LATHAM&WATKINS

Client Alert News Flash

Latham & Watkins Environmental, Social & Governance and Executive Compensation, Employment & Benefits Practices

May 17, 2022 | Number 2963

California Gender Board Diversity Law Is Held Unconstitutional

The law suffers the same fate as the California board diversity law requiring directors from "underrepresented communities."

On May 13, 2022, Los Angeles Superior Court Judge Maureen Duffy-Lewis issued a ruling in *Crest v. Padilla I* finding that California Corporations Code Section 301.3 (SB 826), which requires publicly listed corporations in California to have women on their boards, violates the Equal Protection Clause of the California Constitution.[1] The decision comes less than two months after Los Angeles Superior Court Judge Terry A. Green similarly ruled in *Crest v. Padilla II* that the California Equal Protection Clause rendered unconstitutional a law requiring California publicly listed corporations to have board members from "underrepresented communities."[2]

Crest v. Padilla I

In *Crest v. Padilla I,* Judicial Watch — the same plaintiff as in *Crest v. Padilla II* — mounted a facial challenge to SB 826, arguing that the law violated the Equal Protection Clause of the California Constitution. The court first observed that SB 826 creates a gender-based quota system that "affects two or more 'similarly situated' groups in an unequal manner."[3] After establishing that men and women are similarly situated, the court applied the strict scrutiny test to assess the constitutionality of SB 826. Under strict scrutiny, the state needed to show that SB 826: (1) satisfied a compelling government interest; (2) was necessary to satisfy that interest; and (3) was narrowly tailored to meet that government interest. The court held that the state failed to present sufficient evidence to meet any of the three prongs of the strict scrutiny test.

The court first rejected the state's argument that eliminating and remedying discrimination in director selection was a compelling government interest. In so doing, the court stressed that while rectifying specific and intentional discrimination can be a compelling government interest, "remedying generalized, non-specific allegations of discrimination" is not.[4] In the court's view, "neither the Legislature nor Defendant could identify any specific, purposeful, intentional and unlawful discrimination to be remedied"[5] and thus California lacked a compelling interest. The court also rejected the state's argument that SB 826 satisfied a compelling interest by benefiting the public and state economy. In the court's view, the evidence presented at trial demonstrated that the goal of SB 826 "was to achieve gender equity or parity; its goal was not to boost California's economy, not to improve opportunities for women in the workplace nor not *[sic]* to protect California's taxpayers, public employees, pensions and retirees."[6] Moreover, even if

the goal of SB 826 were to fuel the economy, the court noted that "analysis of S.B. 826 found that connections between women on corporate boards and improved corporate performance and corporate governance are inconclusive."[7] That tenuous connection, the court reasoned, negated California's claim that SB 826 was necessary to achieve its stated interest in growing the state's economy.[8]

While the court agreed that men far outnumber women on corporate boards, it did not attribute this asymmetry to discrimination. The court instead stated:

> [California's own expert witnesses] attributed the differences in the numbers of men and women on corporate boards to reasons other than actual discrimination, including the lack of open board seats, women's networking issues, board propensity to select persons that they already know, and boards *[sic]* preference for choosing CEOs to fill open board positions.[9]

Finally, the court held that SB 826 was not narrowly tailored to California's stated interest because the legislature failed to consider amending existing discrimination laws or adopt more finely tuned legislation to root out alleged discrimination in the board selection process.[10]

The Secretary of State has not yet indicated whether it will appeal the decision.

Senate Bill 826

SB 826 was signed into law in 2018. It required publicly listed corporations headquartered in California to have at least one female director by December 31, 2019, and by December 31, 2021:

- At least two female directors if the number of directors is five; and
- At least three female directors if the number of directors is six or more.

Assembly Bill 979

Following SB 826, California enacted Assembly Bill 979 (AB 979) in 2020, which required publicly listed corporations headquartered in California to have board members from "underrepresented communities." Under AB 979, a director from an underrepresented community is one 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 *Padilla II*, the Los Angeles Superior Court earlier this year struck down the law on similar grounds as in *Padilla I*.

Under both SB 826 and AB 979, noncompliance would have resulted in a fine of US$100,000 in the first violation and US$300,000 for each subsequent violation, with a separate US$100,000 fine for failing to provide required information to the state. However, no fines have been levied and no regulations have been adopted to implement provisions for the fines for either statute.

Conclusion

The rulings in *Padilla I* and *Padilla II* suggest that California may not enforce SB 826 and AB 979. The state may appeal 60 days after entry of judgment. Entry of judgment is pending in both cases, meaning the appeal countdown has not yet started. Several weeks could lapse before judgment is entered in both cases, which could prolong uncertainty around a final outcome.

In any event, public companies will still need to be responsive to the demands of investors and other stakeholders to increase their boards' diversity. A failure to show progress may be scrutinized or lead to

negative votes on the election of nominating committee chairs or on the election of directors more generally. Indeed, Nasdaq-listed companies are required to disclose director diversity statistics beginning in August 2022 — although many companies are including the Nasdaq director diversity disclosure matrix in their proxy statements filed for their 2022 annual meetings. Under Nasdaq's rule, listed companies generally must either have, or explain why they do not have, at least two directors from underrepresented communities. Importantly, while the Nasdaq rule arguably puts a thumb on the scales in the direction of greater gender diversity on boards, it does not actually establish a quota, and thus may be more resilient in the face of legal challenge. Given these trends, public companies are advised to carefully consider their approaches to board composition and succession planning.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Paul A. Davies
paul.davies@lw.com
+44.20.7710.4664
London

Susan E. Engel
susan.engel@lw.com
+1.202.637.3309
Washington, D.C.

Sarah E. Fortt
sarah.fortt@lw.com
+1.737.910.7326
+1.202.637.2200
Austin / Washington, D.C.

Betty M. Huber
betty.huber@lw.com
+1.212.906.1222
New York

Colleen C. Smith
colleen.smith@lw.com
+1.858.523.3985
San Diego

Maj Vaseghi
maj.vaseghi@lw.com
+1.650.470.4852
Silicon Valley

Bradd L. Williamson
bradd.williamson@lw.com
+1.212.906.1826
New York

Brett J. Frazer*
brett.frazer@lw.com
+1.858.509.8478
San Diego

** Not admitted to practice in California. Admitted to practice in Illinois.*

You Might Also Be Interested In

California Board Diversity Law Requiring Directors From "Underrepresented Communities" Is Held Unconstitutional

SEC Approves Nasdaq's Board Diversity Proposal

California Gender Diversity Bill Faces Legal Challenge

ESG in 2021: 10 Things to Look Out For

Endnotes

[1] *Crest v. Padilla*, No. 19-STCV-27561 (LA Super. Ct., May 13, 2022).

[2] *Crest v. Padilla*, No. 20-STCV-37513 (LA Super. Ct., Apr. 1, 2022).

[3] *Crest*, No. 19-STCV-27561 at 5-6.

[4] *Id.* at 8.

[5] Id. at 17.

[6] *Id.* at 9.

[7] *Id.* at 12.

[8] *Id.*

[9] *Id.* at 19.

[10] *Id.* at 22-23.