



California legislation and recent stockholder derivative suits push for more board diversity

Corporate Governance Alert

7 October 2020

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The nationwide spotlight on racial injustice has ignited both legislation and new legal theories. In California, Governor Gavin Newsom recently signed into law AB 979 mandating greater diversity on public company boards of directors. Within the last three months, stockholder derivative actions have been filed against a number of public companies asserting that the alleged underrepresentation of African Americans in leadership positions is an actionable violation of law.

California's attempt to legislate diversity is not entirely new. In 2018 Governor Jerry Brown signed into law Senate Bill No. 826 mandating gender balance on the boards of directors of publicly held corporations headquartered in California. The requirements of AB 979 enacted in 2020 are in addition to those set forth in SB 826.

Recent California legislation to push change

Governor Newsom recently signed AB 979, which requires publicly held corporations headquartered in California to diversify their boards of directors with directors from "underrepresented communities" by December 31, 2021. As the issue of board diversity is brought to the forefront of policy debate, corporations must consider the impact noncompliance with the recently enacted laws will have not only from a monetary perspective, but on public and

investor perception as well.

Applicability of new "underrepresented community" diversity law

AB 979 applies to publicly held corporations that are domestic (California-incorporated) general corporations or foreign (not California-incorporated) corporations whose principal executive offices are located in California.

- A "director from an underrepresented community" means a director who "self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual, or transgender."
- A publicly held corporation is a corporation with outstanding shares on a major United States stock exchange. The law does not define what constitutes a "major United States stock exchange," but ABA 979 will have a significant impact on US capital markets- 10.6 percent of Fortune 500 companies are headquartered in California.
- The law does not make exceptions for "controlled companies" or investment companies, nor does it include phase-in rules for new or small public companies.

Deadlines for compliance

AB 979 sets mandatory deadlines for compliance:

- By the end of 2021, each public company must have at least one director from an underrepresented community.
- By the end of 2022, each public company must comply with the following:
 - If the total number of directors is four or fewer, the corporation must have at least one director from an underrepresented community.
 - If the total number of directors is between four and nine, the corporation must have at least two directors from an underrepresented community.
 - If the total number of directors is more than nine, the corporation must have at least three directors from an underrepresented community.

The Secretary of State is required to publish a report on its website by not later than March 1, 2022 documenting those corporations which satisfy the new board diversity requirements (as well as the existing gender diversity requirements).

Noncompliance and penalties

AB 979 further states that if any of the requisite director seats are not compliant for any portion of a calendar year, a company will be found to be in violation of the statute.

Failure to comply exposes a corporation to significant monetary penalties:

- For an initial violation, the state of California may impose a fine of \$100,000.
- For each subsequent violation, the state may impose a fine of \$300,000 per violation.

Governor Newsom acknowledges that, as with SB 826, AB 979 may face legal challenges. However, until any such matters are resolved, public companies in California are strongly encouraged to take action to meet the requirements of the law or subject themselves to the fiscal and reputational penalties and risks resulting from noncompliance, such as boycotts and shareholder derivative actions.

Recent litigation considering lack of diversity

California's latest corporate diversity law follows a new wave of stockholder derivative actions claiming that an alleged lack of racial diversity in corporate leadership is an actionable violation of law. At least seven diversity-related stockholder derivative actions have been filed against large companies this year. The stockholder complaints include allegations that directors have violated federal and state laws by failing to reflect a company's public statements regarding its commitment to diversity and related initiatives; directors have breached their

fiduciary duties by failing to comply with anti-discrimination laws and to appoint racially diverse board members; and directors have committed federal securities violations by filing proxy statements proclaiming a commitment to diversity while maintaining boards composed of directors who are predominantly white and male.

These claims are likely to face significant legal obstacles, but few motions have been filed and none have been decided yet. In order to proceed, the stockholder plaintiffs will need to establish that they were justified in filing suit before first seeking action directly from the board of directors, which presumptively controls the decision whether to pursue alleged corporate causes of action. Some public companies incorporated in Delaware also have adopted forum selection clauses, which the Delaware courts have held are enforceable to require such claims to be litigated in Delaware. But even though the defenses to these lawsuits are likely to be strong, public companies are urged to pause, take notice and plan ahead. Before any of the currently pending cases are litigated or resolved, this first wave of cases will likely become a much larger wave across California and the nation.

To learn more, please contact Holly Lake, John Gibson, David Priebe, or any member of our Public Company and Corporate Governance group.

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