

December 22, 2021

## Corporate Boards Must Meet Diversity Requirements Amid Developing Legal Challenges

As a practical matter, investors and other corporate stakeholders value the ability to compare diversity data across companies' boards of directors (Boards), and to aggregate such data for various evaluation purposes. This Alert discusses recent laws and regulations addressing Board diversity requirements and disclosure guidelines, as well as the multiple legal challenges they now face in pending court proceedings.

**Attorneys**  
[Rocky C. Tsai](#)  
[Christa Millard](#)

In 2018, California Governor Jerry Brown signed SB 826 into law, which is now codified as California Corporations Code Section 301.3(a). Section 301.3 mandates gender diversity minimum requirements for the board of directors of any “publicly held domestic or foreign corporation whose principal executive offices, according to the corporation’s [Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC)], are located in California.”

Since Section 301.3 has been in effect since 2019, the statute **already requires** a corporation located in California to have a minimum of one female director serving on its board of directors. Because Section 301.3 sets forth a staggered compliance schedule, several defined benchmarks are coming due on **December 31, 2021**—specifically:

1. If its number of directors is six or more, the corporation shall have a minimum of three female directors.
2. If its number of directors is five, the corporation shall have a minimum of two female directors.
3. If its number of directors is four or fewer, the corporation shall have a minimum of one female director.

Section 301.3(e) authorizes the California Secretary of State to impose fines to enforce compliance, including a \$100,000 fine for “failure to timely file board member information with the Secretary of State”; a \$100,000 fine for a first violation, defined as “each director seat required by this section to be held by a female, which is not held by a female during at least a portion of a calendar year”; and a \$300,000 fine for subsequent violations. To date, the Secretary of State has not issued any fines pursuant to Section 301.3(e).<sup>1</sup>

Nevertheless, many corporations have already responded to Section 301.3’s enforcement framework and demonstrated compliance with its statutory requirements. For example, a [Progress Report](#) by the California Partners Project reported that the number of publicly traded companies *without* female board membership dropped from 30 percent in 2018 to 2.3 percent by late 2020.

According to the California Secretary of State’s March 2020 annual “Women on Boards” report, out of the publicly held corporations listing a California principal executive office on their 2019 Form 10-K filing (a total of 625 impacted corporations), 282—that is, 45%—reported compliance with Section 301.3(a)’s gender diversity requirements. In the March 2021 annual “Women on Boards” report, the percentage of impacted corporations that reported compliance with Section 301.3(a) increased from 45% to 48%.

California Corporations Code Section 301.4 institutes a parallel Board diversity compliance and reporting framework focused on directors “from an underrepresented community.” The statutory term “director from an underrepresented community” is defined to mean “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.” Cal. Corp. Code § 301.4(e)(1). Like Section 301.3, Section 301.4 sets forth a staggered compliance schedule. By **December 31, 2021**, a publicly held corporation whose principal executive offices are located in California

must have at least one director from an underrepresented community on its board. The next defined benchmarks will come due on **December 31, 2022**—specifically:

1. If its number of directors is nine or more, the corporation shall have a minimum of three directors from underrepresented communities.
2. If its number of directors is more than four but fewer than nine, the corporation shall have a minimum of two directors from underrepresented communities.
3. If its number of directors is four or fewer, the corporation shall have a minimum of one director from an underrepresented community.

### Current Litigation Challenge to California's Board Diversity Statutes

Earlier this year, a complaint filed in the Central District of California challenged California's new board diversity rules in *Alliance for Fair Board Recruitment v. Shirley N. Weber*.<sup>2</sup> Interestingly, the *Alliance for Fair Board Recruitment* plaintiff is not a California director, board member, or shareholder at all. The named plaintiff is a "Texas non-profit membership association that seeks to defend the civil rights of director candidates."<sup>3</sup> While there have been no substantive rulings in the case to date, four filings preview the main legal arguments put forth by the plaintiff and the defendant, the California Secretary of State:

- **Complaint**—On July 12, 2021, the Alliance for Fair Board Recruitment filed its complaint in the Central District of California. Plaintiff challenges both Section 301.3 (the so-called "Woman Quota") and Section 301.4 (the so-called "Minority Quota") under two overarching legal claims.

First, Plaintiff claimed both statutes are unconstitutional under the Equal Protection Clause of the Fourteenth Amendment. *Id.* at 13-14. Before the bill even passed, legislators debated whether the Equal Protection Clause undermined SB826, because the statute "creates an express gender classification, which subjects the proposed law to heightened scrutiny under the equal protection clause of the 14th Amendment," and remarked that the "use of a quota-like system . . . may be difficult to defend." SB826 Assembly Floor Analysis 4 (2018). When signing the bill, Governor Jerry Brown issued a [letter](#) acknowledging that there "have been numerous objections to this bill," that "serious legal concerns have been raised," and that "potential flaws [...] indeed may prove fatal to its ultimate implementation." Two prior, and still pending, legal challenges employed a similar Equal Protection attack, but neither case has been finally decided on the merits.<sup>4</sup>

Second, Plaintiff invoked the internal affairs doctrine, arguing that California law cannot govern corporations incorporated under the laws of a different state—even those whose principal executive offices are in California.<sup>5</sup> This legal theory was briefly addressed in the SB826 Assembly Floor Analysis, but had not been addressed in prior legal challenges to California's board diversity statutes.

- **Motion to Dismiss**—Attorneys for the California Secretary of State filed a motion to dismiss on November 1, 2021, attacking the two legal theories outlined above. First, Defendant argued that Sections 301.3 and 301.4 do not violate the Equal Protection Clause because the board diversity statutes establish a "flexible floor for the inclusion of women and individuals from underrepresented communities" rather than a rigid numerical or proportional quota.<sup>6</sup> Further, Defendant argued that by appointing directors who self-identify as lesbian, gay, bisexual, or transgender, corporations could reach compliance without taking race-based classifications into account, thereby avoiding strict scrutiny.<sup>7</sup>

Second, Defendant opposed Plaintiff's corporate affairs doctrine claims, characterizing the doctrine as a choice of law doctrine rather than a basis for a cognizable cause of action.<sup>8</sup> Further, Defendant asserted that the plaintiff

Alliance—a Texas membership association—lacked standing to sue on behalf of a California corporation, or any individual shareholders.<sup>9</sup>

- **Opposition to Motion to Dismiss**—Plaintiff filed its opposition brief on October 12, 2021. First, Plaintiff reasserted its Equal Protection argument, claiming that even authorizing or encouraging (rather than requiring) race- or sex-based corporate leadership decisions violates the Fourteenth Amendment.<sup>10</sup>

Second, Plaintiff characterized the internal affairs doctrine as a constitutional issue that implicates the Commerce, Full Faith and Credit, and Due Process Clauses.<sup>11</sup> As such, Plaintiff claimed these constitutional implications furnished the basis for a 42 U.S.C. § 1983 claim for deprivation of civil rights.<sup>12</sup> Finally, Plaintiff argued that, as a non-profit, it had associational standing to assert the rights of its members, whether they are shareholders prevented from electing directors of their choosing, or a board member ousted from his position “because he is not a woman and does not self-identify as an underrepresented minority.”<sup>13</sup>

- **Reply**—Defendant filed its reply brief on October 18, 2021. First, Defendant distinguished Plaintiff’s Equal Protection claims by differentiating California’s board diversity statutory scheme from explicit set-asides or participation goals, like those deemed unconstitutional in certain other cases.<sup>14</sup>

With respect to the internal affairs doctrine, Defendant’s reply emphasized that constitutional principles alone do not provide a federal cause of action.<sup>15</sup> Defendant also argued that the individual third parties the Alliance purportedly represented lacked a concrete legal claim, since a shareholder of a California corporation is “free to vote his conscience,” and an allegedly ousted director has no cause of action under the internal affairs doctrine.<sup>16</sup> Without even cognizable underlying individual claims, the Alliance lacked associational standing to assert on those third parties’ behalf.

Although Plaintiff filed its complaint in the Central District of California, Defendant filed a successful motion to transfer venue on September 17, 2021. The next hearing in this matter is January 11, 2022, before District Judge John A. Mendez in the Eastern District of California.

### Practical Suggestions and Additional Resources

As [reported by Ropes & Gray on August 26](#), the SEC recently approved the Nasdaq Stock Market LLC (Nasdaq)’s board diversity rules (Rules 5605(f) and 5606). Unlike California’s board diversity statutes, Nasdaq’s board diversity rules are exclusively disclosure-based, prescribing that companies either have diverse board composition demographics, or explain why they do not meet their diversity objective. However, Nasdaq will not evaluate the explanations’ merits or mandate explicit diversity quotas. Notably, the same non-profit group challenging California’s board diversity requirements in *Alliance for Fair Board Recruitment v. Weber* has brought a legal challenge against the Nasdaq rules as well.

The ultimate outcome of these corporate Board diversity litigation challenges is difficult to predict. However, even if these challenges prove successful in narrowing or otherwise altering any existing board diversity regulations, corporations would benefit from addressing board diversity now, considering that multiple other states and self-regulatory organizations have enacted, or are likely to enact, board diversity regimens of their own.

Leading institutional shareholders and corporate governance organizations have made known their support for director-by-director reporting as an important input in their evaluation of corporate governance. Going forward, board diversity requirements should be expected to receive continued focus and attention.

1. See *Creighton Meland v. Shirley N. Weber*, No. 20-15762, 2021 U.S. App. LEXIS 18378, at \*5 (9th Cir. June 21, 2021) (“To date, the Secretary of State has not enacted regulations or imposed fines.”); Def. Sec’y of State’s Evid. Obj. to Aff. of Edward Blum 4:16-19, *Alliance for Fair Board Recruitment v. Shirley N. Weber* (Case No. 2:21cv5644) (“In fact, the Secretary of State has not issued any fines and has not issued any regulations to implement [301.3(e)].”).
2. See C.D. Cal. Case No. 2:21cv5644.
3. Complaint at 5:2-3, *Alliance for Fair Board Recruitment v. Weber* (C.D. Cal. Case No. 2:21cv5644).
4. See *Creighton Meland v. Alex Padilla, Secretary of State of California* (Case No. 2:19-cv-02288-JAM-AC); see also *Robin Crest, et al., v. Alex Padilla* (Case No. 20STCV37513).
5. See Complaint at 16, *Alliance for Fair Board Recruitment v. Weber* (C.D. Cal. Case No. 2:21cv5644).
6. See Defendant’s Motion to Dismiss Complaint at 10:2-3, *Alliance for Fair Board Recruitment v. Weber* (Case No. 2:21cv5644).
7. *Id.* at 9:10-11.
8. *Id.* at 11:14-16.
9. *Id.* at 17:2-6.
10. See Response in Opposition to Defendant’s Motion to Dismiss at 7:14-17, *Alliance for Fair Board Recruitment v. Weber* (Case No. 2:21cv5644).
11. *Id.* at 12:14-17, 13:9-14.
12. *Id.* at 14:18-21.
13. *Id.* at 19:4-6, 19:26-20:3.
14. See *Ne. Fla. Chapter of Associated Gen. Contractors of Am. v. City of Jacksonville*, 508 U.S. 656 (1993); *Bras v. Cal. Pub. Utilities Comm’n*, 59 F.3d 869 (9th Cir. 1995); *Monterey Mechanical Co. v. Wilson*, 125 F.3d 702 (9th Cir. 1997). See also Reply Brief in Support of Defendant’s Motion to Dismiss Complaint at 2:26-28, 3:7-9, 3:13-16, *Alliance for Fair Board Recruitment v. Weber* (Case No. 2:21cv5644).
15. *Id.* at 4:17-19.
16. *Id.* at 9:12-14, 10:15-18.