LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
FRIDAY, MAY 27, 2022

GUEST COLUMN

Despite recent adverse rulings, shareholder activism continues

By Kimberly Jaimez, David Oliwenstein and Jordan Rhodes

Boardroom diversity has emerged as a key pillar of ESG (environmental, social, and governance) criteria, but recent court rulings have challenged the legal basis for mandating such diversity despite continued shareholder activism in this area.

To date, board diversity has been mandated by the California legislature, Nasdaq Rules 5605(f), 5606, and 5900-9, and by shareholders who have brought proxy statement proposals and repeated derivative actions related to non-diverse boards and executive management. Until recently, most shareholder lawsuits had been dismissed on procedural grounds. But a ruling earlier this Spring, dismissing a board diversity lawsuit brought by a pension fund against Cisco, marks the first dismissal of such lawsuits on the merits. It was closely followed by two state court decisions striking down California's laws mandating a certain number of women and "underrepresented" individuals on the boards of California-based companies, with the most recent decision being handed down earlier this month.

Yet, notwithstanding these court rulings, continued shareholder proxy statement proposals regarding board diversity show that it is an ESG priority and, thus, a continued enforcement priority for regulators. As such, these rulings should not lull companies into complacency but should be viewed as guidance on how companies might approach and evaluate shareholder concerns regarding diversity in the boardroom and at management levels.

I. Board Diversity Lawsuit Dismissed on the Merits

In March 2021, the federal district court in the City of Pontiac *Employee's Retirement System v. Bush et. al.*, 5:20-cv-06651 (N.D. Cal., filed Sep 23, 2020), dismissed a shareholder lawsuit brought against former and current Cisco board members by a pension fund to challenge the board's lack of diversity, and specifically the absence of any Black directors on the board. The suit was brought after the pension fund had made a demand on the board and after the board had started to investigate plaintiffs' concerns.

Challenged Diversity Statements – In the complaint, the pension fund argued that the following diversity statements were materially false and misleading in light of Cisco's homogenous board composition:

· the company "embraces diversity across the spectrum at every level"

· the "Board believes it is important to consider diversity of race . . . in evaluating board candidates in order to provide practical insights and diverse perspectives"

· "[d]iversity, inclusion, collaboration, and technology are fundamental to who we are, how we create the best teams, and how we will succeed"

Specifically, the pension fund plaintiffs claimed that defendant directors had knowingly declined to carry out the above proclamations and thereby committed federal proxy law violations and breaches of fiduciary duty resulting in unjust enrichment.

Ruling Protected Vague Diversity Statements – The court disagreed. Instead, the court granted the board's motion to dismiss for failure to state a claim pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. Applying heightened pleading scrutiny usually applied to claims of fraud (or claims that "sound in fraud"), the federal judge reasoned that the diversity statements were "not actionable" because the court viewed them as "neither misleading nor material to investors." Rather, the court opined that the above only amounted to vague statements of "optimism" or "quintessential, non-actionable puffery" incapable of verification. Additionally, the Bush court decided that the proxy statements did not have an "essential link" to any "loss generating corporate action" because they did not directly cause "Cisco's failure to nominate a black director" (i.e., the action that hurt profits according to studies referenced by plaintiffs in the complaint). Rather, at most the above statements only influenced director elections. After determining that the statements were not false, misleading, or loss generating, the court quickly rejected plaintiff's fiduciary duty claims as well as the unjust enrichment claims.

Board Investigation Highlighted – In coming to this determination, the judge highlighted the board's investigation of shareholders' complaints. In addition to the substantive ruling, the court ruled that procedurally under Fed. R. Civ. P. Rule 23.1, the pension fund plaintiffs failed to sufficiently plead that the board had "wrongly refused its demand or that the demand was futile" by failing to adequately address the board's investigation following the plaintiff's pre-suit demand. Noting this failure and emphasizing the board's investigation, the court deferred to the board's investigative findings after applying the business judgment rule presumption that the directors were faithful to their fiduciary duties. Although the Bush court dismissed the complaint without prejudice (i.e., potentially allowing plaintiffs an opportunity to replead), on April 12, the parties filed with the court a joint stipulation to dismiss the case with prejudice.

II. California's Board Diversity Laws Ruled Unconstitutional

Since the above federal ruling, California state courts have also ruled against California's attempts to legislatively mandate board diversity. In the last two months, both of California's board diversity statutes were struck down for violating California's state constitution on equal protection grounds – first AB 979 (requiring racial/ LGBTQ diversity) then SB 826 (requiring gender diversity) on May 13, 2022. Courts struck the laws in the context of taxpayer lawsuits – each styled *Robin Crest, et al. v. Alex Padilla* – brought by the watchdog group Judicial Watch on behalf of three individual taxpayers.

In *Crest I, (Crest, et al. v. Padilla,* No. 20STCV37513 (Cal. Super. Apr. 1, 2022) ("Crest I"), a California judge struck down California Corporations Code ("Cal. Corp. Code") §301.4 (a), (b), and (d), which implemented AB 979 regarding broad diversity from underrepresented groups while Crest II (*Crest v. Padilla, et al.*, No. 19STCV27561 (Cal. Super. May 13, 2022) ("Crest II"), struck down Cal. Corp. Code §301.3, which implemented SB 826 regarding gender diversity.

Underrepresented Groups Law – Cal. Corp. Code §301.4 sought to mandate board diversity by fining companies that failed (i) to appoint a director from an "underrepresented community" or (ii) to report information regarding its board composition to the Secretary of State. The law went beyond other states' initiatives, i.e., Maryland, Illinois and New York, which have only required companies to disclose board diversity statistics. In addition to mandatory disclosure requirements, the Illinois law established a rating system that requires the University of Illinois to publish an annual report of aggregate data on the demographic characteristics of boards and corporate executive officers along with individualized ratings for each corporation.

Under Cal. Corp. Code § 301.4, California companies of a certain size were required to include at least one person from an "underrepresented community" on their board by the end of 2021. Then, depending on the size of the board, they would have had to include two to three "underrepresented" individuals by the end of 2022. Section 301.4 of the Cal. Corp. Code defined "underrepresented" community members as anyone who self-identifies as "Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, Alaska Native, gay, lesbian, bisexual or transgender."

Gender Diversity Law – Cal. Corp. Code §301.3 was the precursor to the above, originally signed into law in 2018. The statute required publicly held corporations in California to have at least one female director if the number of directors is four or less, at least two female directors if the number of directors is five, and at least three female directors if the number of directors is six or more.

Overruling State-Mandated Diversity – California judges struck down both laws in Crest I and Crest II, holding that they each violated the Equal Protection Clause of the California Constitution by employing suspect classifications without a sufficient showing that the classifications were "necessary for furtherance of a compelling state interest" and narrowly tailored. In Crest I (regarding diversity from underrepresented groups) decided in April, plaintiff taxpayers were granted declaratory relief as well as a forthcoming permanent injunction preventing the expenditure of taxpayer funds on implementation of Cal. Corp. Code §301.4. Notably, however, the parties in Crest I are still litigating whether the ruling affected the statute's disclosure provision in §301.4(c) – pertaining to the Secretary's collection and reporting of corporations' demographic information. Appeals may be forthcoming as the parties have 60 days to appeal.

Despite ruling Cal. Corp. Code § 301.4 unconstitutional, the Crest I judge notably acknowledged the research correlating board diversity with profitability stating: "[a] homogenous board is vulnerable to stagnant thinking and common assumptions," which results in "poorer business practices, less innovation, and ultimately less profit." Yet, the court still took issue with the breadth of the mandate for diversity in light of an alleged lack of specific discriminatory evidence in any particular arena, i.e., specific industry or particular region, to support the law's suspect classifications.

Further, both judges found the submitted evidence of discrimination generally unconvincing. In the gender diversity case, Crest II, the judge suggested that more sophisticated, econometric statistical analysis was necessary and highlighted the need for testimony about specific examples of purposeful, intentional, unlawful discrimination against women in the board selection process. In the racial/LGBTQ diversity case, Crest I, the judge found Padilla's submitted statistical anomalies unpersuasive because they were based on the general population and not pools of qualified board candidates. More statistical evidence of discrimination was needed to buttress the persuasive anecdotal accounts of discrimination submitted in declarations by board candidates from underrepresented groups – both the anecdotal and statistical evidence were necessary for a complete picture according to the Crest I court. Lastly, even though the Secretary argued that it had a compelling interest in diverse boards because diversity was "good for business" and the California economy, both judges determined that such a justification was not specific enough to mandate diversity compliance.

III. Shareholder Activism Remains Steadfast

Notwithstanding the above rulings, many shareholder groups remain steadfast in their demand for diversity at the top. Last year, approximately 130 shareholder proposals were related to diversity, equity, and inclusion issues (up from 90 proposals in 2020). (Jamie Smith, What boards should know about ESG developments in the 2021 proxy season, EY (Aug. 3, 2021). The most prominent DEI-related proposals addressed increasing board diversity, executive diversity, or both. (Id.) So far this proxy season, shareholders continue making proxy statement proposals related to equity, human capital management, and board diversity. Most notably, DEI-related proposals have begun to prevail over company opposition. Such shareholder activism combined with state demographic disclosure laws and the Nasdaq Rules (which will begin imposing requirements on Nasdaq listed companies this Summer), all mean that companies should remain vigilant about board diversity and diversity generally. Meanwhile, the above rulings provide lessons about how to manage ongoing shareholder pressure.

IV. Takeaways

Investigate Diversity Statements. To the extent diversity statements misalign with the composition of a company's board, executive team, or management demographics, boards should investigate. Ideally, this investigation should be as independent as possible to provide credibility, adequately address shareholder concerns, and prevent future shareholder challenges. Additionally, as intimated above, investigations should employ both anecdotal evidence as well as sophisticated statistical evidence relative to qualified candidates to pass muster. Boards that thoroughly engage, and investigate concerns about misalignment with diversity statements are in a better position to take advantage of the presumption that the board acted within its reasonable business judgment. Indeed, in the Cisco lawsuit, one of the key facts that benefited the board was the board's initiation of an investigation into the plaintiff's concerns prior to the litigation. An independent investigation makes it all the more likely that the business judgment rule presumption will apply and support a finding that the board members acted within their fiduciary obligations.

Comply with Nasdaq Rules. Nasdaq's Rules 5605(f), 5606, and 5900-9 (approved by the SEC in August 2021), will soon start imposing diversity related obligations on issuers in August 2022, notwithstanding recent rulings. They require listed companies to publicly disclose diversity information about their board members and provide an explanation if they do not have "at least two diverse directors." Compliance with these rules remains unaffected by the above rulings, and the Nasdaq – as well as the SEC – are empowered to bring enforcement actions for violations.

Mind Shareholder Activism & Proxy Proposals. A number of institutional investors have made it known that they expect their portfolio companies to meet certain board diversity standards. Likewise, shareholders have been bold with proxy proposals seeking more than just diversity at the board level, but racial equity at all levels of the company in addition to human rights vigilance in the supply chain. Many have specifically called for civil rights audits, racial equity audits, or forced labor audits to assess the implementation of aspirational statements at all levels, not just management levels. A number of companies have failed to stop such proposals from being passed at annual meetings. As such, companies should expect continued shareholder activism on this front and seek counsel in how to address continued shareholder pressure.

Kimberly Jaimez *is a partner,* **Jordan Rhodes** *is an associate, and* **David Oliwenstein** *is counsel at Pillsbury Winthrop Shaw Pittman LLP.*

Reprinted with permission from the *Daily Journal*. ©2022 Daily Journal Corporation. All rights reserved. Reprinted by ReprintPros 949-702-5390.