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CORPORATE BOARD DIVERSITY REQUIREMENTS

EXPAND:

Guidance for
Corporations



The California legislature's passage of a statute requiring companies in the state to have a minimum number of women on their boards of directors has put a spotlight on the issue of gender diversity in corporate leadership and raised a number of questions for corporations and their counsel.

THE CALIFORNIA STATUTE, CA S.B. 826, REQUIRES

"a domestic general corporation or foreign corporation that is a publicly held corporation, as defined, whose principal executive offices, according to the corporation's SEC 10-K form, are located in California" to have at least one female on its board of directors by the close of the 2019 calendar year. The minimum number will rise at the close of the 2021 calendar year to two women for corporations with five directors and to three for corporations with six or more board members. Noncompliance will result in significant fines.

While California is the first state in the nation to enact such a statute, other state legislatures—including Illinois, Massachusetts, Colorado and Pennsylvania—have adopted resolutions supporting gender diversity and urging corporations to voluntarily place specific numbers of women on their boards by certain dates.

Outside of the United States, legislative bodies in Europe have imposed varying degrees of gender diversity on corporations. In 2003, Norway became the first country to legislate a gender diversity standard, requiring corporate boards to have 40% of their seats occupied by women. Germany, Spain, France, Iceland, Italy, and Belgium have all set minimum requirements.

The gender diversity issue has been the subject of much controversy, and the California statute is expected to face challenges in the courts. Opponents argue that the statute unconstitutionally gives preference to one group over the other and that qualifications, not gender, should be the key factor in selecting board members. Proponents say that female membership on corporate boards is needed to address issues of pay equality and sexual harassment. There is no disputing, however, that corporations and their counsel have much to consider.

1. How Can Corporations Best Structure Their Board Composition and Recruiting Requirements to Plan for Such Mandates While Protecting the Best Interests of the Corporate Entity?

Whether or not these diversity mandates survive legal scrutiny, the imperative for greater diversity on boards is here to stay.

The interests of the corporate entity are best served by having a board of directors that is qualified and well-equipped to guide the corporation through changing times. There really should be no inconsistency between board diversity and the best interests of the corporation. Boards should be open to increasing the size of

the board to facilitate having a composition that reflects diverse backgrounds and perspectives without losing valuable experience and expertise. Considering gender diversity in particular, women are vital members of each stakeholder constituency—customers, suppliers, shareholders, employees, regulators, business partners—for almost every business entity. Other forms of diversity are also often relevant to business needs and constituencies. Coupled with the appropriate skill sets and experience, a director candidate's diversity is a strength that will further, rather than hinder, the corporate interest.

Numerous studies have demonstrated the value of diversity to a corporate board, including bringing diverse perspectives to enhance the board's ability to identify issues and solve problems and avoid the perils of group think. The presence of women in leadership positions, on the board as well as in senior management, supports the establishment and maintenance of a corporate culture in which gender equality is presumed, fair treatment expected, and harassment unacceptable. Corporate culture (and the related tone-at-the-top) is created in large part by example and perception, and the visible influence of female leaders promotes an environment in which both the company and its employees are protected.

In order to obtain the benefits of a gender-diverse board, boards and nominating committees should be thoughtful with regard to their recruitment processes. This includes being mindful of how specified criteria may promote or hinder identification of qualified diverse candidates. For instance, the common criterion that candidates must have past public company board experience or have CEO experience is a practical hurdle in building a pool of diverse candidates. If a company values board service as a proxy for leadership experience in a complex organization with different stakeholders who have varying and sometimes competing interests, it could—as many nominating committees do—consider a candidate's service on the board of a large non-profit organization or a university, or perhaps even service in politics or the military. Prior CEO service is also a criterion that can unduly limit the candidate pool if applied to all potential director candidates who would meet the threshold for advancing to the next round of committee consideration.

Research shows that unconscious biases, such as affinity bias (by which people view those with backgrounds or experiences similar to their own more favorably, even given similar qualifications), may come into play in hiring and promotion, including for board service.



Being aware that we all have these unconscious tendencies is a necessary first step towards counteracting them and building a more diverse and stronger board. Boards are increasingly openly discussing and considering the role recruitment practices and unconscious bias may play in their director selection processes.

All that said, a diverse and effective board cannot be successfully created through a superficial compilation of representatives from various identity groups. Not only does this approach devalue the talents of those who are thereby reduced to one or more identifiers, but it limits their ability to contribute meaningfully in areas beyond a narrowly defined category.

With that in mind, there are many ways a company can set about recruiting diverse qualified directors. All major executive search firms are focused on identifying diverse board candidates; some even specialize and have proven track records in recruiting among specific demographics. When using search firms, a company can stipulate diversity as one of the criteria it considers important. Word-of-mouth (including asking for suggestions from counsel and other advisors) continues to be an important source of referrals for board candidates, especially among smaller corporations (as search firms can be expensive). In that context too, diversity can be identified as an important goal of the recruitment exercise. Companies can commit to interviewing a minimum number or percentage of women or otherwise diverse candidates as part of their overall director search (by analogy to the NFL's Rooney Rule). As described in response to Question 4 below, certain professions (such as the law) may be especially rich sources of well-qualified female board candidates.

2. Some Opponents of Mandated Diversity Requirements Claim Qualifications, Not Diversity, Should Be the Main Consideration When Appointing Board Members and Warn of Potential Discrimination Against Qualified Male Candidates. How Can Corporate Boards Best Achieve this Balance?

As noted above, there should be no inconsistency between board diversity and the best interests of the corporation. In case it is not already clear, we are big fans of board diversity but not of mandatory quotas. The benefit of mandatory quotas, however, as the business community has seen through European examples, is that they compel or at least nudge companies to focus on board composition and to establish recruitment processes designed to identify and recruit more diverse directors who will better represent all of the company's various constituencies. Ultimately, the board should be focused on finding the best directors for the company, in terms of qualifications, experiences, and perspectives that are as diverse as the company and its stakeholders. While an initial search that includes gender (or other forms of) diversity as a relevant value or criterion may be necessary in order to be in compliance with the mandate, gender diversity is only one factor out of many that the board should consider in a holistic process designed to find the best directors for the company. We very much doubt that a thoughtful and well-crafted board recruitment program will put a company at risk for claims of discrimination.

3. Considering the Fiduciary Obligations of Corporate Board Members, Will There Be Any Impact if Member Selection Decisions Include Mandated Gender Diversity Requirements? Are There Any Risks Corporations Should Consider?

As noted previously, as long as the board pursues a thoughtful and thorough recruitment and evaluation process in hiring new directors to comply with the mandate (or even its own internally driven diversity imperatives), there should be no impact on the directors' observance of their fiduciary duties. Ultimately, the board should be searching for the best director for the job, one with qualifications, experiences, and personal attributes such as integrity and commitment that will complement the existing board and serve the needs of the company.

It goes without saying that a board should never take on a female director who is otherwise unsuitable just because she superficially fulfills the mandate. That kind of approach is not desired by investors or other constituencies and, in our experience, does not actually occur in practice. If the record demonstrated that the only reason a candidate was selected was because she was a woman and did not otherwise have any experiences, skill sets, or expertise of relevance to the company's business, strategy, or oversight needs, that would be an inadvisable situation and create governance risk. However, as noted above and below, there are plenty of qualified women who can add value to any board of directors, so that should never be the case.

4. What Additional Practical Guidance Do You Have for Corporations Considering Moving To Expand Board Diversity?

In addition to engaging professionals to help with increasing board diversity in the director search process, corporations could consider reaching out to organizations in the space, such as WomenCorporateDirectors, 2020 Women on Boards, and DirectWomen, that have access to a pipeline of qualified and diverse candidates and can work with companies to recruit and retain diverse board members. Investors, other boards, and other corporate constituencies can also be sources for strong, diverse candidates.

Nominating committees seek a wide variety of skill sets in building an ideal board. One often hears that there is a shortage of female candidates with the necessary experience in certain areas (for example, areas where this concern is cited have included the engineering, scientific, and technical fields, although an increasing number of female director candidates do have such backgrounds). Whether that is true or not, one area where there is no shortage of experienced and talented women is in the legal sphere. In recent years, lawyers have been less popular as directors (in part because in past years it used to be quite common for a company's primary outside counsel to be on the board, but that practice fell out of favor as the importance of director independence was recognized). Lawyers, however, can bring important skills to the board room, including in areas of corporate governance, compliance and ethics,



crisis management, and M&A and other transactions. DirectWomen is one organization preparing senior female lawyers, such as former general counsels and law firm partners, to serve as corporate directors. (Statement of interest: one of the authors serves on the advisory board of that organization.)

5. Although Constitutional Challenges to the California Law Are Anticipated, Are Many Corporate Boards Throughout the United States Likely to Move in this Direction with or without a Mandate?

Mandated quotas aside, there has been, and will likely continue to be, significant progress in increasing gender diversity in the board room. In the first fiscal quarter of 2018, nearly one-third of new directorships in the Russell 3000 went to women, and for the first time, fewer than 20% of companies in that index had all-male boards. Institutional investors, corporate governance activists, and many large companies have been at the forefront of this progress. Investors like State Street Global Advisors and BlackRock in the United States and Legal & General Investment Management, Standard Life Aberdeen Plc, and Hermes in the United Kingdom have been vocal on the issue. State Street is prepared to vote against the election of directors of companies with all-male boards that have failed to take corrective steps, and BlackRock has noted, in its Proxy Voting Guidelines for U.S. Securities, its expectation that the companies of which it is a shareholder have at least two female directors, with the potential for withhold votes in future years. In the United Kingdom, Legal & General Investment Management and Standard Life Aberdeen Plc stated that they will vote against boards that are composed of less than 25% or 20% women, respectively. Hermes has said that it expects boards to be composed of, at the minimum, 30% women, and it led a failed opposition to the reelection of the chairman of mining group Rio Tinto Plc due to lack of diversity on the board.

Indeed, “The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth,” developed with the World Economic Forum (WEF) and the International Business Council of the WEF, states the following with respect to diversity:

Directors with diverse backgrounds and experiences strengthen board performance. Boards should develop a system for identifying diverse candidates. Women and minority candidates should be regularly considered for open directorships. If necessary to create a diverse board, the size of the board should be increased . . . While independence is an important consideration, it is only one of several, and the emphasis on director independence should not cause the board to lose sight of the importance of other qualifications, such as diversity and expertise.

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Likewise, in 2017, a group of corporate leaders—including Warren Buffett, Jamie Dimon, Jeff Immelt, and Larry Fink, among others—published their own “Commonsense Principles of Corporate Governance,” an open letter highlighting diversity as a key element of board composition, which was reaffirmed in the 2018 version. A comprehensive 2018 study by James Drury Partners also shows that boardrooms are indeed mirroring the increasingly diverse leadership of U.S. businesses.



6. Is It Possible Diversity Requirements Could Be Expanded Beyond Gender and Include Minority Groups in the Future as Well?

Diversity is an increasingly important consideration for all boards, whether demographic or skills-based. This includes not only gender diversity, but many other aspects, which may include racial, ethnic, geographical, age, religious, sexual orientation, and certain substantive skill sets, each of which will be more or less relevant depending on the company, its business, location, customer base, and other attributes. Boards are recognizing the benefits of having diverse viewpoints represented in decision-making. While we prefer organic and market-driven efforts to increase diversity on boards, the imposition of a mandatory quota for representation of minority groups on corporate boards may be on the horizon if key legislative groups do not believe that the business community is making adequate progress in focusing further on board composition and establishing robust recruitment and self-evaluation processes to build boards that are equipped to handle and anticipate a wide range of emerging opportunities and risks and reflect the diversity of the business' stakeholders and the community at large. It may well be the case that mandatory diversity requirements, like the gender diversity mandate in the California law, will not pass constitutional muster, but their implementation alone is sending a message to the business community.

7. How Should Companies Prepare for Potential Additional Board Structure Requirements?

Companies should be prepared for shareholders and activists using proxy access as a catalyst for change as the push continues for increased diversity on corporate boards. In the recent past, shareholder proposals on board diversity have been submitted or threatened against companies. However, these proposals have generally been precatory, asking the board to act, rather than seeking to implement a binding change. Proxy access, however, allows shareholders to nominate candidates directly, circumventing the company and incumbent board altogether.

After years of wrangling over whether shareholders should have the right to include board candidates in companies' proxy statements (as opposed to having to run a proxy fight with a separate proxy statement and card), most companies have now adopted proxy access. The typical formulation allows a group of 20 or so shareholders who have collectively held at least 3% of the company's stock for three years to propose a couple of candidates in the company's own proxy materials. To date, there have been few instances of this right being deployed. However, companies with all-male or otherwise homogenous boards might expect to see this technique used to propose diverse candidates who may well enjoy significant shareholder support. Given the cost and commitment to mount a successful proxy access campaign, activists and investors will likely seek to engage with the company on the issue of increasing board diversity before submitting proxy access nominations.

It is also likely that economic shareholder activists engaging in proxy fights to further their economic agenda (such as seeking to force the board to break up or sell the company) will use a lack of diversity as a wedge issue to gain shareholder support and nominate diverse candidates in order to increase the likelihood that institutional investors will support the dissident slate.

In short, companies and boards should remain proactive in listening to investors, being responsive, and staying ahead of issues, not only because it is the right thing to do, but also to head off activist attacks over lack of board diversity. **L**

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