Harvard Law School Forum on Corporate Governance

Recent Ruling on Board Diversification

Posted by Virginia Milstead, Skadden, Arps, Slate, Meagher & Flom LLP, on Sunday, May 8, 2022

Editor's note: Virginia Milstead is partner at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on her Skadden memorandum. Related research from the Program on Corporate Governance includes Politics and Gender in the Executive Suite by Alma Cohen, Moshe Hazan, and David Weiss (discussed on the Forum here); Will Nasdaq's Diversity Rules Harm Investors? by Jesse M. Fried (discussed on the Forum here); and Duty and Diversity by Chris Brummer and Leo E. Strine, Jr. (discussed on the Forum here).

In the first test of a state's board-diversity requirement, a Los Angeles County Superior Court judge has entered summary judgment in favor of the plaintiff in *Crest v. Padilla*, who challenged the constitutionality of California's law requiring California-based public companies to have at least one director on their boards from an "underrepresented community"—defined as "an individual 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."

In its April 1, 2022, decision, the court concluded that the law, known as Assembly Bill 979 and codified at California Corporations Code §301.4, violated the equal protection clause in California's constitution. In particular, the court reasoned that the law utilized race, sexual orientation and gender-based classifications because "it impose[d] a duty on corporations to use such categories in the selection of their board members" and to "have a specific number of directors who are members of certain listed races, or else have certain listed sexual orientations or gender identities." Use of these classifications required the defendant, California's Secretary of State, to prove that the law was justified by a compelling state interest and narrowly tailored to accomplish its goal.

While remedying past discrimination in board selection could potentially constitute a compelling state interest, the court concluded that the defendant had "not properly defined a sufficiently specific arena in which discrimination is to be remediated." Instead, the law applied across all industries in California. The defendant also failed to present sufficient evidence of past discrimination, the court said. While it presented evidence that straight, cisgender, white males are overrepresented on public company boards relative to the population as a whole, it failed to show a "disparity between the demographic make-up *of the qualified talent pool* and those who hold positions in the targeted arena." As for the argument that businesses benefit from having a diverse board, the court concluded that "this sort of generic interest in healthy business [cannot] constitute a compelling state interest."

This court also concluded that, even if the defendant had shown that remediating past discrimination in board selection was a compelling state interest, the California legislature had failed to narrowly tailor the law to that goal. For example, instead of mandating appointment of directors from underrepresented communities, the legislature could have required companies to

disclose the racial, sexual orientation and gender identity make-up of their boards, or change the assertedly "subjective, secretive, and insular" process by which they select directors. Because the legislature did not consider these less restrictive means, the court concluded that the law could not survive constitutional scrutiny.

The court's decision is the first to address the constitutionality of board-level diversity requirements. Legal challenges are also pending against the state's law requiring every California-based public company to have at least one woman on its board (Senate Bill 826, California Corporations Code §301.4), as well as Nasdaq's listing rule requiring companies to disclose board-level diversity statistics and, by certain dates, to either have a "diverse" director or explain why they do not. It remains to be seen whether California's Secretary of State will appeal the ruling or whether other courts will follow its reasoning.

Regardless of the ultimate outcome of the *Crest* case, the ruling should have little effect on those companies that already have, or were planning to add, members of underrepresented communities to their boards. As the court observed, "corporations are, and have always been, free to act themselves to increase their own diversity." Nothing in this ruling requires them to change course.