Two Strikes Against Board Diversity: What’s Next for Statutory Governance Initiatives?

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On the heels of the April 1, 2022 court decision striking down California’s groundbreaking statute requiring underrepresented community mandates for corporate boards, a different trial court dealt the state’s corporate governance diversity efforts another blow. On May 13, 2022, a trial court issued a verdict finding the female board representation law similarly violates California’s
Equal Protection Clause.

Now that both statutes have been invalidated – AB 979 (members of underrepresented communities) on summary judgment and SB 826 (females) following a trial on the merits – corporate boards and the stakeholders and communities those boards serve are asking what is next for statutory governance initiatives?

California’s Statutory Governance Initiatives

In 2018, California enacted a female representation mandate for corporate boards for California-based public companies. Two years later, the California legislature expanded the female board representation mandate to require a specified number of board seats be allocated to members of statutorily specified underrepresented communities. Immediately following the enactment of both statutes, taxpayers filed separate lawsuits claiming the statutes violated the Equal Protection Clause of the California Constitution.

The First Court Acts – Striking Down the Underrepresented Community Statute

Following a hearing on the taxpayer’s summary judgment motion, Los Angeles Superior Court Judge Terry Green declared AB 979 unconstitutional and enjoined the State from enforcing it. The Court found the State was unable to demonstrate that AB 979’s racial and other classifications were narrowly tailored enough to address specifically identified harms that the State had a compelling interest in remediating. The Court found that the State had failed to consider “race-neutral” steps to address the discrimination the State perceived was occurring in corporate boardrooms. While the Court did not cite to the Nasdaq diversity initiative that requires its listed companies to disclose the gender and racial makeup of their boards, the Court referenced disclosure as an avenue the State could have considered when evaluating statutory remedies to address community underrepresentation on corporate boards. Judge Green has not yet entered final judgment and the State has not indicated whether it will appeal the ruling.

A Second Court Voids the Gender Mandate After Trial

While the ruling on AB 979 was issued on a motion for summary judgment, the separate legal challenge to SB 826, the State’s gender mandate, was resolved by verdict after trial. Like the AB 979 ruling, Los Angeles Superior Court Judge Maureen Duffy-Lewis found that the State failed to show the statute was narrowly tailored to address compelling state interests, noting that there is no compelling governmental interest in remedying generalized non-specific societal discrimination. The Court found that the statutory mandate for female board representation was not a remedy designed to restore victims of specific, purposeful or intentional, unlawful discrimination to the positions they would have occupied absent such illegal actions. The Court also rejected evidence that there was a connection between female representation on corporate boards and improved corporate performance. Instead, the Court found that the legislative purpose in enacting SB 826 was to
create gender parity, not to remedy past discrimination.

Similar to the AB 979 ruling – but interestingly without citation to Judge Green’s decision invalidating AB 979 – Judge Duffy-Lewis rejected evidence of “like stereotyping, affinity bias, like picking like and gender matching” as justification for the law. She also did not find these issue unique to nor associated with any California-based public companies. Likewise, and again similar to the AB 979 ruling, the Court found significant the absence of compelling evidence that California-based public companies had engaged in purposeful and intentional past unlawful discrimination in the board selection process. Judge Duffy-Lewis concluded (similar to Judge Green’s decision) that the State had failed to carry its burden of demonstrating that the legislature considered gender-neutral alternative to remedy purposeful discrimination in the board selection process. Judge Duffy-Lewis did not propose possible statutory alternatives in the same way that Judge Green did in his ruling striking down AB 979. But the Court unambiguously enjoined the enforcement of the statute it found offended the Equal Protection Clause of the California Constitution. The State has not yet indicated whether it intends to appeal the verdict.

What Now?

Both statutory mandates are now void and California-based public corporations are not obligated to comply with them. For Nasdaq issuers, however, beginning August 8, 2022 (or the date the issuer’s 2022 proxy is filed, whichever is later), an initial board matrix must be filed reflecting the issuer’s board diversity statistics using a Nasdaq template. The rule also requires (after a transition period) issuers to explain whether or not they have at least two diverse directors and if not, why not. This issuer-required reporting is not a mandate. The issuers who fail to provide or meet the stated diversity objectives may elect to explain the unmet objectives in a proxy statement or through other public disclosures. The Nasdaq rule is the subject of a pending lawsuit before the Fifth Circuit challenging the SEC’s legal authority to approve the rule’s implementation (with oral argument currently tentatively scheduled for the same week the rule becomes effective).

In addition to the Nasdaq initiative, other states such as Washington, Illinois and New York have passed legislation addressing corporate board representation. While the Washington State law is most like the California model in that it requires the board be composed of a certain percentage of female representation, the law differs significantly in that no penalties are assessed for compliance failures. In fact, the Washington statute operates like the Nasdaq initiative in the requirement of transparent reporting in the form of a board diversity discussion and analysis that is delivered to shareholders that requires details concerning the representation of diverse candidates for election as directors and other board refreshment disclosures. It would seem this model is more likely to withstand legal challenge: instead of creating suspect classifications that face difficult constitutional challenges, the transparent reporting model is both administrative and informative – two components that meet shareholder demands for accountability, in the same way financial reporting keeps stakeholders informed as to whether or not a corporation is meeting its financial and other goals.
Statutory initiatives may move the needle toward inclusiveness, but they should not be the primary drivers of boardroom diversification. The California experience demonstrates how legal challenges can derail important initiatives. Boards should not rest inclusiveness on statutory mandates. Stakeholders and ESG initiatives demand governance focused on a meaningful process for seating a board that not only reflects the expertise the corporation requires, but fuller representation of the community the corporation serves.

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