B to IV.C *supra*.

- Glass Lewis "d[id not] have any reason to be assured that the Company w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

312. Kimmitt therefore faces a substantial likelihood of liability for breaching his fiduciary duties under *Caremark*.

**<u>Travis</u>**

313. Defendant Travis is a director of Meta and has been a director since 2020.

314. As a director, Travis had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities.[296] Travis was on the Board when it was repeatedly advised—through the media, by proxy advisors, and by other stockholders—about the pernicious conduct occurring on its platforms. Travis was also on the Board in 2021 when a whistleblower published internal Facebook documents reportedly revealing that Facebook's "platform enables all three stages of the human exploitation lifecycle (recruitment, facilitation, exploitation) via complex real-world networks . . . "

315. Travis was on the Board when it was warned by management that:

[296] *See* Sections IV.B to IV.C *supra*.

- ISS recommended that the Board "vote FOR" a stockholder proposal concerning child exploitation (May 2020);
- ISS observed that the Company had "alleged[ly] fail[ed] to catch hundreds of cases of child exploitation on its platform from January 2013 through December 2019" (May 2020); and
- Glass Lewis "d[id not] have any reason to be assured that the Company w[ould] act proactively rather than reactively, as demonstrated by numerous controversies related to the distribution of high-risk content on its platform and messaging services" (May 2020).

316. Travis has been a member of the Audit Committee since 2020. The Audit Committee also received numerous reports that Facebook was failing to control trafficking and exploitation. For example, in December 2020, the Audit Committee was told that:

- 
- 
- The machine learning process and
- The Company lacked concerning child exploitative imagery.

317. In addition, in September 2021, the Audit Committee was warned that:

- 
- 

- There were
- "The CS team does [not] monitor or have alerts to identify anomalies in enforcement volume of recidivist accounts"; and

318. In addition, in February 2022, the Audit Committee was warned that:

- A and
- Meta had not yet

319. Travis therefore faces a substantial likelihood of liability for breaching her fiduciary duties under *Caremark*.

**Xu**

320. Defendant Xu is a director of Meta and has been a director since January 2022.

321. As a director, Xu had fiduciary duties to monitor for compliance and violations of federal criminal law taking place on the Facebook and Instagram platforms, but consciously disregarded those responsibilities.[297] Xu was on the Board when it was repeatedly advised—through the media, by proxy advisors, and by other stockholders—about the pernicious conduct occurring on its platforms. Xu therefore faces a substantial likelihood of liability for breaching his fiduciary duties under *Caremark*.

**B. At Least Half of Meta's Demand Board Lacks Independence**

322. In addition to being conflicted because they face a substantial risk of liability, six of the nine Demand Board members—Zuckerberg, Sandberg, Alford, Andreessen, Houston, and Killefer—are also conflicted because they lack independence.

**Zuckerberg**

323. Zuckerberg is incapable of making an independent and disinterested decision to institute and prosecute this derivative litigation. Zuckerberg is Meta's controlling stockholder, CEO and Chairman of the Board.

324. In addition to being CEO and Chairman, Zuckerberg controls the Board and has exercised such control since the Company was founded. Zuckerberg bragged in two July 2019 question-and-answer meetings with employees that if he

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[297] *See* Sections IV.B to IV.C *supra*.

were not his own boss, he would have been fired from Meta. As reported in a *CNBC* article, at the Meta meeting, Zuckerberg discussed his refusal to sell the Company to Yahoo in 2006, stating:

> Yahoo came in with this big offer for a billion dollars, which . . . was going to, like, fulfill everyone's financial dreams for the company. And I was like, "I don't really think we should do this." . . . In 2006, when Yahoo wanted to buy our company, I probably would've been fired, and we would have sold the company. We wouldn't even be here if I didn't have control.[298]

325. The Board demonstrates its subservience to Zuckerberg by regularly supporting his attempts to maintain his voting control, despite shareholder proposals to dilute his hold on the Company. For example, Meta has long resisted separating the positions of Chairman and CEO, preferring that Zuckerberg occupy both roles (though Google, Microsoft, Apple, and Oracle have separate CEO and chairperson roles). A majority of the Company's independent stockholders have voted in favor of shareholder proposals requesting separation of the Chairman and CEO positions at each of the Company's annual meetings from 2019 through 2022. It was only through Zuckerberg's exercise of his ten votes per share Class B stock that the shareholder proposals were defeated. Despite widespread independent stockholder

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[298] Catherine Clifford, *Mark Zuckerberg: If I Didn't Have Complete Control Of Facebook, I Would Have Been Fired*, CNBC (Oct. 3, 2019), available at https://www.cnbc.com/2019/10/03/zuckerberg-if-i-didnt-have-control-of-facebook-i-wouldve-been-fired.html.

support, the Board has failed to act on stockholder concerns and instead chosen to continue to bend to Zuckerberg's desires.

**Sandberg**

326. Sandberg lacks independence as she is beholden to Zuckerberg and is therefore incapable of making an independent and disinterested decision to institute and prosecute this derivative litigation against Zuckerberg. Sandberg has been a close confidant and business partner of Zuckerberg at Meta since she joined the Company in 2008 as its COO, a role she only recently relinquished while retaining her seat on the Board. Moreover, Sandberg is one of the few individuals other than Zuckerberg who has held Class B stock entitled to ten votes per share. Sandberg converted all of her Class B shares and sold them as Class A shares through a Company repurchase program, thereby helping Zuckerberg maintain his control through his ownership of his own high-vote Class B stock.

327. Sandberg and Zuckerberg cultivated their friendship over dinners at Sandberg's home once or twice a week for six weeks before Zuckerberg decided to hire Sandberg as Meta's COO. Sandberg's late husband described the dinners as being "like dating."[299]

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[299] Ken Auletta, *A Woman's Place*, THE NEW YORKER (July 4, 2011).

328. During her time as Meta's COO, Sandberg was widely considered the Company's second-in-command, behind Zuckerberg, who credited Sandberg with "handl[ing] things I don't want to."[300]

329. Zuckerberg has in turn developed a role as Sandberg's close personal confidant. After Sandberg's husband passed away in 2015, Zuckerberg took the lead in planning his funeral, and Zuckerberg and his wife, Priscilla Chan ("Chan"), "talked to [her] every day ... and [were] just there for [her] and [her] children . . . in every way possible."[301] Sandberg subsequently described Zuckerberg as "the greatest person in the world,"[302] and noted that Zuckerberg is "one of the people who really carried me."[303]

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[300] *Id.*

[301] Seth Fiegerman, *Inside the partnership of Mark Zuckerberg and Sheryl Sandberg*, CNN (Feb. 7, 2019), available at https://www.cnn.com/2019/02/07/tech/mark-zuckerberg-sheryl-sandberg/index.html.

[302] *Sheryl Sandberg Talks Grief, Appreciating Mark Zuckerberg and Why She Won't Run for Public Office*, YAHOO! FIN. (Apr. 13, 2017), available at https://www.yahoo.com/entertainment/sheryl-sandberg-talks-grief-appreciating-mark-zuckerberg-why-153537336.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAIGcaKGoWPENaBMCMypLWx-dfsMMHzi1OMtvgj8zC5C_6zuN6dH6spvy1LIBKEpy8ADP8IV8ALbUTgKOuBRmwUW2I0Wnl7HLJDUjWbx6NyxdrRn8CQZXrspU7bZ8bRMG9bugU2TXsQx9CeSmy1E7DqgOpapnwUvVftckVQT7sCdi.

[303] *Id.*

**Alford**

330. Alford lacks independence from Zuckerberg and is therefore incapable of making an independent and disinterested decision to institute and prosecute this derivative litigation against Zuckerberg. Alford is an executive at PayPal Holdings, Inc. Zuckerberg installed Alford as CFO and Head of Operations at Zuckerberg's personal philanthropy, the Chan Zuckerberg Initiative ("CZI"), the primary beneficiary of Zuckerberg's plans to sell or donate his Company stock. Following Alford's several year stint as Zuckerberg's trusted representative at CZI, Zuckerberg installed Alford on Meta's Board, a move widely viewed as "evidence that Zuckerberg is keen on building a firewall around him by only appointing loyalists."[304]

331. Alford also worked closely with Chan when both served as initial board members of Summit Learning Program, a nonprofit division of an online learning platform created by Meta and Summit Public Schools, a charter school network.

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[304] *See* Mark Emem, *Mark Zuckerberg's Machiavellian Strategy To Crush A Facebook Board Coup*, CCN (aka "Capital & Celeb News") (Sept. 23, 2020), available at https://www.ccn.com/mark-zuckerbergs-machiavellian-strategy-to-crush-a-facebook-boardroom-coup/.

**Houston**

332. Houston lacks independence from Zuckerberg and is therefore incapable of making an independent and disinterested decision to institute and prosecute this derivative litigation against Zuckerberg.

333. Houston is CEO of Dropbox, a cloud company with hundreds of millions of users and companies using its services for file-syncing and sharing of documents. Houston and Zuckerberg have been close friends for years, "with the former often turning to the latter for advice."[305] Houston told an interviewer from Bloomberg that he often reaches out to Zuckerberg for business advice.[306] Zuckerberg has frequently turned up at Dropbox headquarters to visit Houston.[307] Zuckerberg went to Houston's birthday party where they celebrated and played ping-pong against each other.[308] One article on the announcement that Houston was

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[305] *See* Avery Hartmans, *Mark Zuckerberg and Dropbox CEO Have Been "Close Friends" For Years*, Entrepreneur.com, available at https://www.entrepreneur.com/business-news/mark-zuckerberg-and-dropbox-ceo-have-been-close-friends/347526.

[306] *See* Eugene Kim, *How Mark Zuckerberg Helps His Friend, The CEO of $10 Billion Dropbox*, BUS. INSIDER (June 25, 2015), available at https://www.businessinsider.com/dropbox-ceo-drew-houston-turns-to-facebook-ceo-mark-zuckerberg-for-advice-2015-6.

[307] *See* J.J. McCorvey, *Dropbox Versus The World*, FAST CO. (March 30, 2015), available at https://www.fastcompany.com/3042436/dropbox-versus-the-world.

[308] *See Travis Kalanick and Mark Zuckerberg Blow Off Steam At Drew Houston's Ping-Pong Birthday Party*, CNBC (Mar. 9, 2017), available at https://www.cnbc.com/2017/03/09/mark-zuckerberg-travis-kalanick-drew-

joining Meta's Board specifically noted: "Houston and Zuckerberg have a long-running and well-documented friendship."[309] Houston's addition to the Board was viewed as adding "another figure to the board who is likely to be strongly supportive of Zuckerberg at a time of mounting regulatory and political scrutiny of the company."[310] Another commentator, in discussing Houston's appointment to the Board, stated: "Given the choice of acting in the interests of independent shareholders or his buddy, it's obvious whose interests will be sacrificed."[311]

**<u>Andreessen</u>**

334. Andreessen lacks independence from Zuckerberg and is therefore incapable of making an independent and disinterested decision to institute and prosecute this derivative litigation against Zuckerberg.

335. Andreessen's lack of independence from Zuckerberg is well documented. Andreessen has long supported Zuckerberg's belief that a company's founder should maintain company control. In 2009, when Andreessen and Benjamin

houston-ping-pong-birthday-pics.html.

[309] *See* Rob Price, *Mark Zuckerberg's Friend Dropbox CEO Drew Houston Is Joining Facebook's Board of Directors*, BUS. INSIDER (Feb. 3, 2020), available at https://www.businessinsider.com/dropbox-ceo-drew-houston-joins-facebook-board-directors-2020-2.

[310] *Id.*

[311] *See* source cited *supra* note 306.

Horowitz cofounded AH Capital Management, LLC d/b/a Andreessen Horowitz, Andreessen's goal was to "design a venture capital firm that would enable founders to run their own companies."[312] In 2006, Yahoo! offered to buy Meta for $1 billion dollars. According to Andreessen, "Every single person involved in Facebook wanted Mark to take the Yahoo! offer. The psychological pressure they put on this twenty-two-year-old was intense. Mark and I really bonded in that period, because I told him, 'Don't sell, don't sell, don't sell!'"[313]

336. Andreessen and his firm have also profited significantly through Andreessen's business ties with Zuckerberg. Meta purchased two Andreessen Horowitz portfolio companies, Instagram and Oculus VR. Andreessen Horowitz made $78 million on the sale of Instagram. Zuckerberg helped facilitate Andreessen Horowitz's investment in Oculus VR, and Andreessen subsequently joined the company's four-member board. Shortly thereafter, Zuckerberg's Meta offered to acquire Oculus VR for $2 billion. Andreessen Horowitz made $270 million on the Oculus VR transaction.[314]

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[312] Ben Horowitz, "*Why Has Andreessen Horowitz Raised $2.7b in 3 Years*?" BEN'S BLOG, (Jan. 31, 2012), available at https://www.businessinsider.com/why-has-andreessen-horowitz-raised-27b-in-3-years-2012-6.

[313] Tad Friend, *Tomorrow's Advance Man*, THE NEW YORKER (May 18, 2015).

[314] Anita Balakrishnan, *Facebook tried to do Oculus due diligence in a weekend, Zuckerberg reveals in court*, CNBC (Jan. 17, 2017), available at https://www.cnbc.com/2017/01/17/facebook-did-oculus-due-diligence-in-a-weekend-zuckerberg-reveals-in-court.html.

337. Andreessen is also known to have used back-channel communications to Zuckerberg during Board processes to protect Zuckerberg's personal interests. Stockholder litigation challenging the Company's 2016 attempt to issue a new class of shares revealed text messages showing that Andreessen, while serving as a member of the special committee created to represent stockholders considering the share issuance, betrayed stockholders and fed Zuckerberg information regarding the special committee's progress and concerns. These covert communications helped Zuckerberg negotiate against the purportedly independent committee. Andreessen and Zuckerberg communicated privately throughout the committee's negotiation process, with Andreessen providing Zuckerberg live feedback via text explaining how to convince the committee to approve the new class of shares.

**Killefer**

338. Killefer lacks independence from Sandberg and is therefore incapable of making an independent and disinterested decision to institute and prosecute this derivative litigation against Sandberg. From 1997 to 2000, Killefer and Sandberg both worked at the U.S. Treasury Department. Killefer served as Treasury Assistant Secretary for Management, CFO, and Sandberg served as the Chief of Staff for Treasury Secretary Lawrence Summers. In addition, Killefer was a Senior Partner at McKinsey & Company when Sandberg was hired as a consultant in 1995. Killefer started working at McKinsey in 1979 and, except for her stint at the Treasury Department, worked there until she retired in August 2013. Sandberg remains involved with McKinsey through its partnership with her Lean In Foundation.

**FIRST CLAIM FOR RELIEF**
**(Against All Director Defendants and Former-Director Defendants for Breach of Fiduciary Duty)**

339. Plaintiffs repeat and reallege all of the preceding allegations as if fully set forth herein.

340. As Meta's directors, the Director Defendants Zuckerberg, Sandberg, Alford, Andreessen, Houston, Killefer, Kimmitt, Travis, and Xu, and the Former-Director Defendants Bowles, Chenault, Desmond-Hellmann, Hastings, Koum, Thiel, and Zients owed Meta the highest obligation of loyalty, good faith, due care, oversight and candor.

341. The fiduciary duties these directors owed to Meta included, without limitation, implementing and overseeing a system to monitor sex trafficking and other human trafficking on Meta's online interactive platforms, as well as Meta's legal compliance with all applicable laws and regulations. The Director Defendants and Former-Director Defendants had a fundamental duty to make good faith efforts to ensure that the Company's online, interactive platforms were not and are not a danger to public safety.

342. The Director Defendants and Former-Director Defendants consciously breached their fiduciary duties and violated their corporate responsibilities in at least the following ways:

a. despite being made aware of red flags that Meta's platforms—which the Company owns, manages, or operates—promote, facilitate and contribute to widespread sex trafficking and other human trafficking—they consciously and repeatedly failed to assure that the Company's reporting system was adequately designed to elevate all such reports, thus disabling them from being informed of risks or problems requiring their attention;

b. consciously disregarding their duty to investigate red flags and to remedy any misconduct uncovered; and

c. issuing false and misleading statements to Meta's shareholders regarding the Company's programs, systems, and capabilities to detect, prevent, and address the fact that Meta's online, interactive platforms promote, facilitate, and contribute to widespread sex trafficking and other human trafficking, as well as downplaying the extent of sex trafficking and other human trafficking on Meta's platforms.

343. The conduct of the Director Defendants and Former-Director Defendants, individually and collectively, as set forth herein, was due to their intentional, knowing, and/or reckless disregard for the fiduciary duties owed to the Company.

344. The Director Defendants and Former-Director Defendants consciously turned a blind eye to sex/human trafficking, child sexual exploitation, and other predatory conduct occurring on Meta's online platforms, which violated federal and state laws against sex/human trafficking and has exposed Meta to liability through FOSTA-SESTA and other laws. They further disregarded their duties to ensure that Meta was not operating online platforms that facilitated the prostitution of another person and that the Company was not acting in reckless disregard of the fact that conduct on its platform contributed to sex trafficking. The Director Defendants and Former-Director Defendants, consistent with their fiduciary duties, were required to implement and monitor policies and systems to monitor such illegal conduct.

345. The Director Defendants and Former-Director Defendants were required to fulfill their responsibilities as directors under the Audit Committee Charter, the Corporate Governance Guidelines and the Code of Conduct.

346. The Director Defendants and Former-Director Defendants had actual or constructive knowledge that they caused the Company to fail to maintain adequate internal controls and failed to provide adequate oversight to protect the Company from liability related to federal and state sex trafficking laws.

347. These actions were not good-faith exercises of prudent business judgment to protect and promote the Company's corporate interests and those of its shareholders.

348. As a direct and proximate result of the Director Defendants' and Former-Director Defendants' conscious failure to perform their fiduciary duties, Meta has sustained significant damages, both financially and to its corporate image and goodwill. Such damages to Meta include, and will include, substantial risk of liability, legal costs, increased regulatory scrutiny, reputational damages, declining users, declining revenue, declining stock price, increased cost of capital, and other costs, damages and liabilities.

349. For their conscious and bad faith misconduct alleged herein, Director Defendants and Former-Director Defendants are liable to the Company.

**SECOND CLAIM FOR RELIEF**
**(Against the Officer Defendants for Breach of Fiduciary Duty)**

350. Plaintiffs repeat and reallege all of the preceding allegations as if fully set forth herein.

351. As executive officers of Meta, the Officer Defendants Bosworth, Schroepfer, Clegg, Cox, Newstead, Sandberg, Wehner, and Zuckerberg owed Meta the highest obligation of loyalty, good faith, due care, oversight and candor.

352. The fiduciary duties owed by the Officer Defendants included the obligation to operate the Company in compliance with state and federal laws and without undue risk to public safety, the duty to implement and oversee programs to ensure compliance with criminal and civil laws and regulations governing sex trafficking and other human trafficking, and the duty to report significant risks to the Board, governmental and civil authorities, and Meta and its stockholders.

353. The Officer Defendants, individually and collectively, breached their fiduciary duties and/or acted with gross negligence in at least the following ways:

a. Acting in conscious disregard of the red flags that Meta's online platforms promote, facilitate, and contribute to widespread sex trafficking and other human trafficking and that Meta was benefiting financially from such illegal misconduct;

b. Consciously and repeatedly failing to implement, maintain, audit, and/or monitor a compliance and safety program to detect, prevent, and

address the predation on Meta's online platforms, contributing to widespread sex trafficking and other human trafficking;

c. Consciously disregarding their duties to investigate red flags and other evidence of wrongdoing and to remedy any misconduct uncovered; and

d. Consciously failing to report to the Board and/or covering up red flags that Meta's online platforms promote, facilitate and contribute to widespread sex trafficking and other human trafficking.

354. As officers of the Company, the Officer Defendants are not entitled to exculpation under 8 *Del. C.* § 102(b)(7).

355. The Officer Defendants had actual or constructive knowledge that they caused the Company to fail to maintain adequate internal controls and failed to provide adequate oversight to protect the Company from liability related to federal and state sex trafficking laws.

356. These actions were not good-faith exercises of prudent business judgment to protect and promote the Company's corporate interests and those of its shareholders.

357. As a result of the Officer Defendants' breaches of fiduciary duty—including their conscious and/or grossly negligent failure to perform their fiduciary duties—Meta has sustained significant damages both financially and to its corporate image and goodwill. Such damages to Meta caused by the Officer Defendants'

misconduct include, and will include, substantial risk of liability, legal costs, increased regulatory scrutiny, reputational damages, declining users, declining revenue, a declining stock price, increased cost of capital, and other costs, damages, and liabilities described herein.

358. As a result of the misconduct alleged herein, the Officer Defendants are liable to the Company.

## **PRAYER FOR RELIEF**

WHEREFORE, Plaintiffs request the following relief:

A. An order declaring that Plaintiffs may maintain this action on behalf of Meta and that Plaintiffs are adequate representatives of the Company;

B. An order declaring that Defendants have breached their fiduciary duties to Meta;

C. An order determining and awarding to Meta the damages sustained as a result of the violations set forth above by all Defendants, jointly and severally, together with pre-judgment and post-judgment interest thereon;

D. An order directing Meta to take all necessary actions to reform and improve its corporate governance, internal controls, and policies by implementing a Board-level reporting and information system—and to monitor that system—to ensure that the Company addresses the

rampant sex trafficking, human trafficking, and child sexual exploitation occurring on Meta's interactive computer platforms, and to ensure the Company's compliance with FOSTA-SESTA and other civil and criminal laws relating to sex trafficking, human trafficking, and child sexual exploitation (including the statutes set forth in Section I, *supra*);

E. An order against all Defendants and in favor of the Company for extraordinary equitable and injunctive relief as permitted by law and/or equity as this Court deems just and appropriate;

F. Awarding Plaintiffs' costs and disbursements for this action, including reasonable attorneys' fees and expenses; and

G. Granting such other relief as this Court deems just and appropriate.

Dated: March 10, 2023

**GRANT & EISENHOFER P.A.**

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# The Shareholder Commons Supports 2023 Proposals that Prioritize Portfolio Returns, Curtail Company Strategies Threatening Diversified Investors

*Filings at McDonald's by Amundi, HESTA, LGIM America and by others at Meta Platforms and State Street push to protect social, environmental, and economic systems that support diversified portfolios*

March 22, 2023 09:20 AM Eastern Daylight Time

NORTHAMPTON, Mass.--(BUSINESS WIRE)--In advance of the 2023 proxy season, The Shareholder Commons (TSC), a non-profit advocate for diversified investors, has worked with shareholders filing proposals at McDonald's, State Street, Meta Platforms, and other major corporations to end extractive practices that threaten the financial interests of shareholders in preserving a resilient economy.

"Most investors own a broad range of securities, but individual companies sometimes pursue profits at the expense of their diversified shareholders," said TSC Chief Strategy Officer Sara E. Murphy. "These proposals are designed to preserve the systems that support both the economy and their portfolios, but which are threatened by the social or environmental costs of certain corporate behavior."

Global financial institutions Amundi, HESTA, and LGIM America—together representing more than $3.5 trillion in client assets—have co-filed the McDonald's proposal, which addresses the risk that antimicrobial overuse poses to diversified portfolios that rely on an effective health care system. As companies such as McDonald's overuse antibiotics and exacerbate antimicrobial resistance (AMR), the efficacy of these life-saving drugs is compromised, putting the whole economy at risk. Antimicrobial overuse in the McDonald's supply chain may improve its margins and share price, but it also undermines the high-functioning health care systems that diversified portfolios rely on for long-term performance. The proposal calls on McDonald's to follow World Health Organization guidelines for safe antimicrobial use.

"The antibiotics in the supply chains of McDonald's and other food companies represent a material risk," said Maria Ortino, Senior Global ESG Manager at LGIM. "AMR kills more than a million people each year and could cause $100 trillion in economic damage by 2050. Failure to adequately respond to AMR could lead to far greater risks—for our clients, society, and the global economy—than any individual company costs McDonald's would incur by addressing this issue. Without coordinated action now, AMR could lead to the next global health crisis."

The State Street proposal, filed by long-time shareholder advocate Jim McRitchie, seeks a report on whether the asset manager could better serve its clients by stewarding companies away from practices that threaten the systems undergirding diversified client portfolios, even when those practices might be financially beneficial to the individual companies.

"State Street manages trillions of dollars for ordinary workers saving for retirement and other life needs through diversified stock and bond funds," said McRitchie. "It cannot effectively do its job to protect those savers unless it stops portfolio companies from engaging in practices that drain the social and environmental resources that support the portfolios of most savers."

The proposal at Meta Platforms asks for a report on whether executive compensation could be calibrated to address the costs externalized by its operations, including costs imposed on the global economy and the environment. By prioritizing web traffic and user engagement to maximize profits, Meta often puts users, workers, political stability, and public health at risk. The proposal encourages compensation adjustments to offset any incentive to create costs that will be absorbed by the economy and, ultimately, Meta's own diversified shareholders.

In an increasingly interdependent global economy, diversified shareholders must analyze the financial effect of companies' social and environmental impacts on their entire portfolio. The Shareholder Commons' forthcoming report, "Portfolios on the Ballot," will highlight other 2023 shareholder initiatives that implicate the portfolio impact of individual companies' policies.

Read more about system stewardship here.

**About The Shareholder Commons**

The Shareholder Commons (TSC) is a non-profit organization that addresses social and environmental issues from the perspective of shareholders who diversify their investments to optimize risk and return. TSC's advocacy focuses on the divergence that often emerges between a company's interest in maximizing its cash flows over the long term and its shareholders' interests in optimizing overall market returns.

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