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Mitigating Litigation Risk When Incorporating DEI Goals Into Executive Incentive Programs

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Editor's note: JT Ho and Mike Delikat are Partners, and Bobby Bee is a Practice Support Counsel at Orrick Herrington & Sutcliffe LLP. This post is based on an Orrick memorandum by Mr. Ho, Mr. Delikat, Mr. Bee, and John Giansello. Related research from the Program on Corporate Governance includes The Perils and Questionable Promise of ESG-Based Compensation (discussed on the Forum here) by Lucian A. Bebchuk and Roberto Tallarita.

On June 29, 2023, the Supreme Court found Harvard and UNC's admissions policies, which considered race and ethnicity as factors in admissions, to be unlawful under Title VI of the Civil Rights Act of 1964 and the Equal Protection Clause of the Fourteenth Amendment. While this ruling does not directly impact corporate DEI programs due to existing legal prohibitions on considering race in employment decisions, this case may embolden more applicants, employees, government officials like state Attorneys General and conservative activist groups to bring "reverse discrimination" claims and shareholder demands and proposals, a trend that already is on the rise.

Executive compensation programs that include DEI performance as a metric have already been and may continue to be a source of such claims and attacks. Many executive compensation programs in recent years have incorporated DEI metrics due to institutional investor demands. Such goals are often tied to increasing the number of women or diverse employees by a certain percentage, especially in higher-paid roles or retaining a certain percentage of such groups of employees, and have become more formulaic and rigorous over the years due to investor scrutiny.

However, while "the devil is in the details," incorporating DEI metrics into executive compensation programs can lead to the risk that managers perceive the achievement of the metrics as a de facto quota and impel employment decision-making based on diversity metrics instead of individual qualifications and job performance—or the reasonable perception thereof, which could give rise to reverse discrimination claims. For example, in Frank v. Xerox Corp. (5th Cir. 2003), where the Fifth Circuit reversed summary judgment for Xerox on a reverse discrimination claim, the court noted that "[s]enior staff notes and evaluations also indicate that managers were evaluated on how well they complied with the [diversity] objectives," among other factors. As a result, the Fifth Circuit noted a jury could find the company "had considered race in fashioning its employment policies" and that because of plaintiff's race, "their employment opportunities had been limited." According to the EEOC amicus brief filed on appeal, managers were evaluated on how well they followed and adhered to diversity objectives in making personnel decisions; numerical targets were considered in hiring, promotion or pay decisions; and money designated for merit pay increases was allocated based on achievement in specific "EEO categories."

The court arrived at a different conclusion in Coppinger v. Wal-Mart Stores (N.D. Fla. Oct. 25, 2008), where the plaintiff alleged, among other things, that Wal-Mart tied manager bonuses to its diversity program involving two components: (1) placement goals, which measured the disparity between the rate at which women and minorities apply for managerial positions and the rate they obtained such jobs, and (2) good faith effort goals, which required all salaried managers to mentor three employees from diverse backgrounds and attend at least one diversity event each year. Although the court granted Wal-Mart's summary judgment motion, the court noted that it did so because, despite the allegations, "no part of any decisionmaker's bonus or compensation was related to placement goals or good faith efforts goals other than attending one diversity event each year." Although the court concluded that the plaintiff had failed to point to any record suggesting that managers took the goals into consideration when making any employment decision, it left open the question of whether it would have held differently had such goals been more concretely tied to the managers' evaluations or bonuses.

While there are few cases in this area to date, in light of the recent Supreme Court decision, companies who incorporate DEI metrics into executive compensation programs should do a privileged evaluation of their programs to determine whether their goals actually impact individual employment decisions, which can be problematic, or merely inspire broader initiatives, such as improvements in outreach and in the composition of candidate and interview pools or evaluation techniques, which is legally permissible. In other words, rewarding executives for their overall efforts on DEI rather than for achieving targeted metrics will mitigate some of the legal risk.

Further, whether goals involve hiring or retention is also relevant as what leads to employee retention is a complicated set of factors, including organizational culture, effective leadership and employee perceptions of working conditions, and it is often difficult to connect goals related to retention to any individual employment decision in hiring, promotion, termination or salary and benefits. Such analyses are complicated, and companies are advised to seek legal counsel and the benefits of privilege to ensure that factors that mitigate against the risk of reverse discrimination claims are being considered and implemented when constructing executive incentive plans.