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Federal Court Invalidates California's Board-Diversity Statute

Corporate Defense and Disputes on **May 18, 2023**

A California federal court held that a California statute requiring California-based corporations to have a minimum number of directors from designated under-represented groups violates the federal Constitution's Equal Protection Clause. The decision in *Alliance for Fair Board Recruitment v. Weber* (E.D. Cal. May 16, 2023) is one of the latest skirmishes in the culture wars raging around diversity and other ESG-related matters. The ruling addresses the same law that a California state court previously invalidated in a decision that is currently on appeal.

Background

In 2020, California enacted Assembly Bill 979 ("AB 979"), which required public companies headquartered in California to have a minimum number of directors from designated groups that the legislature viewed as historically under-represented. Those groups included persons who identify as "Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, [or] gay, lesbian, bisexual, or transgender." The number of directors required depended on the size of the corporation's board and ranged from one to three directors. The statute imposed fines for noncompliance.

The Alliance for Fair Board Recruitment, a nonprofit organization composed of persons who do not self-identify within the designated groups, challenged the law, alleging violations of the U.S. Constitution's Equal Protection Clause, 42 U.S.C. § 1981 (a federal civil-rights statute), and the internal-affairs doctrine. The court dismissed the internal-affairs claim, but permitted the other two claims to proceed. And on May 16, 2023, the court granted summary judgment for the plaintiff on the constitutional and § 1981 claims.

The Court's Decision

The court first held that AB 979 facially violated the Equal Protection Clause because it imposed quotas based on racial and ethnic classifications despite Supreme Court authority prohibiting such quotas. California had contended that no quota was involved because the statute allowed corporations to have as many directors as they wished, so no candidate was insulated from competition with any other candidate, and each candidate was evaluated individually. But the court rejected that argument, holding that the statute imposed "a racial quota as it requires a certain fixed number of board positions to be reserved exclusively for certain minority groups."

The court also ruled that the statute violated § 1981, because, under Supreme Court precedent, "a violation of the Equal Protection Clause of the Fourteenth Amendment also constitutes a violation of § 1981."

The court rejected California's request to sever the supposedly unconstitutional parts of the statute (the racial and ethnic classifications) from the rest of it. The court reasoned that removing the racial and ethnic classifications "would adversely affect the coherence of the remaining provision regarding those who identify as gay, lesbian, bisexual, or transgender because the statute's language is almost exclusively cast in racial and ethnic terms and figures." The court added that "(1) the language of the statute, (2) Defendant's opposition brief, which argues that AB 979's main purpose is to remedy racial and ethnic discrimination, and (3) the lack of a severability clause collectively indicate that the legislature would not have adopted the remainder of AB 979 had it foreseen its partial invalidation."

Implications

The *Alliance for Fair Board Recruitment* decision could potentially affect other challenges to statutory or rule-based efforts to diversify corporate boards. The most direct impact could be in pending appeals in California state court from another decision invalidating AB 979 and a separate ruling invalidating Senate Bill 826, California's gender-diversity statute for corporate boards.

The Alliance also is the plaintiff in a pending Fifth Circuit challenge to the SEC's approval of Nasdaq's board-diversity rule. That rule generally requires Nasdaq-listed companies to have at least one female director and at least one minority or LGBTQ director on their boards, or to explain why they do not have such representation. A decision in that appeal is expected soon.

The California court's severability analysis could provide guidance to legislatures that still wish to venture into this area and to impose board-diversity or related requirements. Although the court might have reached the same conclusion against severability regardless of how the California legislature had framed the statute, the court observed that AB 979 – which combined racial and ethnic classifications with other classifications – focused primarily on racial and ethnic discrimination and did not contain a severability clause. Legislatures might therefore decide to consider racial/ethnic and other classifications separately, provide distinct (even if similar or identical) remedies for each group, and include severability provisions so that all classifications do not rise or fall together. In other words, legislatures might wish to negate any suggestion that (in the California court's words) they "would not have adopted the remainder of the [statute] had [they] foreseen its partial invalidation."

Of course, legislative and rule-based efforts to diversify corporate boards are not the only initiatives in that area. Internal and external pressures from shareholders, proxy advisors, investment banks, and other organizations and stakeholders have also sought to achieve that goal. In recent years, some institutional investors have pushed for board diversity, and some financial organizations have expressed reluctance to finance corporations that do not have sufficiently diverse boards. In addition, legal and business academics have noted the importance of board diversity as a way to improve corporate governance, expand cognitive diversity and reduce traditional "group think" at the board level, motivate increasingly diverse workforces, and attract customers – particularly younger ones, who have been perceived as placing greater emphasis on social issues and engagement than have previous generations. Despite resistance from some political quarters, attention to board diversity is not likely to diminish in the near future.

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