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CORPORATE GOVERNANCE

Analysis

Solving the Board Composition Puzzle

Recent state court decisions striking down board diversity mandates in California present an opportunity to consider the current regulatory context and the realities facing nominating committees and boards today.

By **David A. Katz and Laura A. McIntosh** | May 25, 2022 at 12:19 PM

David A. Katz and Laura McIntosh. Courtesy photos

Determining the proper composition of a public company board is a bit like trying to find the solution to a challenging, dynamic puzzle. Once solved, the puzzle updates to a slightly different configuration that then requires a new answer. With a limited number of board seats to fill, nominating committees must identify director candidates who satisfy the company's substantive needs, applicable regulatory requirements, and investor demands. Moreover, as the needs of the company evolve and as directors complete their terms, board composition must be continually re-evaluated to ensure that the expertise and other qualities of the board as a whole are well-suited to the company's ongoing challenges and strategy. Regulatory intrusion into board sovereignty, though intended for the benefit of the public interest, makes solving this puzzle much more difficult and risks reducing the effectiveness of directors, both individually and as a group. Recent state court decisions striking down board diversity mandates in California present an opportunity to consider the current regulatory context and the realities facing nominating committees and boards today.

Board composition is governed by an overlapping array of regulatory requirements. These laws and rules, while well-intentioned, have the effect of limiting board discretion in an area where it is vital. Early regulatory action focused on director independence, while more recent efforts—such as the California laws—have been aimed at increasing board diversity. In recent years, institutional investors and proxy advisors have also linked their voting recommendations to certain parameters of board diversity. Diversity is certainly a key factor in board composition today. Yet statutory diversity requirements have met with resistance even as momentum toward board diversity grows in corporate America. With this momentum has come a gradual expansion of the working definition of "diversity" among some of the strongest proponents of increased board diversity. A broader definition of "diversity" would be beneficial if it facilitates the work of nominating committees in identifying candidates whose skills, background, and personal characteristics represent the right solution at the right time for their boards and companies.

The Requirements

There is hardly any matter more fundamental to the management and affairs of a company than board composition. Nonetheless, in response to high-profile corporate abuses and historical injustices, a number of regulatory and legislative authorities have, over the past two decades, adopted mandates in this area to further certain objectives. These have taken on a layered quality over the years that is increasingly challenging to parse. At the federal level, the Sarbanes-Oxley Act of 2002 was the first legislation to touch board composition with its requirement—albeit through a "comply or disclose" format—that every public company audit committee have an independent director who is also a financial expert. The New York Stock Exchange soon followed with its 2004 requirement that a majority of each listed company board, other than controlled companies, be independent directors in the determination of the board (a determination that itself is increasingly complex and multifaceted).

The NYSE rules reach deeply into board structure and composition. For example, audit committees must be fully independent (per overlapping but distinct NYSE and securities laws independence requirements) and financially literate. Companies must have fully independent nominating committees. Compensation committees too must be fully independent and are subject to specific requirements beyond those applicable to other independent board members, both under NYSE rules and under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which imposed additional independence requirements on the compensation committee as of 2011. Independence determinations are based on a range of factors including employment, family connections, organizational affiliations, and consulting arrangements, in some cases qualified by "cooling off periods" of varying duration. Proxy advisory firms also have their own, different and often stricter, definitions of independence (such as outlined in ISS' category of "Non-Independent Non-Executive Director"); while not legally binding, these definitions are nonetheless influential, and nominating committees must take them into account. The web of requirements to which public company boards are now subject is so complex that many-paged charts are often necessary to capture and explain the entire regulatory picture of board composition.

At the state level, California is in the vanguard, attempting in recent years to reshape board composition with mandatory diversity quotas. In 2018 and 2020, California enacted laws

requiring the inclusion of women and minorities on the boards of public companies headquartered in California. These two laws were promptly challenged, and in recent weeks, California state courts held that they constitute unlawful discrimination in violation of the equal protection clause of the California constitution. The court that struck down the requirement relating to minority directors (board members from "underrepresented communities") acknowledged the legislation's worthy goals but observed: "The difficulty is that the Legislature is thinking in group terms. But the California constitution protects the right of *individuals* to equal treatment." Similarly, the court that struck down the gender diversity requirement stated: "Generalized assertions of discrimination in a particular region or industry are insufficient to give rise to a compelling governmental interest … and the discrimination must be identified with specificity." The state of California has not yet announced whether it will appeal either ruling.

Washington is the only other state to have enacted a law mandating board diversity. The law states that as of Jan. 1, 2022, women must comprise at least 25% of each public company board. A company that does not meet this quota must provide to shareholders, prior to the annual meeting, a discussion and analysis regarding the company's approach to board diversity. While the California cases have no precedential value, Washington, like California, has an equal protection clause in its state constitution. No other states have adopted mandatory quotas, but several, including Maryland and Illinois, have enacted mandatory disclosure requirements regarding board diversity.

Nasdaq has also adopted a board diversity rule, approved by the SEC in 2021, that requires listed companies to publicly disclose board-level diversity statistics using a standardized template and requires—via "comply or disclose"—that companies have at least two diverse directors, including one who self-identifies as female and one who self-identifies as either an underrepresented minority or LGBTQ+. This requirement has been challenged in federal court, with the lawsuit garnering support from 17 states. The states' amicus brief asserts that the rule "not only contravenes the federal Constitution, but potentially undermines state law and policy on corporate board composition and on racial and gender preferences" and that the "SEC has transgressed both constitutional and statutory limitations on its authority." Strong arguments have also been made on the other side. An amicus brief from a nonpartisan group of corporate governance experts, for example, argues that a government veto of the Nasdaq rule would constitute "federal intrusion of an unprecedented kind on the free market." This case is now on appeal in the Fifth Circuit.

The Realities

The question often arises as to whether mandates are the only way to generate meaningful progress in the area of board diversity. Since the passage of the California board diversity laws, the number of women and minorities on subject boards has indeed risen, but it is clear that neither actual nor threatened enforcement was the cause. No penalties for noncompliance have ever been imposed, and state officials indicated that they had no intention of levying the fines set forth in the law. And noncompliance was high: According to the March 2022 California report on board diversity, the two laws were applicable to 716 corporations in the prior year, of which 358 filed the required disclosure report, 301 reported that they had complied with the underrepresented communities diversity requirement, and only 186 reported that they had

complied with the gender diversity requirement. Insofar as board diversity increased during the short lifespan of the California legislative efforts, it is far more likely attributable to the growing sense in corporate America that diversity is worth pursuing in order to improve board and company performance. The state mandates reflected rather than shaped this evolving perspective.

The fact that government enforcement was not the motivating force behind increasing board diversity in California is good news, as the fall of the unconstitutional state mandates is unlikely to slow progress toward greater board diversity. In the context of multifactorial needs and requirements, public companies are working hard to increase the diversity of their boards by recruiting women and minority directors. Pressure from institutional investors is a significant factor. For example, State Street's guidance indicates an expectation that companies have at least one woman director and one director from an "underrepresented community." State Street also expects portfolio companies to provide disclosure as to gender, racial, and ethnic diversity on the board and to "articulate efforts to achieve diverse representation at the board level (including race, ethnicity, and gender, at minimum)." Proxy advisors are adding their weight to this issue; ISS and Glass Lewis now recommend voting against nominating committee chairs at companies without specified levels of diversity on their boards.

From a disclosure standpoint, it is now common for a board to create and publish both a diversity matrix (which is called for by the Nasdaq rule and includes elements such as gender, race, ethnicity, and sexual identity) as well as a skills matrix illustrating the substantive expertise of its members. Companies that have made measurable progress in diversifying their boards are eager to show it. A recent Conference Board report indicates that both the amount and scope of board diversity disclosure are markedly increasing. The challenge is for companies to show continued progress. In order to keep board size to a manageable number, each individual director must fill several boxes on these matrices; unfortunately, it is increasingly difficult for boards to identify and attract perfect-combination candidates, particularly in the current competitive marketplace. And, as boards are not large, the loss of just one or two directors can significantly affect the mix of expertise, background, and diversity. This problem is exacerbated for smaller public companies, which pay their directors less and tend to have greater difficulty attracting diverse candidates.

Board diversity calculations seem poised to become increasingly multifactorial. In a guidance discussion section titled, "Expanding the Aperture of Diversity, Equity, and Inclusion," State Street observes that "[i]nvestors, regulators, and other stakeholders are increasingly focused on other dimensions of diversity beyond gender, race, and ethnicity," noting that both the California law and the Nasdaq requirement included sexual orientation and transgender identity in their definition of diversity. The guidance continues: "Some advocates are calling for the prioritization of disability as an essential dimension of diversity, and several companies (especially outside the US) already disclose information regarding the role of people with disabilities in their organization. We encourage our portfolio companies to consider providing disclosures about the full diversity of their organization." The guidance concludes on a warning note: "The reputational and regulatory risk of not doing so also may increase in the coming years."

Under SEC disclosure rules, boards have the latitude to make their own determinations of what "diversity" means. Since 2010, the SEC has required proxy disclosure regarding whether and how the board considers diversity in identifying director nominees; if the board has a policy

regarding the consideration of diversity, the company must disclose how the policy is implemented and how its effectiveness is assessed. The SEC does not define "diversity," noting that "some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin." Overwhelmingly, large public companies take the expansive approach.

The Upshot

As a practical matter, it is becoming harder for nominating committees to find candidates who are a good fit for the board, fulfill the applicable regulatory requirements, and satisfy investor wishlists on diversity. And, at first glance, it may seem that "expanding the aperture of diversity" would only complicate this enterprise further. But, so long as this expansion does not manifest itself in quotas or similar intrusive mandates, a broadening perspective among some of the most vocal proponents of board diversity as to the qualities or characteristics that are considered "diverse" would be helpful to nominating committees. Taking a broad view of diversity enables boards to look not just to, but through and beyond the categories of gender and race as they seek candidates for open board seats. Boards need broad latitude to determine their own composition on an ongoing basis, and directors are in a unique position to understand both the company's needs and the group dynamics of the board. If new directors do not have the full confidence and respect of the continuing directors from the outset, board effectiveness may be severely compromised. Term limits for directors, which are becoming more common, will increase the challenge of the board composition puzzle. To accommodate the many factors that must be taken into account, average board size is rising.

The failure of the California legislation to survive legal challenge is a cautionary signal to proponents of quotas and diversity mandates. Regulators should use a light touch when it comes to board composition requirements, not only because they may be struck down but also because this is an area in which boards can and should exercise their business judgment. Determining board composition has always been squarely within the board's directive under state corporation law to manage the "business and affairs" of a corporation. Investor and stakeholder pressures will continue to push companies toward greater diversity, and it is the board's role, and well within its core competence, to balance these pressures with its understanding of the company's particular needs and the practical realities of finding available candidates with the necessary professional qualifications and personal characteristics to add value to the board and the company.

David A. Katz *is a partner at Wachtell, Lipton, Rosen & Katz.* **Laura A. McIntosh** *is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.*