Economic Analysis of Board Diversity

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Critics of initiatives to diversify corporate boards frequently rely on efficiency arguments. Diversity opponents marshal four principal claims. First, they contend that if diversity were efficient, firms would have adopted it by now. Second, they posit that there is a lack of supply of qualified minority candidates, and thus, mandates will lower the quality of board members. Third, they point to evidence that arguably shows that board diversity and, in particular, mandated quotas harm firm value and performance. Fourth, they maintain that the campaign to diversify is motivated by populist ideology. The debate about board diversity, thus, pits fairness and equality, on the one hand, against efficiency, on the other. In this Article, we argue there is neither theoretical nor empirical basis for the position that the current trend to diversify boards is inefficient. We posit that inefficient discrimination in board nominations entrenched itself in American corporations due to a lack of information, network effects, and agency costs. Furthermore, we argue that board diversity could improve board performance by tapping into a hitherto unused talent pool, thereby increasing directors' quality. In addition, the inclusion of members of currently underrepresented groups could improve board oversight of management. Consistent with the hypothesis of inefficient discrimination on American boards, recent studies find that minority directors were not less, and even more qualified than non-minority directors. Our analysis has far-reaching normative implications. We contend that in light of our theoretical analysis and recent empirical studies, courts should have shifted the burden to diversity opponents to show that the striking under-representation of females and minorities on corporate boards does not result from discrimination. Doing so would have probably led the courts to uphold the California legislation, and as importantly, would have enabled the individual members of under-represented groups to sue corporations that unjustifiably passed them up.

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INTRODUCTION 1044
I. THE PUSH FOR BOARD DIVERSITY 1050
A. The Campaign for Board Diversity – Stage One 1051
B. The Campaign for Board Diversity – Stage Two 1056
II. THE SHORTCOMINGS OF THE EFFICIENCY-BASED OPPOSITION TO BOARDROOM DIVERSIFICATION 1061
A. The Myth that if Board Diversity were Efficient Firms would Have Diversified their Boards 1062
B. The Myth that there is an Insufficient Number of Qualified Minority Candidates 1067
C. The Myth that Board Diversity Harms Firm Performance 1070
D. The Virtue of Public Opinion 1076
III. THE BENEFITS OF BOARD DIVERSITY 1078
IV. NORMATIVE IMPLICATIONS 1081
CONCLUSION 1086

> NASDAQ's proposal—and the precedent set by approving it—would harm economic growth by introducing unnecessary regulatory costs, decreasing the attractiveness of U.S. capital markets, and presenting an additional concern for corporations deciding to go and stay public.[1]

INTRODUCTION

In 1932, approximately 15% of the senior managers of the German companies listed on the Berlin stock exchange were Jewish.[2] The rise of the Nazi party to power in 1933 resulted in the purging or retirement of all these managers.[3] By 1938, there were hardly any Jewish managers left.[4] In a recent study, entitled "The Real Cost of Discrimination: A Case Study from Nazi Germany," Kilian Huber and coauthors found that as a consequence of the departure of Jewish managers the German economy lost almost 2% of its gross national product ("GNP").[5] The companies that employed the Jewish managers saw their share prices decline by an average of 10%, relative to peer companies, without ever rebounding.[6]

Notwithstanding this historic lesson, the California courts, in two decisions issued within one month in *Crest v. Padilla,* struck down California's Senate Bill 826, and

1. Letter from Senate Banking Comm. Republicans to Allison Herren Lee, Acting Chair, SEC 5 (Feb. 12, 2021), https://www.sec.gov/comments/sr-nasdaq-2020-081/srnasdaq2020081-8369379-229219.pdf [https://perma.cc/EZ92-T9LW].

2. Kilian Huber, Volker Lindenthal & Fabian Waldinger, *Discrimination, Managers, and Firm Performance: Evidence from 'Aryanizations' in Nazi Germany*, 129 J. POL. ECON. 2455, 2457 (2021).

3. *Id.* at 2456.

4. *Id.*

5. *Id.* at 2457.

6. *Id.* at 2458. Consistent with the hypothesis of inefficient discrimination, stock prices declined only for those firms whose managers possessed specific characteristics. Huber, Lindenthal & Waldinger, *supra* note 2, at 2485 (finding that stock declined only for those firms whose managers possessed university degrees or connections to other firms and concluding that "it is unlikely that other shocks to firms with Jewish managers in 1932 explain the declines in stock prices").

California's Assembly Bill 979, which mandated the inclusion of women and members of minority groups on the boards of California corporations.[7] The first decision, issued on April 1, 2022, struck down Section 301.4 of the California Corporations Code, which required public corporations with principal executive offices in California to have a minimum number of directors from underrepresented groups.[8] Judge Terry A. Green of the Los Angeles Superior Court held that the legislation violated the Equal Protection Clause in the California Constitution by treating similarly situated individuals differently.[9] While Judge Green acknowledged that the Secretary of State has shown that corporate boards are highly homogenous,[10] he determined that statistical underutilization is not sufficient to prove discrimination, since the general population does not represent a qualified pool of candidates for U.S. boards.[11] A month later, on May 13, 2022, Judge Maureen Duffy-Lewis of the California Superior Court for the County of Los Angeles similarly struck down the legislative gender diversity mandate.[12] These decisions handed an important victory to the camp that opposes efforts to diversify corporate boards.

In a separate suit, *The Alliance for Fair Board Recruitment v. Weber*, a non-profit organization from Texas challenged Assembly Bill 979 for violating the Equal Protection Clause of the Fourteen Amendment of the U.S. Constitution.[13] On May 15, 2023, Judge John A. Mendez of the District Court for the Eastern District of California granted summary judgment to the plaintiff, ruling that the legislation employed a non-permissible racial quota by mandating a set number of "Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian or Alaska Native" members on corporate boards.[14]

The legal battle over board diversity continues to rage in other jurisdictions as well. Nasdaq's diversity listing standards, which require companies traded on the exchange to diversify their boards or explain why they failed to do so, are currently being challenged at the Fifth Circuit.[15] Nasdaq's listing standards have also attracted heated criticism. The Wall

7. Crest v. Padilla, No. 20STCV37513, 2022 WL 1073294, at *19–20 (Cal. Super. Ct. Apr. 1, 2022) (striking down the codified Assembly Bill 979); Crest v. Padilla, No. 19STCV27561, 2022 WL 1565613, at *12 (Cal. Super. Ct. May 13, 2022) (striking down Senate Bill 626).

8. *See Crest*, 2022 WL 1073294, at *19–20 (ruling Section 301.4 unconstitutional on equal protection grounds); CAL. CORP. CODE § 301.4 (2021) (setting a minimum number of directors from underrepresented communities).

9. *Crest*, 2022 WL 1073294, at *20 ("Because Section 301.4 treats similarly-situated individuals differently based on race, sexual orientation, and gender identity, because that use of suspect categories is not justified by any compelling interest, and because the statute is not narrowly tailored to serve the interests offered, Section 301.4 violates the Equal Protection Clause of the California Constitution.").

10. *Id.* at *1 ("[T]he Legislature spotted an issue; corporate board seats by and large belong to members of one race, sexual orientation, and gender identity.").

11. *Id.* at *14 ("While anyone off the street might someday *become* the sort of person who sits on boards, it is absurd to suggest that any member of society, selected at random, would *presently* fit that bill.").

12. *See Crest*, 2022 WL 1565613, at *12 ("S.B. 826 violates the Equal Protection Clause of the California Constitution and is thus enjoined.").

13. Alliance For Fair Board Recruitment v. Weber, No. 21-CV-01951, 2023 WL 3481146 (E.D. Cal. May 15, 2023).

14. *Id.*, at *5–6.

15. *See* Alliance For Fair Board Recruitment v. SEC, 85 F.4th 226 (5th Cir. 2023). This challenge failed as the Court found Nasdaq's rules were not subject to constitutional scrutiny and that the SEC's approval of Nasdaq's rules was permissible. *Id.*

Street Journal's editorial board published several harsh critiques of Nasdaq's policy, calling the exchange "nuts,"[16] and "[w]oke,"[17] and claiming that the new policy would "harm economic growth and job creation."[18]

The Wall Street Journal's criticisms are representative. Opponents of the movement to diversify boards rely on efficiency arguments to justify their position, routinely employing four specific claims: First, diversity critics contend that if diversity had been efficient, firms would have adopted it voluntarily.[19] Second, they warn that there are not enough qualified minority candidates, and thus, the calls to diversify boards would harm the quality of boards.[20] Third, they argue that diverse boards would compromise firm performance and reduce firm value.[21] Fourth, and finally, diversity opponents posit that the campaign to diversify boards is *motivated* by *ideology and public sentiment*, in contrast to economic motives.[22]

In this Article, we challenge all four claims. We argue that the conflict between equality and efficiency is illusory. The efficiency-based arguments on which critics of board diversity rely do not withstand rigorous economic analysis.

As leading theorists in the field of economics have shown, discrimination in the labor market is not just morally wrong, but also highly inefficient. Strikingly, the "efficiency-minded" critics conveniently ignore the seminal work of the late Nobel Prize laureate Gary Becker, who powerfully demonstrated that discrimination leads to lower profits and output.[23] By restricting their search to certain segments of the population, firms forego high-quality board candidates in favor of less qualified ones.

16. Editorial Board, Opinion, *Nasdaq vs. Warren Buffett*, WALL ST. J. (Dec 2, 2020), https://www.wsj.com/articles/nasdaq-vs-warren-buffett-11606951218?mod=article_inline [https://perma.cc/DG3P-4WMT].

17. Editorial Board, Opinion, *The Woke Nasdaq*, WALL ST. J (Dec. 1, 2020), https://www.wsj.com/articles/the-woke-nasdaq-11606865986?mod=article_inline [https://perma.cc/3XQG-XPV3].

18. *Id.* ("Imposing its own identity politics on some 3,300 listed companies meddles in corporate management and will harm economic growth and job creation.").

19. *See id.* ("In its filing with the SEC, according to the Wall Street Journal, Nasdaq 'cited multiple studies which found that greater diversity on boards is associated with improved corporate governance and financial performance.' But if that's true, companies hardly need the Nasdaq to mandate the board's makeup. Or is the Nasdaq suggesting that without its racial and gender orders, companies will eschew the profit motive?").

20. *See* Press Release, United States Senate Comm. on Banking, Hous., & Urb. Aff's, Toomey Statement on the SEC's Approval of Nasdaq Board Diversity Requirements (Aug. 6, 2021), https://www.banking.senate.gov/newsroom/minority/toomey-statement-on-the-secs-approval-of-nasdaqs-board-diversity-requirements [https://perma.cc/B3EE-YQGQ] ("By defining diversity by race, gender, and sexual orientation, NASDAQ's mandate will inevitably pressure companies to subordinate crucial factors such as knowledge, experience, and expertise when selecting board members . . . by pressuring companies to select directors from a narrower pool of candidates.").

21. *Id.* ("These prescriptive requirements may ultimately harm economic growth and investors . . . ."); *cf.* Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?*, 12 HARV. BUS. L. REV. ONLINE 1, 3 (2021) (arguing that "a close look at these studies [cited by Nasdaq] as well as studies that Nasdaq fails to cite suggests that increasing board diversity may well reduce investors' returns.").

22. *See* Alexander Osipovich & Akane Otani, *Nasdaq Seeks Board-Diversity Rule that Most Listed Firms Don't Meet*, WALL ST. J. (Dec. 1, 2020), https://www.wsj.com/articles/nasdaq-proposes-board-diversity-rule-for-listed-companies-11606829244 (on file with the *Journal of Corporation Law*) ("Critics called Nasdaq's proposal an overreach . . . . 'This is Nasdaq getting into woke ideology, and it's outside the law.'").

23. *See* discussion *infra* Part II.A.

Furthermore, Kenneth Arrow, another Nobel Prize winner, has shown that with asymmetric information market forces might *not* wipe out costly discrimination.[24] He found that stereotyping is especially persistent when discrimination leads to non-hiring (as opposed to hiring minorities with lower wages).[25] For decades, more than ninety percent of U.S. boards did not hire even one black board member. Classic economic theory suggests that this level of discrimination, which amounts to labor market segregation, is seldom corrected by market forces. Importantly, Arrow's "statistical discrimination" theory explains why discrimination in the labor market can persist over very long periods without a discriminatory motive.

In addition, Arrow observed that social networks and interactions might further contribute to the sustainability of prejudice, and, in turn, inefficient discrimination.[26] Indeed, as many commentators have pointed out, directors and the managers who appoint them come from the same social milieu.[27] They also share two salient commonalities: they are mostly male and mostly white.[28] Unsurprisingly, this resulted in a self-perpetuating dynamic of homogenous board selections. Managers, by and large, propose directors from their social network, namely, people like them. Worthy candidates with diverse backgrounds could not compete on this unlevel playing field and had no opportunity to refute incorrect biased assumptions. These theoretic predictions were substantiated in a 2022 study by Isabelle Allemand and coauthors who established that social networks reduce the likelihood of a woman being nominated to a board by 28%.[29] The study also found that mandated quotas mitigated the effects of social networks.[30]

Finally, and importantly, the corporate context poses a significant impediment for board diversification: the managerial agency problem. Economic models of discrimination assume that the employer as an entrepreneur bears the inefficiency cost. Managers of large firms are only agents, and the costs of discrimination fall on the shareholders' shoulders. Furthermore, managers' personal interest is frequently skewed against replacing their allies

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24. Kenneth J. Arrow, *The Theory of Discrimination*, *in* DISCRIMINATION IN LABOR MARKETS 3–33 (Orley Ashenfelter & Albert Rees eds. 1973) [hereinafter ARROW, *Theory of Discrimination*]; Kenneth J. Arrow, *What Has Economics to Say About Racial Discrimination?* 12 J. ECON. PERSP. 91 (1998) [hereinafter Arrow, *Economics and Discrimination*].

25. Arrow, *Economics and Discrimination*, *supra* note 24, at 97 ("[T]o the extent that discrimination takes the form of segregation, then there will in fact be little experimentation to find out abilities.").

26. *Id.* at 98 ("Models of racial discrimination in which all racial attitudes are expressed through the market will get at only part of the story. At each stage, direct social transactions unmediated by a market play a role.").

27. *See, e.g.*, Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope – Faint Promise*, 76 MICH. L. REV. 581, 584–85 (1978) ("Outside directors are often friends and social acquaintances of the chief executive . . . . These social and professional connections may overlap; regionally and nationally, the elites who do business together also work for the same community and charitable organizations, belong to the same social clubs, and even relax at the same camps."(footnote omitted)); Bryan Ford, *In Whose Interest: An Examination of the Duties of Directors and Officers in Control Contests*, 26 ARIZ. ST. L.J. 91, 124 (1994) ("Independent directors tend to be drawn from the same social milieu as corporate chief executives. The directors often attend similar schools, belong to the same clubs and charitable organizations, and have similar backgrounds.").

28. *See, e.g.*, Marleen A O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1245 (2003) ("[C]orporate boards are quite homogeneous, consisting mostly of white males, in their mid-fifties, who are predominately Protestant and Republican.").

29. Isabelle Allemand et al., *Role of Old Boys' Networks and Regulatory Approaches in Selection Processes for Female Directors*, 33 BRITISH J. MGMT. 784, 784 (2022).

30. *Id.*

with diverse board members who are more inclined to exert board monitoring and to hold management accountable.[31]

The second argument employed by diversity opponents, that there are not enough *qualified* women and minority candidates, is likewise baseless. Theory and evidence strongly suggest that diverse directors are at least as qualified as non-diverse directors who dominated boards for decades.[32] From a theoretical standpoint, there is no reason to assume that members of under-represented groups are less qualified to serve on boards than white males. Rather, both under Becker's and Arrow's models of discrimination firms pass on minority employees that are as, or even more qualified, than non-minority employees that were hired.[33] Furthermore, there is no evidence that newly appointed minority directors reduce the quality of U.S. boards. Quite the contrary, results from different studies suggest that the newly nominated minority candidates are not less qualified, and in some cases are more qualified, than current board members.[34] For example, Anete Pajuste and coauthors studied board diversification in response to the murder of George Floyd.[35] They found that the newly appointed board members were more qualified than the traditional candidates that had been appointed in the past.[36] Studies on California mandates and Nasdaq listing standards reach similar results.[37] Accordingly, the rhetoric employed by the anti-diversification camp suggesting that firms will have to tap from a limited pool of less qualified candidates should be dismissed.

The third argument made by diversity opponents is that diverse boards harm firm performance. To support this claim, proponents of this argument turn to empirical studies that arguably find a negative association (and even causation) between diverse boards and firm performance.[38] We argue that the empirical evidence is neither conclusive nor persuasive. Most studies examined short-term effects. Yet, the positive effects of diversity are likely to come to fruition only in the long term. Even if diverse directors are more qualified, we do not expect to see short-term effects on firm performance. Gaining experience, achieving a critical mass of diversity, and making changes within companies—all take time. Second, studies of the effect of any corporate governance change, including board diversity, on firm performance face significant challenges. Indeed, recent studies show that most of the negative effects studies that opponents point to do not survive careful analysis.[39] Similarly, older studies, we argue, have limited implications for the current diversity movement, as they rely on evidence from two decades ago when board diversification was rare and *highly self-selected*.[40] Finally, findings from recent studies—that newly appointed minority

31. *See* discussion *infra* Part II.A.

32. *See* discussion *infra* Part II.B

33. *See* discussion *infra* Part II.B.

34. *See* discussion *infra* Part II.B

35. Anete Pajuste, Maksims Dzabarovs & Romans Madesovs, *Boardroom Racial Diversity: Evidence from the Black Lives Matter Protests*, 32 CORP. GOVERNANCE 170, 176 (2024).

36. *Id.*

37. Vicky L. Bogan, Ekaterina Potemkina & Scott E. Yonker, What Drives Racial Diversity on U.S. Corporate Boards? 60 (Mar. 27, 2024) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3952897.

38. *See* discussion *infra* Part III.C.

39. *Id.* In contrast, over the last decades, due to outside pressure, all of the Fortune 500 firms have added at least one minority director.

40. *See* discussion *infra* Part III.

directors have more qualifications than incumbent directors—are consistent with inefficient discrimination in board nominations.

As for the final argument of the anti-diversity camp—according to which the drive to diversify boards is driven by popular sentiment—our analysis demonstrates that popular ideology can induce efficient change when market forces fail. One should not automatically presume that ideologically driven reforms are *a priori* inefficient. We show that ideology as reflected by public opinion is relevant to the decisions of financial actors. Furthermore, we argue that public involvement in financial markets can remedy market and political failures.

After refuting the claims of diversity opponents, we proceed to show that diverse boards offer three advantages over traditional ones. First, board diversification would tap into a hitherto unused talent pool, thereby leading to an increase in directors' quality. The fact that directors are predominantly white males means that other groups in our society with the same talent and skills are largely left out of the corporate boardroom. The push for proportionate representation opens up a new wealth of possibilities for shareholders, a wealth they have been denied due to the self-interested behavior of corporate managers.

Second, and relatedly, the inclusion of members of currently underrepresented groups will improve board oversight of management. As more individuals lacking natural alignments with management—and the indebtedness that follows—assume board positions, managers would know that they should expect more inquiries and more pushback from the board. Importantly, the enhanced monitoring we envision will improve corporate governance in the long run as it will lower agency costs. Among other things, it will minimize opportunities for tunneling, address the well-documented problems of the current executive compensation model, and diminish the ability of managers to appoint members of their milieu and background to their company's board.[41] By diversifying boards, firms replace high tenure, excessively loyal, and only weakly independent board members, who were not necessarily elected based on their qualities, with highly qualified, independent minority candidates.

Third, board diversification is consistent with the contemporary trend to expand corporate goals beyond wealth maximization. There is increasing recognition in the corporate law scholarship that shareholders wish to see corporations engaging in myriad social goals, primarily environmental and social ones.[42] Board diversification is not only consistent with the preference of many shareholders for more diversity in all aspects of life, but it also caters to the demands of shareholders, customers, and employees.[43]

Our analysis has important normative implications. It suggests that the decisions in *Crest v. Padilla* and *The Alliance for Fair Board Recruitment v. Weber* are misguided. Rather than requiring the state to prove that the legislation would improve the state economy or that it is necessary to remedy intentional discrimination, we argue that the courts should have placed the burden on the plaintiffs to show that the striking under-

41. *See* Renee Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291, 292 (2009) (finding that "diverse boards are more likely to hold CEOs accountable for poor stock price performance").

42. *See, e.g.*, Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism & the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243 (2020) (arguing that millennials prioritize ESG in their investment, consumption and employment choices).

43. *Id.*

representation of female and minorities on corporate boards does not result from discrimination.[44] Our proposal draws on the Supreme Court's Title VII jurisprudence, under which courts have placed the burden to prove a lack of discrimination in various circumstances.[45] To be sure, quotas are also suspect under Title VII jurisprudence. Yet, the arguments that were raised against quotas in the labor market do not apply to the case of corporate boards, when as we noted the minority and female candidates who were rejected were as qualified for the position as the white males who ultimately got them.[46] Shifting the burdens of production and persuasion to the plaintiffs would have probably led the courts to uphold the California legislation. Economic theory demonstrates that the exclusion of women and members of minority groups was inefficient.[47] Moreover, recent empirical studies show that women and minority members who have been recently appointed to boards are at least as qualified as their white male peers.[48] Challengers of the legislation would have thus faced an uphill battle invalidating the legislation.

Structurally, this Article unfolds in three parts. In Part I, we describe the movement toward board diversification as it has emerged in recent years. The effort to diversify boards initially focused on adding female representatives to boards. In the last several years, the movement has expanded to include racial and ethnic diversity, as well as LGBTQ+ directors. In Part II, we present the arguments against board diversification and critically examine them. In Part III, we enumerate the benefits of diverse boards. We demonstrate that board diversification is likely to enhance, rather than diminish (as critics suggest) productive efficiency and economic growth. In Part IV, we discuss the normative implications of our analysis normative implications. A short conclusion follows.

I. THE PUSH FOR BOARD DIVERSITY

While it is difficult to identify the exact date on which the campaign to diversify boards commenced, several landmark events shaped it. In this Part, we will review the battle to add members of underrepresented groups to corporate boards as it unfolded over the last few years. Schematically, the campaign can be divided into two stages. Initially, in what we call stage one, the focus of the campaign was gender diversity—namely, adding women to corporate boards. Then, after George Floyd's murder in 2020 and the public uproar that followed, the aim of the campaign was expanded to cover other underrepresented groups. We refer to this period as stage two of the campaign.

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44. *See* discussion *infra* Part IV (referencing the argument that that the courts should have placed the burden on the plaintiffs to show that the striking under-representation of female and minorities on corporate boards does not result from discrimination).

45. *See* discussion *infra* notes 49–51.

46. *See* discussion *supra* notes 32–36.

47. Jay Shambaugh, Ryan Nunn & Stacy A. Anderson, *How Racial and Regional Inequality Affect Economic Opportunity*, BROOKINGS (Feb. 15, 2019), https://www.brookings.edu/articles/how-racial-and-regional-inequality-affect-economic-opportunity [https://perma.cc/7V4U-TFB2] (showing how economic theory supports the idea that diversity does not make boards inefficient).

48. *Id.*

A. The Campaign for Board Diversity – Stage One

The modern campaign to diversify corporate boards has taken place over the last two decades. The initial focus of the campaign was gender diversity. The importance of board diversification has been advocated by activists,[49] funds,[50] public figures, and academics.[51] Yet, corporations, by and large, refused to heed such calls. Change, to the extent that it occurred, was slow to come. Finally, winds of change are blowing through the corporate world.

Over the past several years, the push for board diversification has gained unprecedented momentum. David A. Katz and Laura A. McIntosh from Wachtell, Lipton, Rosen & Katz, called 2016 "a 'breakout year' for gender diversity on U.S. public company boards."[52] In July 2016, a group of corporate executives, among them titans, such as Warren Buffett, Jamie Dimon, Jeff Immelt, and Larry Fink, posted a document called "Commonsense Principles of Corporate Governance." The document stated, *inter alia*, that "directors should have complementary skill sets, backgrounds and experiences" and that "[d]irector candidates should be drawn from a rigorously diverse pool."[53]

In October 2016, the Business Roundtable, described by the New York Times as "an influential association of chief executives of American companies,"[54] recognized the connection between "racial and ethnic diversity in boards and board effectiveness and the creation of long-term shareholder value."[55] It resolved to make the promotion of board diversity a primary goal. To this end, it included the following statement in its Principles of Corporate Governance: "Boards should develop a framework for identifying appropriately diverse candidates that allows the nominating/corporate governance committee to consider

49. *See* Elise Perrault, *Why Does Board Gender Diversity Matter and How Do We Get There? The Role of Shareholder Activism in Deinstitutionalizing Old Boys' Networks*, 128 J. BUS. ETHICS 149, 151 (2015) ("[A] list of all the shareholder proposals submitted on the issue of board gender diversity in the U.S. during the 5-year period 2004–2008 was obtained from RiskMetrics, totaling 62 proposals.").

50. *See e.g.*, CAL. PUB. EMPS.' RET SYS., GLOBAL GOVERNANCE PRINCIPLES 11 (2016), https://www.calpers.ca.gov/docs/board-agendas/201603/invest/item05a-02.pdf [https://perma.cc/Z6L6-S62L] (explaining how funds have been advocated for by for in diversifying boards).

51. *See e.g.*, Steven A. Ramirez, *Diversity and the Boardroom*, 6 STAN. J.L. BUS. & FIN. 85, 94 (2000) ("On a very pragmatic level, globalization and demographic developments create a compelling justification for corporate America to embrace diversity."); Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1403 (2002) ("Diverse boards of directors have the potential to counter the new managerialism by focusing the enterprise not only on stock price, but also on the perspectives of lower-level employees and consumers.").

52. David A. Katz & Laura McIntosh, *Corporate Governance Update: Prioritizing Board Diversity*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 30, 2017), https://corpgov.law.harvard.edu/2017/01/30/corporate-governance-update-prioritizing-board-diversity [https://perma.cc/7VQW-CDPR].

53. Margaret Popper, *Commonsense Principles of Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 22, 2016), https://corpgov.law.harvard.edu/2016/07/22/commonsense-principles-of-corporate-governance [https://perma.cc/F2MX-V8N6].

54. Michael W. Peregrine, *Corporate Board Diversity Gets Push from Business Leaders*, N.Y. TIMES (Oct. 12, 2016), https://www.nytimes.com/2016/10/14/business/dealbook/corporate-board-diversity-gets-push-from-business-leaders.html (on file with the *Journal of Corporation Law*).

55. *Id.*

women, minorities and others with diverse backgrounds as candidates for each open board seat."[56]

Another important development came from the keynote address of then-SEC chair Mary Jo White at the International Corporate Governance Annual Conference, in which she highlighted the salutary effects of diversity on corporate performance. She bemoaned "the low level of board diversity in the U.S.,"[57] calling it "unacceptable"[58] and "urge[d] that CEOs and boards of public companies act aggressively to alter this landscape and to do so quickly."[59] She also noted that "major efforts are underway in the United States and elsewhere to improve board diversity."[60]

Mary Jo White's words have not fallen on deaf ears. The three largest institutional investors—BlackRock, Vanguard, and State Street—that collectively managed over $4 trillion in equities at the time, recognized the importance of boardroom diversity and took action. Of the three, State Street positioned itself as the leader of the board diversification campaign and was a trailblazing maverick for others.

In March 2016, even before Mary Jo White's speech, State Street launched its "Gender Diversity Index Exchange Traded Fund."[61] The fund, traded on the New York Stock Exchange Arca under the ticker SHE, was selected from approximately 144 of the 1000 largest companies "based on the presence of women at the CEO, board, and senior leadership level."[62] The stated goal of the fund was to invest in U.S. corporations that "are leaders in advancing women through gender diversity on their boards of directors and in management,"[63] and "empower[] investors to encourage more gender diverse leadership and support better long term social and economic outcomes in support of gender diversity."[64] A 2015 MSCI empirical study found that although corporations with at least three female directors outpaced other firms by 36.4 percent in terms of return on equity, women represented only 16 percent of corporate executives.[65] State Street set out to change this reality.

The strength of State Street's commitment to the cause is open to some debate. Research conducted by Morningstar in 2019 revealed that State Street's diversity fund

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56. BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 11 (2016), https://s3.amazonaws.com/brt.org/archive/Principles-of-Corporate-Governance-2016.pdf [https://perma.cc/RU8X-XQ4K].

57. Mary Jo White, Chair, SEC, Keynote Address at the International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability (June 27, 2016), https://www.sec.gov/news/speech/chair-white-icgn-speech [https://perma.cc/FE3D-5VPZ].

58. *Id*.

59. *Id.*

60. *Id.*

61. *State Street Global Advisors Launches Gender Diversity ETF to Help Investors Seek a Return on Gender Diversity*, BUS. WIRE (Mar. 7, 2016), https://www.businesswire.com/news/home/20160307005890/en/State-Street-Global-Advisors-Launches-Gender-Diversity-ETF-to-Help-Investors-Seek-a-Return-on-Gender-Diversity [https://perma.cc/RX4H-YKZ2].

62. *Id.*

63. Paul Sullivan, *In Fledgling Exchange-Traded Fund, Striking a Blow for Women*, N.Y. TIMES (Mar. 4, 2016), https://www.nytimes.com/2016/03/05/your-money/in-fledgling-exchange-traded-fund-striking-a-blow-for-women.html (on file with the *Journal of Corporation Law*).

64. *State Street Global Advisors Launches Gender Diversity ETF*, *supra* note 61.

65. LINDA-ELING LEE ET AL., WOMEN ON BOARDS: GLOBAL TRENDS IN GENDER DIVERSITY ON CORPORATE BOARDS 4 (2015), https://www.msci.com/documents/10199/04b6f646-d638-4878-9c61-4eb91748a82b [https://perma.cc/ZCZ5-7CR2].

supported only two out of ten "diversity resolutions it faced, voting against six and abstaining on two."[66] A possible explanation for the fund's less-than-stellar voting record was provided by State Street Global Advisors CEO Cyrus Taraporevala, who explained that the company has a preference for engagement over voting.[67] Be that as it may, the launch of the fund sent a clear signal to Wall Street that the cause of gender diversity was not a mere fad. As importantly, it committed State Street to that cause.

If State Street's first message went unnoticed by some, its second message reverberated through Wall Street. In March 2017, on the eve of International Women's Day, State Street positioned a fifty-inch tall statue of a girl in front of Wall Street's most iconic symbol, Arturo Di Modica's "Charging Bull" statue.[68] The stark contrast between the sheer size of the "Charging Bull" and Kristen Visbal's much smaller, yet resolute "Fearless Girl" evoked immediate and strong reactions.[69] This time, the symbolism was too powerful to be ignored. To emphasize its commitment, a few days later, State Street sent a letter to the companies comprising the Russell 3000 Index requesting them to enhance diversity on their boards.[70] At the time, about one-quarter of the Index companies had no women directors.[71]

That same month, State Street announced that it would start voting against new male nominations to boards with no female members.[72] At the commencement of the initiative, 1,228 companies, with 816 of those companies located in the United States, did not have a single female director.[73] State Street carried out its promise. In 2017, State Street opposed the nomination of directors in 512 companies for diversity reasons.[74] In the first half of 2018, it voted "no" in 581 cases involving committee chairs and board members because the companies failed to add at least one woman to the board.[75] By October 2018, State Street was credited for the addition of a female director to the boards of just over 300 corporations worldwide.[76] Furthermore, State Street committed to escalate its campaign, announcing that as of 2020 it "will vote against the nominating committee's entire slate of

66. Emma Rapaport, *State Street's Gender Diversity Fund Fails to Live Up to Its Name, Says Morningstar*, MORNINGSTAR (Apr. 10, 2019), https://www.morningstar.com.au/Funds/article/state-streets-gender-diversity-fund-fails-to/186951 [https://perma.cc/TXX9-5D9Q].

67. *See id*. ("Our preference continues to be constructive engagement, and we only take voting action as a last resort . . . .").

68. Bethany McLean, *The Backstory Behind That 'Fearless Girl' Statue on Wall Street*, THE ATLANTIC (Mar. 13, 2017), https://www.theatlantic.com/business/archive/2017/03/fearless-girl-wall-street/519393 [https://perma.cc/L63E-NJ92].

69. *Id.*

70. *Id.*

71. *Id.*

72. Joann S. Lubin & Sarah Krouse, *State Street Says it Will Start Voting Against Companies that Don't Have Women Directors*, WALL ST. J. (Mar. 6, 2017), https://www.wsj.com/articles/state-street-says-it-will-start-voting-against-companies-that-dont-have-women-directors-1488862863 (on file with the *Journal of Corporation Law*).

73. Lyuba Goltser, *State Street Escalates Policy on Board Gender Diversity and Touts Impact of its "Fearless Girl" Campaign*, WEIL, GOTSHAL & MANGES LLP: GOVERNANCE & SEC. WATCH (Oct. 10, 2018), https://governance.weil.com/insights/state-street-escalates [https://perma.cc/M2R6-JG68].

74. *Id.*

75. *Id.*

76. *Id.*

nominees if a company does not have at least one woman on its board and has not engaged in successful dialogue with us on the matter for three consecutive years."[77]

While State Street led the charge to diversify boards among the Big Three, BlackRock, the largest institutional investor, did not lag far behind. In 2017, BlackRock supported eight proposals urging U.S. and Canadian corporations to adopt measures that enhance board diversity.[78] In February 2018, BlackRock posted its proxy voting guidelines, announcing its expectation to see at least two female directors in every boardroom.[79] BlackRock also committed to "achieving 30% female representation in senior management by 2020."[80] In addition, BlackRock's investment stewardship group mailed letters to the 367 Russell 1000 companies with two women or fewer on their boards, requiring them to report efforts to enhance gender diversity or explain how their current policies comport with their long-term vision.[81] BlackRock's message made it clear to corporations that State Street is not alone in the push for boardroom diversity.

Not to be left behind, in August 2017, Vanguard issued an open letter to all public company directors, stating its expectation for governance improvements.[82] In setting forth its vision, Vanguard noted the importance it attributed to diversity and climate issues.[83] The letter pointed out that "[t]here is compelling evidence that boards with a critical mass of women have outperformed those that are less diverse" and emphasized that its "stance on this issue is, therefore, an economic imperative, not an ideological choice."[84]

In 2018, the pro-diversity dynamic received an important boost when International Shareholder Services (ISS), the largest proxy advisory firm, updated its 2019 proxy voting

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77. Rakhi Kumar, *Invested in Gender Diversity*, IMF (Mar. 2019), https://www.imf.org/external/pubs/ft/fandd/2019/03/gender-diversity-and-leadership-on-corporate-boards-kumar.htm [https://perma.cc/B8WV-A7VB].

78. Trevor Hunnicutt, *BlackRock Supports Effort to Boost Number of Women Board Members*, REUTERS (July 13, 2017), https://www.reuters.com/article/us-blackrock-women/blackrock-supports-effort-to-boost-number-of-women-board-members-idUSKBN19Z09C [https://perma.cc/785U-J929].

79. Sarah Krouse, *BlackRock: Companies Should Have at Least Two Female Directors*, WALL ST. J. (Feb. 2, 2018), https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407 (on file with the *Journal of Corporation Law*) ("BlackRock Inc. said in a new set of proxy voting guidelines posted this week on its website that it wants its portfolio companies to have diverse boards and that 'we would normally expect to see at least two women directors on every board.'").

80. *Diversity, Equity and Inclusion*, BLACKROCK CAREERS, https://careers.blackrock.com/life-at-blackrock/inclusion-and-diversity [https://web.archive.org/web/20210129053138/https://careers.blackrock.com/life-at-blackrock/inclusion-and-diversity]. Unfortunately, this goal has not been achieved.

81. *See* Emily Chasan, *BlackRock Asks Companies to Explain Dearth of Women on Boards*, BLOOMBERG (Feb. 2, 2018), https://www.bloomberg.com/news/articles/2018-02-02/blackrock-asks-companies-to-explain-dearth-of-women-on-boards (on file with the *Journal of Corporation Law*).

82. Open Letter from F. William McNabb III, Chairman and Chief Exec. Officer, Vanguard, to Directors of Public Companies Worldwide (Aug. 31, 2017), https://www.wlrk.com/docs/2017VanguardOpenLettertoBoards.pdf [https://perma.cc/Q8RE-L67E].

83. *See id.* at 2 ("Gender diversity is one element of board composition that we will continue to focus on over the coming years . . . As significant long-term owners of many companies in industries vulnerable to climate risk, Vanguard investors have substantial value at stake."). This is interesting considering Vanguard's recent hesitance to sign onto climate change measures. Ross Kerber & Tim McLaughlin, *Biggest U.S. Index Funds Oppose Most Climate Proposals in Shareholder Votes*, REUTERS (Oct. 9, 2019), https://www.reuters.com/article/us-usa-funds-index-climatechange/biggest-u-s-index-funds-oppose-most-climate-proposals-in-shareholder-votes-idUSKBN1WN105 [https://perma.cc/3JJB-AW96].

84. McNabb III, *supra* note 82, at 2.

policies to address gender diversity. The policy stated that, after a one-year grace period, negative voting recommendations may be used against nominating committee chairs at companies without gender diversity.[85] Although the policy specifically targeted nominating committee chairs as the parties responsible for insufficient diversity, it added that in specific cases negative recommendations may also be issued against the election of directors who were responsible for blocking women.[86] ISS enunciated that it was willing to consider explanations for the lack of board diversity in exceptional cases.[87] The new policy applied to all Russell 3000 and S&P 1500 firms.[88] In 2020, ISS updated its proxy voting policy once again, requiring companies to "account for a lack of women on their boards."[89] Moreover, ISS committed to issuing a negative recommendation against the nominating committee's chair, or other directors in appropriate cases, if a firm has no women directors and has no firm commitment to gender diversity.[90]

The campaign for boardroom diversity has not been solely carried out by the private sector. Though almost all state legislatures chose to sit on the fence and allow investors and corporate leaders to spearhead the charge for diversity, the California legislature took exception to the rule. On September 30, 2018, the governor of California signed a bill into law mandating that companies with a principal executive office in the state and shares listed on a major U.S. stock exchange appoint one woman to their boards by December 31, 2019, and at least two or three women, depending board size, by December 31, 2021.[91] A fine of $100,000 was imposed on noncomplying corporations.[92] At the time of the legislation's enactment, one-quarter of the corporations falling within its ambit had no women

85. INSTITUTIONAL SHAREHOLDER SERVICES, UNITED STATES PROXY VOTING GUIDELINES 12 (2018), https://www.issgovernance.com/file/policy/2019/americas/US-Voting-Guidelines.pdf [https://perma.cc/944S-26ZP].

86. Press Release, Institutional S'holder Servs., ISS Announces 2019 Benchmark Policy Updates (Nov. 19, 2018), https://www.issgovernance.com/iss-announces-2019-benchmark-policy-updates [https://perma.cc/V2DX-89Y9].

87. *Id.*

88. *Id.*

89. Betty Moy Huber & Paula H. Simpkins, *ISS Releases Final Changes to Its Voting Policies for 2020 Proxy Season – Newly Public Companies, Independent Chair and Share Buyback Proposals, Board Gender Diversity, EVA and More*, DAVISPOLK: BRIEFING: GOVERNANCE (Nov. 12, 2019), https://www.briefinggovernance.com/2019/11/iss-releases-final-changes-to-its-voting-policies-for-2020-proxy-season-newly-public-companies-independent-chair-and-share-buyback-proposals-board-gender-diversity-eva-and-more [https://web.archive.org/web/20201123170055/https://www.briefinggovernance.com/2019/11/iss-releases-final-changes-to-its-voting-policies-for-2020-proxy-season-newly-public-companies-independent-chair-and-share-buyback-proposals-board-gender-diversity-eva-and-more].

90. *Id.*; INSTITUTIONAL SHAREHOLDER SERVICES, PROPOSED ISS BENCHMARK POLICY CHANGES FOR 2021 11 (2020), https://www.issgovernance.com/file/policy/proposed-benchmark-policy-changes-2021.pdf [https://perma.cc/5PQ7-UJGB].

91. 2018 Cal. Stat. 954.

92. *Id*.

directors.[93] Despite the fine, forty-eight companies failed to appoint a single female director by the end of 2019.[94]

As we noted, in the second of the two cases relating to *Crest v. Padilla*, the California statute was challenged for violating the Equal Protection Clause in the California Constitution. On May 13, 2022, Judge Maureen Duffy-Lewis of the California Superior Court for the County of Los Angeles invalidated the legislation.[95] Applying a strict scrutiny standard to the legislation, she ruled that the Secretary of State failed to show that the legislature "considered gender-neutral alternatives to remedy . . . discrimination against women by private-sector corporations in the selection of board members or that gender neutral alternatives were not available."[96] She further noted that there was no proof that legislation was remedial and was enacted "as nearly as possible to restore the victims of specific, purposeful, or intentional, unlawful discrimination to the position the victims would have occupied in the absence of discrimination."[97]

B. The Campaign for Board Diversity – Stage Two

Oddly, the abysmally small percentage of directors from minority groups did not initially attract as much attention as the gender gap on boards. Of course, the problem was well known, and various investors, business leaders, and activists called for measures that would render boards more representative of the entire population. Recall that in 2016, the "Commonsense Principles of Corporate Governance,"[98] the Business Roundtable,[99] and then-SEC Chair Mary Jo White[100] broadly defined "diversity" and did not restrict their calls to enhance diversity to gender.

Likewise, activist investors fought to secure board representation for members of minority groups, both men and women. For example, the CtW investment group pressured Amazon to adopt a shareholder resolution demanding that "the initial list of candidates from which new management-supported director nominees are chosen . . . should include (but need not be limited to) qualified women and minority candidates."[101] In May 2018, when the proposal was brought, all ten members of Amazon's board were white and seven

93. Casey Leins, *Report: Some California Corporations Ignore Law Requiring Females on Boards*, U.S. NEWS & WORLD REPORT (Mar. 4, 2020), https://www.usnews.com/news/best-states/articles/2020-03-04/many-california-corporations-refuse-to-follow-gender-diversity-law-report-finds [https://perma.cc/95BM-4Y3s] ("According to [the California Secretary of State's] website, when the law passed in 2018, a quarter of California's publicly held corporations had no women directors on their boards.").

94. *Id*.

95. Crest v. Padilla, No. 19STCV27561, 2022 WL 1565613, at *1 (Cal. Super. Ct. May 13, 2022).

96. *Id.* at *12.

97. *Id*. at *4.

98. Popper, *supra* note 53.

99. In 2019, the Business Roundtable went even further and issued a statement on the *purpose* of a corporation. One pertinent part reads: "We foster diversity and inclusion, dignity and respect." *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'*, BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/7DQB-MAUY].

100. White, *supra* note 57.

101. Amazon, Inc., 2018 Proxy Statement (Form 14A) 14–15 (Apr. 18, 2018).

of them were men.[102] Initially, the board recommended that the proposal be voted down.[103] Fortunately, word got out to Amazon's workforce. The employees threw their weight behind the initiative, and it was adopted.[104] In February 2019, Amazon appointed Rosalind Brewer, a black woman who served as Starbucks' COO, to its board.[105] Also in 2019, Vanguard made it clear that diversity encompasses not only gender but also race, ethnicity, national origin, and even age.[106] Vanguard also called on boards to share their vision for diversity, publicize measures adopted to encourage diversity and identify diverse candidates for future board positions.[107]

Sadly, it took the murder of George Floyd to fully awaken corporate America.[108] In the same way the #MeToo movement helped raise awareness of board gender disparities, the protests that ensued after Floyd's death on May 25, 2020, and the actions of the #BlackLivesMatter movement hastened the push for racial and ethnic diversity on corporate boards. The problem of racial underrepresentation was far more acute than that of gender. According to a survey conducted by the ESG division at ISS, in 2020 only 12.5% of all directors in Russell 3000 companies were members of underrepresented racial and ethnic groups even though they constitute 40% of the general population.[109] Black male directors occupied only 4% of all board seats while black women made up just 1.5% of the pool of

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102. Stefanie K. Johnson, *What Amazon's Board Was Getting Wrong About Diversity and Hiring*, HARV. BUS. REV. (May 14, 2018), https://hbr.org/2018/05/what-amazons-board-is-getting-wrong-about-diversity-and-hiring [https://perma.cc/E7GU-D92A].

103. 2018 Proxy Statement, *supra* note 101, at 15.

104. Sharon Florentine, *Amazon's Board Adopts Shareholder-Backed Diversity Proposal*, CIO (May 18, 2018), https://www.cio.com/article/3273488/amazons-board-adopts-shareholder-backed-diversity-proposal.html [https://perma.cc/89RX-DPJ5]; *Amazon Adopts New Policy to Promote Board Diversity*, REUTERS (May 14, 2018), https://www.reuters.com/article/us-amazon-diversity/amazon-adopts-new-policy-to-promote-board-diversity-idUSKCN1IG006 [https://perma.cc/RJY7-H73B].

105. Spencer Soper, *Amazon Names Ex-Walmart Executive Rosalind Brewer to Board*, BLOOMBERG L. (Feb. 4, 2019), https://news.bloomberglaw.com/esg/amazon-names-ex-walmart-executive-rosalind-brewer-to-board-1 (on file with the *Journal of Corporation Law*).

106. VANGUARD, INVESTMENT STEWARDSHIP 2019 ANNUAL REPORT 18 (2019), https://www.wlrk.com/files/2019/Vanguard_2019_Annual_Report_Investment_Stewardship.pdf [https://perma.cc/TX6K-ZMGV]; John Galloway, *A Continued Call for Boardroom Diversity*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 19, 2020), https://corpgov.law.harvard.edu/2020/12/19/a-continued-call-for-boardroom-diversity [https://perma.cc/23J6-CVQ4].

107. VANGUARD, *supra* note 106; Galloway, *supra* note 106.

108. Peter Eavis, *Diversity Push Barely Budges Corporate Boards to 12.5%, Survey Finds*, N.Y. TIMES (Sept. 15, 2020), https://www.nytimes.com/2020/09/15/business/economy/corporate-boards-black-hispanic-directors.html (on file with the *Journal of Corporation Law*) ("Since the death of George Floyd in police custody in May, many chief executives have backed efforts to tackle racial injustice."); Gillian Friedman, *Here's What Companies Are Promising to Do to Fight Racism*, N.Y. TIMES (Aug. 23, 2020), https://www.nytimes.com/article/companies-racism-george-floyd-protests.html (on file with the *Journal of Corporation Law*) ("[S]ince Mr. Floyd's killing last month, businesses of all kinds have expressed their solidarity with protestors . . . . But some have gone further, announcing intentions to make concrete changes inside their own institutions or in how they do business."); Jessica Guynn, *New California Law, the First of Its Kind, Requires Racial Diversity on Corporate Boards of Directors*, USA TODAY (Oct. 5, 2020), https://www.usatoday.com/story/money/2020/09/30/california-law-requires-racial-diversity-corporate-boards/5874469002 [https://perma.cc/NUC4-HQJY] ("Nationwide protests over the death of George Floyd prompted pledges from corporate America to close the racial gap.").

109. Eavis, *supra* note 108 ("Underrepresented ethnic and racial groups make up 40 percent of the U.S. population but just 12.5 percent of board directors, up from 10 percent in 2015, according to a new analysis by the Institutional Shareholder Services' ESG division.").

over 20,000 directors.[110] Another study by USA Today examined the composition of senior management and "found that less than 2% of top executives at the 50 largest companies are Black."[111]

The first meaningful reaction was taken by Goldman Sachs. On July 1, 2020, Goldman Sachs stated that it will not take companies public if they do not have a woman or at least one non-white board member.[112] It further announced that, in the future, the minimum number of female or non-white board members will go up to two.[113] Goldman Sachs' new policy set the tone for other financial institutions whose responses were swift.

Heeding the public sentiment, State Street took immediate action. On August 27, 2020, State Street issued a letter to board chairs setting forth its expectations for workforce diversity.[114] State Street iterated its will to see firms collect data on the racial and ethnic diversity of their workforces and their strategies to improve on this dimension. In the part pertaining to board composition, the letter required companies to "[a]rticulate goals and strategy related to racial and ethnic representation at the board level, including how the board reflects the diversity of the company's workforce, community, customers and other key stakeholders."[115] The letter further requested companies to map potential barriers to the hiring and retention of diverse employees.[116]

BlackRock acted a short time later. In December, it announced it would require companies to disclose the racial, ethnic, and gender composition of its workforce,[117] and made it clear that it would scrutinize boardroom diversity more closely in 2021 "with an eye toward more voting action against boards not exhibiting diversity in 2022."[118] Vanguard, too, announced that, as of 2021, "[it] may vote against directors at companies where progress on board diversity falls behind market norms and expectations,"[119] as well as hold nominating committee chairs and relevant individual directors personally accountable.[120]

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110. *Id.*

111. Guynn, *supra* note 108.

112. Elana Lyn Gross, *The CEO of Goldman Sachs Says the Bank Won't Take Companies Public Unless There is at Least One 'Diverse' Board Member*, FORBES (Jan. 23, 2020), https://www.forbes.com/sites/elanagross/2020/01/23/the-ceo-of-goldman-sachs-says-it-wont-take-companies-public-unless-there-is-at-least-one-diverse-board-member [https://perma.cc/7KRV-TMYW].

113. *Id.*

114. Letter from Richard F. Lacaille, Glob. Chief Inv. Officer, State St. Glob. Advisors, to Bd. Chair (Aug. 27, 2020), https://www.ssga.com/library-content/pdfs/global/letterhead_racial_equity_guidance.pdf [https://web.archive.org/web/20211104153839/https://www.ssga.com/library-content/pdfs/global/letterhead_racial_equity_guidance.pdf].

115. *Id.*

116. *Id.* ("[W]e ask companies to assess the barriers to entry and impediments to recruitment and retention of diverse talent, especially at senior levels of the organization.").

117. BLACKROCK, OUR 2021 STEWARDSHIP EXPECTATIONS 8 (2020), https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf [https://perma.cc/NUJ2-GJWH] ("In the U.S., we are asking companies to disclose the diversity of their workforce, including demographics such as race, gender, and ethnicity . . . as well as the actions they are taking to . . . support an engaged workforce.").

118. *Id.* at 12.

119. Galloway, *supra* note 106.

120. *Id.* It should be noted that reports revealed that BlackRock's and Vanguard's voting records in 2019 were not always consistent with its policies. *See* Nik Pratt, *BlackRock/Vanguard Defend Voting Records on Racial Equity*, FUNDS EUROPE (Dec. 16, 2020), https://www.funds-europe.com/news/blackrockvanguard-defend-voting-records-on-racial-equity [https://perma.cc/YY7L-A2RB] ("A report produced the US-based Service

In October 2020, ISS published its proposed policy changes for 2021, declaring that it is considering "adding a new policy that expressly addresses racial/ethnic board diversity."[121] According to ISS, that change was motivated by the public reaction to racial and ethnic injustices.[122] The adoption of the new policy would mean that "starting in 2022, ISS would generally recommend voting against or withholding from the chair of the nominating committee (or other relevant directors on a case-by-case basis) at any Russell 3000 or S&P 1500 company that has no apparent racial and/or ethnic board diversity."[123]

As was the case with the push for gender diversity, California positioned itself as a clear leader in the drive for racial diversity. On August 31, 2020, the California legislature passed a bill requiring large companies in California to diversify their boardrooms by the end of 2021.[124] The bill defines members of underrepresented minorities as individuals who self-identify as "Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, Alaskan Native, or who self-identif[y] as gay, lesbian, bisexual, or transgender."[125]

The legislation was voided for violating the Equal Protection Clause in the California Constitution in the first of the two *Crest v. Padilla* decisions. Judge Terry A. Green of the Los Angeles Superior Court ruled that by treating "qualified potential corporate board members . . . differently based on their membership (or lack thereof) in certain listed racial, sexual orientation, and gender identity groups," the law violated the Equal Protection Clause in the California Constitution.[126] He concluded that the Secretary of State of California failed to point to a compelling state interest that would justify the differential treatment and that the broad social benefits the legislation meant to achieve were insufficient.[127] Judge Green further noted that the direct approach taken by California "should be the last resort, not the first."[128]

The legislation was also challenged for violating the federal Constitution. In a suit filed in the District Court for the Eastern District of California, The Alliance for Fair Board

Employees International Union (SEIU) and Majority Action states that both BlackRock and Vanguard voted for boards with no black directors and voted against shareholder efforts for racial equity.").

121. Betty Moy Huber & Paula H. Simpkins, *ISS Proposes 2021 Benchmark Voting Policy Changes*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 10, 2020), https://corpgov.law.harvard.edu/2020/11/10/iss-proposes-2021-benchmark-voting-policy-changes [https://perma.cc/GA62-8SPE]; *see also* INSTITUTIONAL SHAREHOLDER SERVICES, *supra* note 90, at 2 ("For its U.S. Benchmark Policy, ISS proposes to adopt a new policy, to be effective from February 2022, at companies where the board has not identified any ethnically or racially diverse members.").

122. Huber & Simpkins, *supra* note 121.

123. *Id.; see also* INSTITUTIONAL SHAREHOLDER SERVICES, *supra* note 90, at 2 ("The proposed policy will be to generally recommend voting against the chair of the nominating committee (or other relevant directors on a case-by-case basis) where there are no identified ethnic or racially-diverse board members, beginning in 2022. Mitigating factors will be considered and the proposed coverage universe is all companies in the Russell 3000 and S&P 1500 indexes.").

124. Anne Steele, *California Lawmakers Back Mandate for Racial Diversity on Corporate Boards*, WALL ST. J. (Aug. 31, 2020), https://www.wsj.com/articles/california-lawmakers-mandate-racial-diversity-on-corporate-boards-11598915372 (on file with the *Journal of Corporation Law*) ("New legislation passed over the weekend would mandate that publicly traded companies headquartered in the state must have at least one director from a minority community by the close of 2021.").

125. 2020 Cal. Stat. 316.

126. Crest v. Padilla, No. 20STCV37513, 2022 WL 1073294, at *19–20 (Cal. Super. Ct. Apr. 1, 2022).

127. *Id.* at *15.

128. *Id*. at *20.

Recruitment, a non-profit organization from Texas, brought suit against Shirley Weber, California's Secretary of State, arguing that Assembly Bill 979 violates the Equal Protection Clause of the Fourteen Amendment of the U.S. Constitution.[129] On May 15, 2023, Judge John A. Mendez granted summary judgement to the plaintiff, ruling that the legislation is facially unconstitutional for its using of racial quota.[130] The court rejected Weber's arguments that the legislation was necessary to remedy past discrimination and that it merely set a "flexible floor" to encourage diversity. [131]

After these decisions, the last stronghold of the pro-diversity camp is Nasdaq's listing rules. On December 1, 2020, Nasdaq adopted a new policy requiring companies traded on the exchange to comply with its diversity rules or explain their failure to do so.[132] Under Nasdaq's policy traded companies must have at least two diverse directors, among them one who self-identifies "as female and one who self-identifies as either an underrepresented [minority] or LGBTQ+"[133] or explain the reason for their failure to do so. The new rules, likewise, require companies traded on Nasdaq to disclose statistics about board diversity.[134]

Nasdaq's diversity rules generated an unprecedented wave of criticism, attracting rapid fire from The Wall Street Journal and its editors. The Wall Street Journal's editors, reporters, and columnists went on a journalistic crusade against Nasdaq, calling the listing rules "a diversity stunt,"[135] and declared Nasdaq itself "nuts."[136] Furthermore, they predicted that Nasdaq's diversity policy would "make itself even less competitive,"[137] and "harm economic growth and job creation."[138] The Wall Street Journal's editorial board noted that "no one objects to board diversity, but Nasdaq wants to force Americans to pay for its political signaling."[139] The rules withstood a challenge at the Fifth Circuit after they were approved by the U.S. Securities and Exchange Commission ("SEC"). [140]

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129. Alliance For Fair Board Recruitment v. Weber, No. 21-CV-01951, 2023 WL 3481146, at *2 (E.D. Cal. May 15, 2023).

130. *Id.*

131. *Id.* at *5. The court also ruled that the legislation violated the prohibition in 42 U.S.C. § 1981 on the making and enforcement of contracts based on race. *Id.* at *3.

132. Press Release, Nasdaq, Nasdaq to Advance Diversity through New Proposed Listing Requirements (Dec. 1, 2020), https://www.nasdaq.com/press-release/nasdaq-to-advance-diversity-through-new-proposed-listing-requirements-2020-12-01 [https://perma.cc/W6SY-UVHU].

133. *Id.*

134. *Id.*

135. Holman W. Jenkins, Jr., Opinion, *A Nasdaq Chief's Diversity Stunt*, WALL ST. J. (Dec. 8, 2020), https://www.wsj.com/articles/a-nasdaq-chiefs-diversity-stunt-11607469679 (on file with the *Journal of Corporation Law*).

136. Editorial Board, *supra* note 16.

137. Editorial Board, *supra* note 17.

138. *Id.* ("Imposing its own identity politics on some 3,300 listed companies meddles in corporate management and will harm economic growth and job creation.").

139. Editorial Board, Opinion, *Nasdaq and 'Groupthink'*, WALL ST. J. (Dec. 9, 2020), https://www.wsj.com/articles/nasdaq-and-groupthink-11607556598 (on file with the *Journal of Corporation Law*).

140. Alliance for Fair Board Recruitment v. SEC, 85 F.4th 226, 236 (5th Cir. 2023).

II. THE SHORTCOMINGS OF THE EFFICIENCY-BASED OPPOSITION TO BOARDROOM DIVERSIFICATION

The anti-diversity campaign has relied primarily on efficiency arguments. The critics maintain that diversity is likely to harm firms and shareholders. In this Part, we will review the main arguments against the push for boardroom diversity and critically evaluate them.

We would like to make it clear at the outset that there are strong non-utilitarian reasons to favor boardroom diversity. Enhancing diversity on corporate boards can be justified, first and foremost, on grounds of human dignity, fairness, equality, and respect.[141] Furthermore, it can help eradicate barriers in our society and lead to solidarity among individuals with different backgrounds.[142] We wholeheartedly agree with these justifications.

At the same time, we believe it is important to address these "efficiency-based" arguments against diversity. To begin with, capital markets are inextricably related to economics, and we elect to defend diversity from this perspective because, for decades, it has been the bastion of those who sought to preserve the status quo at all costs. Second, we view the argument that diversity would harm the quality of U.S. boards as especially incorrect and damaging. Third, these arguments ignore a whole body of literature on the economics of discrimination, as well as evidence on board quality. Fourth, these arguments took center stage in recent policy debates and litigation of the CA mandate.

In particular, four principal efficiency-based arguments were frequently used in board diversity recent debates and litigation. First, it has been argued that if diversity was efficient firms would have adopted it by now. Thus, when Nasdaq adopted diversity listing standards, the editorial board of the Wall Street Journal, for example explained that:

> Nasdaq 'cited multiple studies which found that greater diversity on boards is associated with improved corporate governance and financial performance.' But if that's true, companies hardly need the Nasdaq to mandate the board's makeup. Or is the Nasdaq suggesting that without its racial and gender orders, companies will eschew the profit motive?[143]

Second, opponents frequently argue that there is a lack of supply of qualified minority candidates, and thus mandates will lower the quality of board members. For example, U.S. Senate Banking Committee Ranking Member Pat Toomey released a statement cautioning against SEC approval of the Nasdaq listing standards when the supply of qualified

141. *See* Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does Difference Make?*, 39 DEL. J. CORP. L. 377, 401 (2014) ("[N]either should boards understate other justifications for diversity, including values such as fairness, justice, and equal opportunity . . . ."); Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 850 ("It is possible that corporations and society cannot effectively manage diversity without acknowledging the moral and social issues that underlie conflicts associated with diversity."); Lissa L. Broome, John M. Conley & Kimberly D. Krawiec, *Dangerous Categories: Narratives of Corporate Board Diversity*, 89 N.C. L. REV. 759, 763 (2011) ("[C]orporate boards should be more diverse because it is the morally correct outcome.").

142. *See, e.g.*, Abraham Bell & Gideon Parchomovsky, *The Integration Game*, 100 COLUM. L. REV. 1965 (2000).

143. Editorial Board, *supra* note 17.

candidates is lacking.[144] Nasdaq's mandate will inevitably pressure companies to subordinate crucial factors such as knowledge, experience, and expertise when selecting board members. These prescriptive requirements may ultimately harm economic growth and investors by pressuring companies to select directors from a narrower pool of candidates and discouraging others from going public.[145] The SEC, however, approved the listing standards, relying on other commentators that "state that finding qualified Diverse directors would not be unduly difficult."[146]

Third, opponents point to evidence that arguably shows that board diversity and mandated quotas harm firm value and performance. In *Crest v. Padilla*, the court mentions that "[e]mpirical research has been inconclusive in showing positive benefits related to company performance, corporate decision-making, or beneficial effects on the representation of women . . . ."[147]

Fourth, and finally, it has been argued that the campaign to diversify is motivated by populist ideology. The court in *Crest* noted this in saying that "S.B. 826's goal was to achieve gender equity or parity; its goal was not to boost California's economy . . . ."[148]

We address each claim in order. The following parts with address each in order, against theory and evidence.

A. The Myth that if Board Diversity was Efficient, Firms would Have Diversified their Boards

The first argument opponents of board diversity raise is that if diversification of boards were efficient, it would happen already. As we will show the exact opposite is true: the lack of board diversity is due to three market failures that combined to keep women and minorities from serving on boards. The first failure is asymmetric information. The second is a social network effect, which limits the pool of potential board candidates to white men. The third is the managerial agency problem that enabled corporate executives to fend off pressures to appoint women and minority candidates.

Strikingly, in their efficiency-based opposition to board diversity, opponents overwhelmingly ignore a significant body of economic literature that shows that discrimination is inefficient, and nevertheless persistent. Credit for this critical insight redounds to the late Gary Becker, who won the Nobel Prize in economics for his pathbreaking work. In 1957, Becker published his innovative work on human capital, in which discrimination was a core focus. He used economic tools to analyze discrimination in the labor market as early as 1955 when he wrote his doctoral dissertation.[149]

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144. *Id.*

145. United States Senate Comm. on Banking, Hous., & Urb. Aff's, *supra* note 20.

146. Nasdaq Stock Market LLC, Order Approving Proposed Rule Changes, Exchange Act Release No. 34-92590, SR-NASDAQ-2020-081; SR-NASDAQ-2020-082 (Aug. 6, 2021), https://www.sec.gov/rules/sro/nasdaq/2021/34-92590.pdf [https://perma.cc/8FKT-2SAQ].

147. Crest v. Padilla, No. 19STCV27561, 2022 WL 1565613, at *7 (Cal. Super. Ct. May 13, 2022).

148. *Id.* at *5.

149. *See* Pedro Nuno Teixeira, *Gary Becker's Early Work on Human Capital - Collaborations and Distinctiveness*, 3 IZA J. LAB. ECON., Nov. 2014, at 1, 4 ("In [his doctoral dissertation], Becker analyzed discrimination by using a neoclassical framework and producing quantified indications of the importance of this phenomenon, measured by what he called the 'discrimination coefficient.'").

Becker's rigorous analysis shows how discrimination is not only pernicious to employees but also economically harms discriminating employers, who must pay a higher price for labor, and pass on top talent.[150] Of course, egalitarian, or non-discriminating, employers did not bear that cost. Furthermore, they could gain an important advantage in the marketplace by hiring workers from excluded groups. Competition therefore reduces discrimination. Becker cautioned that competition will not necessarily root out discrimination if consumers prefer to do business with discriminating companies, if fellow employees also have a taste for discrimination, if labor markets are segregated, or if discriminatory preferences are sufficiently widespread among employers.[151] Becker demonstrated that competitive forces might not be sufficient to wipe out costly discrimination.[152]

Furthermore, markets are seldom perfectly competitive,[153] and to that extent, Becker's analysis provides a testable prediction—inefficient discrimination should be more salient in concentrated markets. Consistent with this prediction, empirical studies found that discrimination is negatively correlated with how competitive markets are.[154] Furthermore, directly on point, Ruth Mateos de Cabo, Ricardo Gimeno, and Lorenzo Escot found a negative association between industry concentration and the proportion of females on boards in Spanish firms.[155] The authors interpreted these findings to be "in line with the dynamics predicted by Becker's theory, that discrimination is less likely in competitive sectors."[156]

We would like to emphasize that we do not think that it was the discriminatory preferences of consumers or employees, per Becker's hypothesis, that prevented board diversification. We believe that the problem lies elsewhere. It is notable, however, that Becker himself did not accept the assumption that competition would wipe out inefficient discrimination. Furthermore, following Becker, several prominent economists, among them Nobel prize winners, identified additional impediments to markets' power to correct inefficient discrimination.

We argue that the lack of board diversity is due to three factors: (1) asymmetric information and prejudice; (2) social networks; and (3) the managerial agency problem. Each of these was established separately as an impediment to efficiency and market correction.

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150. GARY S. BECKER, THE ECONOMICS OF DISCRIMINATION (2nd ed. 1971) (discussing the economic effects of discrimination); *see also* Jacob E. Gersen, *Markets and Discrimination*, 82 N.Y.U. L. REV. 689, 698 (2007) ("[D]iscriminating firms will also earn lower profits than nondiscriminating firms because of their labor costs."); Richard A. Posner, *The Efficiency and the Efficacy of Title VII*, 136 U. PA. L. REV. 513, 514 (1987) (discussing John Donohue's argument regarding the efficiency of Title VII, which builds on Becker's theory of racial discrimination and recognizes, "[w]hite employers who are not averse to such associations will have lower labor costs and will therefore tend to gain a competitive advantage over their bigoted competitors").

151. *See* BECKER, *supra* note 147, at 46–83.

152. *See id.* at 46–54 (providing an analysis of labor discrimination in monopolistic industries).

153. *See* James J. Heckman, *Detecting Discrimination*, 12 J. ECON. PERSP. 101, 112 (1998) (noting that "[o]nly if the supply of entrepreneurship is perfectly elastic in the long run at a zero price, so entrepreneurs have no income to spend to indulge their tastes," and even then, he explains "[i]t may take decades for the effects of past discrimination in employment . . . to fade out of the labor market").

154. *See, e.g.*, Ken S. Cavalluzzo, Linda C. Cavalluzzo & John D. Wolken, *Competition, Small Business Financing, and Discrimination: Evidence from a New Survey*, 75 J. BUS. 641, 644 (2002) (finding that African Americans were less likely to receive credit in more concentrated financial markets).

155. Ruth Mateos de Cabo, Ricardo Gimeno & Lorenzo Escot, *Disentangling Discrimination on Spanish Boards of Directors*, 19 CORP. GOVERNANCE: AN INT'L REV. 77, 78 (2011).

156. *Id.*

As we show in the case of corporate boards, all three existed and contributed to the persistence of inefficient discrimination.

The first factor—prejudice and asymmetric information—was identified by another Nobel Prize Laureate, Kenneth Arrow. Arrow showed that a lack of information, combined with wrong prior beliefs, may sustain a discriminatory inefficient equilibrium.[157] If discrimination is so extreme that it results in non-hiring (as opposed to hiring with lower wages)—namely, with labor market segregation—prior wrong beliefs might not be corrected and inefficiencies will remain.[158]

Notably, in contrast to Becker's theory, Arrow's "Statistical Discrimination" theory shows that inefficient discrimination may occur and persist with no taste for discrimination. Rather, employers with partial information hire based on their misguided belief that certain groups are less productive.[159] Their hiring patterns, however, prevent them from learning and correcting their wrong and costly beliefs. In segregated markets, their learning is close to zero, and accordingly, there is zero correction of their misguided beliefs and segregation.[160]

The second factor—social networks—was also analyzed by Arrow.[161] Arrow observed that social networks may create and perpetuate discrimination. The economic literature on network effects demonstrates that networks have a positive side and a negative side. Social networks can create tremendous value for members,[162] the "in-crowd." The positive aspect of networks can be seen in the contexts of telecommunication and credit cards. The more businesses accept a credit card, the more valuable it is for the holder. The same is true of social and professional networks, such as Facebook, Instagram or LinkedIn. As the network grows, members have access to more individuals and content. The downside of networks is experienced by outsiders, individuals who are not part of the network and cannot share the positive effects. Not all networks are open to everyone and, for those who cannot join them, networks represent a barrier to entry.

Arrow observed that social networks and interactions might contribute to the sustainability of inefficient discrimination.[163] Furthermore, he explained how social networks can stunt the efficient allocation of labor:

> The network concept of labor allocation differs considerably from a market. It is indeed very easy to say how social segregation can give rise to labor market

157. *See* Arrow, *Theory of Discrimination*, *supra* note 24, at 23–32.

158. *See* Arrow, *Economics and Discrimination*, *supra* note 24, at 97 ("[T]o the extent that discrimination takes the form of segregation, then there will in fact be little experimentation to find out abilities . . . the very fact of segregation will reinforce beliefs in racial differences.").

159. *See* Arrow, *Theory of Discrimination*, *supra* note 24, at 23 ("There is an alternative interpretation of employer discrimination. It can be thought of as reflecting not tastes but perception of reality.").

160. *See supra* note 157 and accompanying text.

161. *See* Arrow, *Economics and Discrimination*, *supra* note 24, at 97–98.

162. *See, e.g.*, Ariel Porat & Robert E. Scott, *Can Restitution Save Fragile Spiderless Networks?*, 8 HARV. BUS. L. REV. 1, 13 (2018) ("In short, the network [of firms] serves as a club good that reduces contracting costs and enhances innovation opportunities for network members."); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 488–89 (1998) ("The value of the telephone or fax machine one has already purchased increases with each additional purchaser, so long as all machines operate on the same standards and the network infrastructure is capable of processing all member communications reliably.").

163. *See* Arrow, *Economics and Discrimination*, *supra* note 24, at 98.

> segregation through network referrals. Discrimination no longer has any cost to the discriminator; indeed, it has social rewards. Profit maximization is overcome by the values inherent in the maintenance of the network or other social interaction.[164]

Developing the point further, Arrow wrote that the problem is especially acute in the context of labor markets where "personal interactions occur throughout this process, and therefore there is plenty of room for discriminatory beliefs and preferences to play a role which would be much less likely in a market subject to competitive pressures."[165] Arrow's analysis explains why there is an under-representation of women and minorities on corporate boards. Directors and the managers who appoint them belong to the same social network and in many cases have had prior interactions.[166] Unsurprisingly, when it comes to board appointments, managers, by and large, propose directors they know, people they have interacted with; in other words, individuals similar to them. This course of action has perpetuated a dynamic of homogenous board selections.

In a recent article, Isabelle Allemand and coauthors found that social networks reduce the likelihood of a female being nominated to a board by 28%.[167] They also found that mandated quotas mitigated the adverse effects of networks on female nominations.[168] Another study that looks at the death of minority and non-minority directors finds that the market reaction to the death of a female director is negative and stronger than the market reaction to the death of a non-minority director.[169]

The third factor that prevents board diversification from occurring is a more familiar one: the managerial agency problem. The division of ownership and managerial powers is the hallmark of the modern public corporation. This feature has enabled corporations to attract investments from multiple individuals, but it has also given rise to the managerial agency problem. The common lore in the corporate world is that disparate shareholders have neither the means nor the incentive to monitor management.[170] A vast literature suggests that the management controls the appointment process of directors. As Lucian

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164. *Id*. at 98.

165. *Id*.

166. *See* Amanda K. Packel, *Government Intervention into Board Composition: Gender Quotas in Norway and Diversity Disclosures in the United States*, 21 STAN. J.L. BUS. & FIN. 192, 198 (2016) (book review) ("The board nomination process relies very heavily on the social networks of existing directors, which tends to result in newly appointed directors with sociodemographic characteristics similar to those of existing directors."); Darren Rosenblum & Yaron Nili, *Board Diversity by Term Limits*, 71 ALA. L. REV. 211, 228 (2019) ("Nominating committees tend to choose people who have skills familiar and similar to theirs. Leaders find replacements for themselves in a process of corporate elite reproduction.").

167. Allemand et al., *supra* note 29, at 784.

168. *Id.*

169. Thomas Schmid & Daniel Urban, *Female Directors and Firm Value: New Evidence from Directors' Deaths*, 69 MGMT. SCI. 2449 (2023).

170. *See* Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 545 (2000) ("In the United States . . . stockholders are fragmented and distant from the firm, with each unwilling individually to invest heavily in monitoring their managerial agents and in making those agents toe the line to perform for shareholders."); M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation when Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1558 (2007) ("[S]hareholders are by and large dispersed and hold relatively small stakes in the firm, and therefore each shareholder is unwilling to incur monitoring costs since the benefits will inure to all shareholders without regard to who spent the time or money to monitor.").

Bebchuk and Jesse Fried explain: "dissidents putting forward their own director slate confront substantial impediments, and such challenges are therefore exceedingly rare. Typically, the director slate proposed by management is the only one offered."[171]

The management's effective control of the board selection process explains why women and minority candidates found it so difficult to be appointed to boards. The board is responsible for monitoring management, setting executive compensation, and holding them accountable if needed. As a result, managers have strong incentives to nominate their allies and peers as directors. Moreover, there is an element of reciprocity in the process. Often, board members are themselves executives of another company and can therefore return the favor by appointing the managers who selected them as directors in the companies where they are officers.[172]

Diverse, newly appointed directors, without ties to management, are more likely to be more probing and less acquiescing.[173] They are also more likely to challenge management proposals. As one director-interviewee blatantly put it: "It is hard to vote against the CEO if you are going to see him that weekend at the country club."[174] Indeed, evidence suggests that "diverse boards are more likely to hold CEOs accountable for poor stock price performance."[175] Thus, managers' personal interest is skewed against board diversity.

Equally important, not only do managers have clear incentives to nominate directors who are close to them, but they also do not bear the inefficiency costs that discrimination imposes on their firms. Economic models of discrimination assume that the employer, as an entrepreneur, bears the inefficiency cost. Managers of large diverse firms are only agents, and the costs of discrimination fall on the shareholders' shoulders.

The theoretical insights from economics, finance, and law provide a clear and consistent explanation for the lack of diversity on corporate boards. But how big was the problem? The problem was profound, deeply entrenched, and global. So much so that many countries used legislation to affect boardroom diversity. In 2003, Norway became the first country in the world to mandate gender quotas for boards.[176] Several European countries, including Belgium, France, Finland, Germany, Iceland, and Italy followed suit, adopting legislation "requiring firms to appoint between 30 and 40% of women into corporate

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171. Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSPS. 71, 73 (2003) (citation omitted); *see also* Lucian A. Bebchuk, *The Myth of Shareholder Franchise*, 93 VA. L. REV. 675, 693 (2007) (finding that between 1996–2005 incumbent managers faced no challenges in close to all annual elections).

172. Especially since now these two executives will have incentives to reward each other. *See, e.g.*, Kevin F. Hallock, *Reciprocally Interlocking Boards of Directors and Executive Compensation*, 32 J. FIN. & QUANTITATIVE ANALYSIS 331, 332 (1997) ("If two CEOs, or their subordinates, serve on each other's boards (they are reciprocally interlocked), then these CEOs may have both the incentive and the opportunity to raise each other's pay.").

173. Jared Landaw, *Maximizing the Benefits of Board Diversity: Lessons Learned from Activist Investing*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 14, 2020), https://corpgov.law.harvard.edu/2020/07/14/maximizing-the-benefits-of-board-diversity-lessons-learned-from-activist-investing [https://perma.cc/D395-R4CF] ("[D]irectors may be long-tenured, have ties to the same community, or have long-standing personal or business relationships with the CEO, each of which can potentially weaken their ability to oversee management effectively.").

174. *Id.*

175. *See* Adams & Ferreira, *supra* note 41, at 292.

176. Heike Mensi-Klabach & Catherine Seierstad, *Gender Quotas on Corporate Boards: Similarities and Differences in Quota Scenarios*, 17 EUR. MGMT. REV. 615, 616 (2020) ("In 2003, Norway became the first country to introduce a [corporate board quota], having major international impact.").

boards."[177] Kenya, too, adopted a similar legislative mandate.[178] The United Kingdom chose to avoid a mandatory solution and opted for a voluntary approach. In 2017, the UK government "published the Hampton Alexander report which recommends FTSE 100 companies to have 33% females in their leadership teams by 2020."[179]

What distinguishes the United States from other countries is not the problem, but rather the nature of the solution. Whereas all other countries elected to remedy the problem of lack of boardroom diversity via a public solution, the United States, except California, left it to the private sector to contend. For this reason, in the United States, change was slower to come. The main takeaway from our comparative survey is, however, that market forces alone did not suffice to lead corporations to change the gender and racial composition of boardrooms. In Europe, it took a legislative intervention to force a change. In the United States, the main impetus for the change came from institutional investors, activists, and Nasdaq. Of course, California, too, ought to be thanked. Corporate officers and directors, if left to their own devices, would not have rushed to embrace diversity—not in the present, at least. Accordingly, women and minorities who become directors should not view themselves as "tokens" or beneficiaries of affirmative action. Rather, they should perceive themselves as recipients of positions that should have been theirs long ago based on merit.

B. The Myth that there is an Insufficient Number of Qualified Minority Candidates

A second oft-cited argument against diversity on corporate boards is that there are simply not enough minority candidates and women who can serve as directors. Board diversity opponents frequently raise this argument. In his criticism of the SEC's approval of Nasdaq's listing rules, Senator Pat Toomey, a member of the U.S. Senate Banking Committee, stated:

> By defining diversity by race, gender, and sexual orientation, NASDAQ's mandate will inevitably pressure companies to subordinate crucial factors such as knowledge, experience, and expertise when selecting board members. These prescriptive requirements may ultimately harm economic growth and investors by pressuring companies to select directors from a narrower pool of candidates and discouraging others from going public. I'm disappointed Chairman Gensler is turning a financial regulator into a laboratory for progressive social engineering.[180]

177. Sanjukta Brahma, Chioma Nwafor & Agyenim Boateng, *Board Gender Diversity and Firm Performance: The UK Evidence*, 26 INT'L J. FIN. & ECON. 5704, 5705 (2021) ("To increase female representation at board level, other countries including Germany, Norway, Spain, France, Iceland, Italy, Belgium, Finland, and Kenya have introduced a legislative quota requiring firms to appoint between 30 and 40% of women into corporate boards.").

178. *Id*.

179. *Id*.

180. *See* Press Release, *supra* note 20.

This argument is not new. It is a staple in the writings against affirmative action. It is also highly damaging since it encourages women and minority "tokenism".[181] Echoing this argument, Judge Green rejected California's Secretary of State's argument that a quota is needed to correct discrimination in board selection.[182] One basis for rejection was that the government did not provide relevant evidence to prove discrimination. While Judge Green acknowledges that "the Legislature spotted an issue; corporate board seats, by and large, belong to members of one race, sexual orientation, and gender identity."[183] The government he explains, merely provided aggregate statistics that demonstrate underutilization of minorities on boards, as compared to their proportion in the population, citing *Connely*:

> Under equal protection principles, the use of statistical underutilization to establish hiring goals suffers from a fatal flaw . . . . [W]hile statistical underutilization may serve as significant evidence of prior discriminatory hiring practices, it is not conclusive and is not, in itself, proof of discrimination. There may be explanations other than discrimination for statistical variations, and detailed consideration of past hiring.[184]

Underscoring the problem with adopting a presumption of discrimination merely based on under-representation, Judge Green explains: "[b]ut the general population is manifestly not the qualified talent pool for corporate board seats. While anyone off the street might someday become the sort of person who sits on boards, it is absurd to suggest that any member of society, selected at random, would presently fit that bill."[185]

The judge then goes on to express his frustration that the governance did not provide evidence that pertains to whether there is a disparity of treatment between minority and non-minority *qualified* candidates.[186]

Opponents of board diversification are skeptical about the supply of qualified minority candidates and accordingly argue that the pressure to diversify is likely to lead to nominations of less qualified board members. Yet, they do not bring any evidence to support this argument. Worse, as this section will show, they ignore a body of evidence that refutes this concern.

The question of whether diverse candidates are qualified is ultimately an empirical one. Diversity detractors ignore a body of evidence that shows that minority directors are either similarly, or more, qualified than non-minority directors. This body of evidence suggests that there is no shortage of supply of qualified minority directors and is consistent with Gary Becker's predictions for markets that are infused with inefficient discrimination. Indeed, there is no evidence that newly appointed minority directors reduce the quality of U.S. boards, that incumbent minority directors are less qualified than their fellow non-minority directors, or that the supply of qualified minority candidates is limited. Quite the

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181. Chip Cutter, *Companies Face New Pressures to Diversify Boards. It's Sensitive*, WALL ST. J. (Dec. 7 , 2020), https://www.wsj.com/articles/companies-face-new-pressures-to-diversify-boards-its-sensitive-11607380004 (on file with the *Journal of Corporation Law*).

182. *See* Crest v. Padilla, No. 20STCV37513, 2022 WL 1073294, at *20 (Cal. Super. Ct. Apr. 1, 2022).

183. *Id.* at *1.

184. *Id.* at *13.

185. *Id.* at *14.

186. *Id.* at *15 ("The Secretary has not produced evidence of discrimination which this court could find "convincing" under *Connerly*. Their statistics do not have a proper comparison group—they have no measurement of the qualified talent pool, and thus they cannot show a proper statistical disparity.").

contrary, results from different studies suggest that incumbent as well as newly nominated minority candidates are not less qualified, and in some cases are more qualified than incumbent and newly appointed non-minority directors.

Begin with incumbent directors. Laura Casares Field, Mathew E. Souther, and Adam S. Yore, who studied U.S. boards between 2006 and 2017, found that female and minority directors were more educated and experienced than white male board members.[187] These authors also found that these female directors were less likely to fill leadership positions despite their higher qualifications.[188] Similarly, Amy J. Hilmman, Albert A. Cannella, and Ira C. Harris studied the qualifications of minority directors relative to white males in Fortune 1000 firms.[189] They found that minority directors and female directors had less business experience but were more educated.[190]

Evidence from recent nominations supports the conclusion that women and minority candidates are more qualified than white males. A recent study by Anete Pajuste, Maksims Dzabarov, and Romans Madesovs found that following the murder of George Floyd, between May 26, 2020 and July 15, 2021, S&P 500 firms nominated 107 new black directors, an increase of almost 25%, relative to the number of incumbent black directors.[191] In comparison, during the same time, 198 white directors were added, an increase of approximately 4% over the number of white incumbents.[192] Comparing the qualifications of black and white directors that were nominated, Pajuste and coauthors found that the new black directors had significantly higher number of academic and professional qualifications than the other new directors.[193] The new black directors had similar qualifications to the incumbent black directors and significantly higher qualifications than other incumbent directors.[194] In sum, even in these unusual circumstances, firms increased the number of black directors by 25%, not only did the quality of board members not decline, but rather the new black directors increased the average quality of boards.[195] These results are consistent with a deep supply of minority candidates.

Another recent study by Daniel Greene, Vincent Intintoli, and Kathleen Kahle utilized the passage of CA 826 to test the depth of the supply of female directors.[196] The authors constructed a qualifications index of 18 qualifications and characteristics, including financial/accounting, legal/consulting, management, academic, political, military, and venture capital (VC) experience, age, and education, to compare the quality of quota nominations

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187. Laura Casares Field, Mathew E. Souther & Adam S. Yore, *At the Table but Cannot Break through the Glass Ceiling: Board Leadership Positions Elude Diverse Directors*, 137 J. FIN. ECON. 787, 790 (2020).

188. *Id.* at 787 ("[D]iverse directors are significantly less likely to serve in leadership positions despite possessing stronger qualifications than nondiverse directors.").

189. Amy J. Hillman, Albert A. Cannella, Jr. & Ira C. Harris, *Women and Racial Minorities in the Boardroom: How do Directors Differ?* 28 J. MGMT. 747, 748 (2002).

190. *Id.* at 759.

191. Of the firms that added black directors, they found that 53 had no black director prior to the murder. *See* Pajuste, Dzabarovs & Madesovs, *supra* note 35, at 172.

192. *Id.* at 180.

193. *Id.* at 172.

194. *Id.*

195. *Id.*

196. Daniel Greene, Vincent J. Intintoli & Kathleen M. Kahle, How Deep is the Labor Market for Female Directors? Evidence from Mandated Director Appointments 1 (Feb. 28, 2023) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3943718.

to the quality of incumbent directors.[197] They found that despite the large number of new female appointments, director qualifications in California remained stable after the legislation became effective.[198] Furthermore, the authors reported positive stock price reactions to the appointment of quota female directors.[199]

Finally, studying all firms that were listed on NYSE or Nasdaq, Vicky L. Bogan, Katya Potemkina, and Scott E. Yonker similarly found that black directors that were appointed following BLM protests, the California mandate, and the Nasdaq listing standards, were not less qualified than incumbent black directors.[200] These results, the authors conclude, "are inconsistent with the notion that the supply of minority directors being insufficient to meet the increased demand."[201] Rather, referring to Becker's model, the authors suggest that results are consistent with "racial bias or taste based discrimination."[202]

The forgoing literature provides evidence against the argument that there is a lack of supply of qualified minorities. The empirical evidence, thus, does not support the argument that board diversity will lower the quality of U.S. boards. Overall, the results are more consistent with discrimination, either taste-based or driven by management interest, networks, and lack of knowledge, as the main driver of the lack of diversity on U.S. boards.[203] Accordingly, the pressure to diversify is not likely to harm firms and has a potential to contribute to firm's success.

C. The Myth that Board Diversity Harms Firm Performance

Opponents rely on several studies that arguably show that board diversity has a negative effect on firm value. In this Part, we will address the literature on the effects of board diversity on firm performance and explain the empirical challenges they face. We will pay especially close attention to the studies that opponents point to.

At the outset, we would like to note that studies on the effect of board diversity on firm performance suffer from significant empirical challenges and limitations. To begin with, testing the effects of corporate governance changes (including board diversity) on firm performance is filled with empirical challenges, and the results are seldom robust. Second, if board diversity has a potential to improve firm performance, as Becker's theory suggests,[204] we do not expect to see significant short-term effects of changes to diversity on firm value. Achieving a critical mass of diversity on corporate boards, gaining experience, gaining influence, and making changes, inevitably takes time. Moreover, empirical studies suggest that it is not enough to appoint one woman director and expect firm performance to improve. Several studies from different countries support the "critical mass"

197. *Id.* at 5.

198. *Id.* at 2–3 (finding that despite a surge in female appointments, director qualifications remain stable when benchmarked to control groups, indicating a deep labor market).

199. *Id.* at 6.

200. Vicky L. Bogan, Ekaterina Potemkina & Scott E. Yonker, What Drives Racial Diversity on U.S. Corporate Boards? 60 (Mar. 27, 2024) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3952897.

201. *Id.* at 7.

202. *Id.* at 8.

203. *Id.* at 6 (stating that their study suggests "that racial bias (due to discrimination or limited attention) played a central role in the lack of racial diversity on corporate boards").

204. Brahma, Nwafor & Boateng, *supra* note 177, at 5706.

theory of diversity, which suggests that unless there are two or more women in the boardroom, female representation is unlikely to motivate significant improvement in performance.[205] Empiricists tend to converge on three as the magic number. As James Kristie sharply put it: "one is a token, two is a presence, three is a voice."[206] Consistent with this finding, Miriam Schwartz-Ziv, who studied minutes of board meetings, reported that women directors tend to be more active in board discussions when there are three or more female board members.[207] Consistent with this skepticism, the evidence of the effect of board diversity on firm performance, perhaps unsurprisingly, is inconclusive.[208] The evidence that critics mention has already been refuted by recent studies.

The most famous study that critics point to as evidence that mandates could harm firm value, by Kenneth Ahren and Amy Ditmmar, found that the passage of Norway's mandated board gender diversity quota resulted in a stock market decline of an average of 3.5%.[209] The authors further found that the decline was larger among firms with a "larger shortfall", that is firms that had to add more female directors to meet the quota.[210] Finally, the negative effects persisted over several years after the mandated quota was applied. David Matsa and Amalia Miller provided a potential explanation for the short-term negative response.[211] In particular, they found that firms with female directors were less likely to fire employees in difficult times, and thus had higher short-term operational costs, and lower short-term operational revenues.[212] However, another study by Knut Nygaard defined a different event window for the passage of the law, which lead to opposite findings from Ahren and Ditmmar, that is, a positive market response to the Norway mandate.[213] Thus, the evidence

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205. *Id.* at 5705; *see also* Alison M. Konrad, Vicki Kramer & Sumru Erkut, *Critical Mass: The Impact of Three or More Women on Corporate Boards*, 37 ORGANIZATIONAL DYNAMICS 145, 146 (2008) ("First, multiple women help to break the stereotypes that solo women are subjected to. Second, a critical mass of women helps to change an all-male communication dynamic. Third and finally, research on influence and conformity in groups indicates that three may be somewhat of a 'magic number' in group dynamics, which suggests that having three women may be particularly beneficial for creating change."); Yu Liu, Zuobao Wei & Feixue Xie, *Do Women Directors Improve Firm Performance in China*? 28 J. CORP. FIN. 169, 170 (2014) ("[W]e find that boards with three or more female directors have a much stronger impact on firm performance than boards with two or fewer, supporting the critical mass theory . . . .").

206. James Kristie, *The Power of Three*, DIRS. & BDS., Third Quarter 2011, 22, 22.

207. *See* Miriam Schwartz-Ziv, *Gender and Board Attractiveness: The Role of a Critical Mass*, 52 J. FIN. & QUANTITATIVE ANALYSIS 751, 763 (2015) ("Indeed, the results show that a critical mass of at least 3 women directors . . . significantly increases the likelihood of the board requesting an update . . . and taking an initiative . . . .").

208. *See generally* Holger Spamann & Jacob Fisher, *Corporate Purpose: Theoretical and Empirical Foundations/Confusions* (Eur. Corp. Governance Inst., Law Working Paper No. 664, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4269517 (explaining that current studies do not prove that board diversity affects firm performance).

209. Kenneth R. Ahern & Amy K. Dittmar, *The Changing of the Boards: The Impact on Firm Valuation of Mandated Female Board Representation*, 127 Q. J. ECON. 137, 139 (2012).

210. *Id.*

211. David A. Matsa & Amalia R. Miller, *A Female Style in Corporate Leadership? Evidence from Quotas*, 5 AM. ECON. J.: APPLIED ECON. 136, 144–48 (2013).

212. *Id.* at 165.

213. *See* Knut Nygaard, *Forced Board Changes: Evidence From Norway* 3, (NHH Dept. of Econ., Working Paper No. 5, 2011), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1793227 (finding a positive market response to the Norway mandate, for a different event window); *cf.* Olga Kuzmina and Valentina Melentyeva,

concerning the market response to the Norway mandate was considered to vary depending on the event window chosen.[214] More importantly, in a recent study, B. Espen Eckbo, Knut Nygaard, and Karin S. Thorburn demonstrate how both the short-term and long-term effects that Ahren and Dittmar identified do not survive a more careful analysis, which takes into account confounding events, correlations with compliance levels, noise, and other empirical challenges.[215] For example, they show that the Ahren and Dittmar event window included an announcement that reduced the likelihood of the quota passing, which when taken into account produces the opposite conclusion; that the market responded positively to the mandated quota.[216] In addition to refuting the Ahren & Dittmar results, the Eckbo study demonstrates how difficult it is to assess board diversity's effects on firm performance.

Second, board diversification critics also point to studies that analyze the market reaction to California's statutory gender mandates. Felix von Meyerinck, Alexandra Niessen-Ruenzi, Markus Schmid, and Steven Davidoff Solomon found that the legislation caused negative announcement returns of 2.6 percent for California firms, as well as large spillover effects [of -1.9 percent] for non-California firms.[217] Similar results were shown by other studies of California's law.[218] Yet, event studies only assess the market reaction in a short window of one-to-two days following the announcement of the law's passage. Thus, these results, while important, may not reflect the long-run effects of the California law that took effect in 2018.[219] Furthermore, as Arrow's statistical discrimination approach suggests, the market might underestimate the contribution of minority directors.

Equally important, the market reaction to the mandate can reflect other sentiments. Indeed, von Meyerinck and coauthors hypothesize that their findings may be due to what

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Gender Diversity in Corporate Boards: Evidence from Quota-Implied Discontinuities 23 (ZEW – Ctr. For Eur. Econ. Rsch., Working Paper No. 21-023, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3805617)(analyzing the long-term effect of mandated quotas in Norway, UK, Spain and reporting that a 10 percent increase in the proportion of females on boards increases firms Tobin's Q by 2 percent.).

214. *See* Matsa & Miller, *supra* note 211, at 139 ("Event studies of the stock market reaction to these policies find opposite results, depending on which announcement date is examined.") (citation omitted).

215. *See generally* B. Espen Eckbo, Knut Nygaard & Karin S. Thorburn, *Valuation Effects of Norway's Board Gender-Quota Law Revisited*, 68 MGMT. SCI. 4112 (2022); *see also* Spamann & Fisher, *supra* note 208.

216. See Eckbo, Nygaard & Thorburn, *supra* note 215, at 4113 ("[W]e show that AD missed a second important event inside their five-day event window that lowered this prior probability . . . .[U]sing AD's event study methodology, we show that the negative market reaction reported by AD should have been attributed to this second, probability-reducing event, which effectively reverses their main conclusion.").

217. Felix von Meyerinck et al., *As California Goes, So Goes the Nation? Board Gender Quotas and the Legislation of Non-Economic Values* 1, 3 (Eur. Corp. Governance Inst., Working Paper No. 785, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3303798.

218. *See generally* Daniel Greene, Vincent J. Intintoli & Kathleen M. Kahle, *Do Board Gender Quotas Affect Firm Value? Evidence from California Senate Bill No. 826*, 60 J. CORP. FIN., Article 101526 (2019) (finding negative effect, and explaining it by lack of supply of female directors); Sunwoo Hwang, Anil Shivdasani & Elena Simintzi, *Mandating Women on Boards: Evidence from the United States* (Kenan Inst. of Priv. Enter., Research Paper No. 18-34, 2021), https://ssrn.com/abstract=3265783.

219. Applying an Event Study methodology, the study tests the effect of the legislation over a short window, right after the event. *See* Meyerinck et al., *supra* note 217, at 6 ("[W]e use three alternative abnormal return measures, estimated over event windows that range from two to five days in length."). Thus, it reports only the short-term market response. Furthermore, it is possible that the effect is confounded by other investors' concerns. *Id.* at 16 ("We hypothesize that the adoption of the gender quota signals California's general willingness to legislate non-economic values.").

they call shareholder aversion to "legislation of non-economic values."[220] In particular, they suggest that the negative reaction reflects an uncertainty among investors as to whether the legislation signals a shift toward social legislation that at times might not be efficient.[221]

Finally, Daniel Greene, Vincent J. Intintoli, and Kathleen M. Kahl similarly found a negative market response to the passage of the California gender diversity mandate.[222] They found larger negative results for firms that operate in industries that have low proportions of female CEOs and Directors and interpreted the results to suggest that the market response reflects concerns of supply shortage. Yet in a following study described above, the same authors found that the quality of new nominees was not lower than those of incumbent directors and that the market responded positively to these nominations.[223] The authors concluded that "[o]verall, the evidence suggests that the female director labor market is sufficiently deep to satisfy the SB 826 mandate."[224]

On the other hand, it is well known that a long line of studies has found a positive association between board diversity and firm performance. Diversity is positively associated with firm value, Return on Equity (ROE), Return on Invested Capital (ROIC), and other performance measures. For example, a study from 2004 that surveyed the performance of Fortune 500 companies reported that the percentage of female top executives was positively correlated with return on equity and share prices.[225] The return on equity of companies with the highest representation of women in their highest managerial echelons was 35% better relative to companies with the lowest representation of women, and the total returns to shareholders were 34% higher.[226] Similarly, a 2010 study by David Carter, Frank D'Souza, Betty Simpkins, and Gary Simpson found a positive correlation between the number of female directors and return on assets for S&P 500 firms for the years 1998 to 2002.[227] The association between diversity and performance has strengthened in recent years. For example, a 2019 McKinsey report finds that firms "in the top quartile for gender

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220. *Id*. at 4. Furthermore, event study results are sensitive and could vary with minor differences like the length of the event definition. *See* Matsa & Miller, *supra* note 211, at 139 ("Event studies of the stock market reaction to these policies [board mandated quota] find opposite results, depending on which announcement date is examined.") (citation omitted).

221. Meyerinck et al., *supra* note 217, at 5.

222. *See* Greene, Intintoli & Kahle, *supra* note 218.

223. Greene, Intintoli & Kahle, *supra* note 196, at 20–23.

224. *Id.* at 5.

225. CATALYST, THE BOTTOM LINE. CONNECTING CORPORATE PERFORMANCE AND GENDER DIVERSITY 1 (2004), https://www.catalyst.org/wp-content/uploads/2019/01/The_Bottom_Line_Connecting_Corporate_Performance_and_Gender_Diversity.pdf [https://perma.cc/78B7-C5FY] ("Catalyst used two measures to examine financial performance: Return on Equity (ROE) and Total Return to Shareholders (TRS). Upon examining 353 Fortune 500 companies, Catalyst found that there is a connection between gender diversity and financial performance.").

226. *Id*. at 2 ("The group of companies with the highest representation of women on their top management teams experienced better financial performance than the group of companies with the lowest women's representation. This finding holds for both . . . Return on Equity (ROE), which is 35.1 percent higher, and Total Return to Shareholders (TRS), which is 34.0 percent higher.").

227. David A. Carter et al., *The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance*, 18 CORP. GOVERNANCE: AN INT'L REV. 396, 410 (2010) ("The results of our estimation of fixed effect regression equations indicate a positive and significant relationship between both the number of women on the board and the number of ethnic minorities on the board and the [return on assets].").

diversity on executive teams were 25% more likely to have above-average profitability than companies in the fourth quartile."[228] Importantly, this is an increase from 21% in a 2017 McKinsey report and 15% in a 2014 McKinsey report.[229] Firms in the top quartile for ethnic diversity were 36% more likely to perform better.[230] According to the latest McKinsey diversity report the "business case for inclusion and diversity is stronger than ever."[231] Similarly, the Carlyle group found that between 2017 and 2020 the earnings growth of firms with at least two diverse board members was five times faster than firms with no diverse board members.[232] Finally, a 2019 study by FCLTGlobal found that a portfolio of the top 20% of firms with the most diverse boards outperformed a portfolio of the bottom 20% by more than three percentage points.[233]

Yet, as critics correctly pointed out, correlation is not causation. The fact that firms with diverse boards perform better does not prove that diversity improves value.[234] Rather, it could be that firms with better performance are also more likely to nominate diverse directors. Indeed, an important study that they point to, by Renee Adams and Daniel Ferreira, found a strong positive association between board gender diversity and firm performance according to data from 1996–2003.[235] Yet, when they applied firm fixed effects and an IV instrument to explore whether this relationship is causal, the sign of the coefficient flipped, suggesting a negative effect of diversity on firm performance.

This study too, however, does not provide the evidence that opponents claim to have. To begin with, since Adams and Ferreira analyzed data from more than two decades ago, diversity rates, as well as the number of diverse candidates on each board, were very low, to the point that it could affect the results. More importantly, older studies are based on firms that chose diversity *voluntarily*, and not as a result of outside pressure by funds or a mandated quota. Yet, as one of us has argued in previous work, those early movers—firms that are quick to adopt constraints voluntarily—are also firms that have better governance

228. *Most Diverse Companies Now More Likely than Ever to Outperform Financially*, MCKINSEY & CO. (June 19, 2020), https://www.mckinsey.com/featured-insights/coronavirus-leading-through-the-crisis/charting-the-path-to-the-next-normal/most-diverse-companies-now-more-likely-than-ever-to-outperform-financially [https://perma.cc/9B6F-4RXW].

229. *Id.*

230. *Id.*

231. *Diversity Wins: How Inclusion Matters*, MCKINSEY & CO. (May 19, 2020), https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters [https://perma.cc/4292-XX4R].

232. JASON M. THOMAS & MEGAN STARR, GLOBAL INSIGHTS: FROM IMPACT INVESTING TO INVESTING FOR IMPACT 5 (2020), https://www.carlyle.com/sites/default/files/2020-02/From%20Impact%20Investing%20to%20Investing%20for%20Impact_022420.pdf [https://perma.cc/CCP9-SJEB] ("Over the past three full years, the average earnings growth of Carlyle portfolio companies with two or more diverse board members has been nearly 12% per year greater than the average of companies that lack diversity . . . . After controlling for industry, fund, and vintage year, companies with diverse boards generate earnings growth that's five times faster, on average, with each diverse board member associated with a 5% increase in annualized earnings growth.").

233. ARIEL F. BABCOCK ET AL., THE LONG-TERM HABITS OF A HIGHLY EFFECTIVE CORPORATE BOARD 11 (2019), https://www.fcltglobal.org/wp-content/uploads/long-term-habits-of-highly-effective-corporate-boards.pdf [https://perma.cc/LD9U-64WP] (analyzing data from 2010 to 2017).

234. *See, e.g.*, Fried, supra note 21 ("[M]ore successful firms may be better able to attract female and minority candidates in high demand for board service"); Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does Difference Make?*, 39 DEL. J. CORP. L. 377, 387 (2014).

235. *See* Adams & Ferreira, *supra* note 41, at 295.

and constraints to begin with.[236] Those firms, however, are less in need of changes to their board or governance and of the improved monitoring and independence that diverse boards offer. Consistent with this, while Adams and Ferreira found that diversity, on average, decreased firm performance, the effect varied for different types of firms. As they explain, diversity increased the value of firms with weak governance (as measured by antitakeover defenses) but decreased the value of firms with strong governance, presumably because they did not need additional monitoring.[237] The latter, however, were more likely to have diverse boards, and as a result the average diversity effect on firms was negative.[238]

Thus, it is possible, if not likely, that the current wave of board diversity, that pressures reluctant firms to refresh their boards, will produce better casual results than data from several years ago. In contrast to the past, in this wave, firms that could benefit from additional monitoring are pressured to diversify their boards. Similar effects were demonstrated for the requirement to have independent board members that was imposed by the Sarbanes Oxley Act ("SOX") in 2002. Empirical studies of board independence did not find any association between board independence and positive firm performance (and thus were even less optimistic than studies on board diversity).[239] Thus, following the passage of SOX, when NYSE and Nasdaq adopted listing rules that demanded boards to have a majority of independent directors, they were similarly criticized for imposing requirements that are not supported by evidence. Interestingly, however, subsequent studies, that tested the effects of these listing standards on firms, found that the performance of those firms that did not comply pre-SOX improved after adding independent directors to meet the listing standards.[240] This dynamic is consistent with the interpretation that firms that need governance constraints are less likely to adopt them.

In a recent study, one of us took the task of repeating Adams & Ferreira's analysis on the last decade, when firms faced pressure to diversity. The study finds that the negative effect that Adams & Ferreira reports disappears.[241] These results suggest that the current wave, be it socially or ideologically motivated, has not harmed firms' efficiency. Furthermore, the study finds that Adams & Ferreira's results might have been driven by self-selection—since firms in their sample (but not in recent years) were more likely to increase diversity following a decline in their performance.[242] These results suggest that Adams and Ferreira's negative effect might have been driven by a problem that is now well-known in modern empirical analysis—the challenge to control for time-variance heterogeneity.[243]

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236. *See generally* Michal Barzuza, *Inefficient Tailoring: The Private Ordering Paradox in Corporate Law*, 8 HARV. BUS. L. REV. 131 (2018) (developing a theory of inefficient self-selection and demonstrating how it is consistent with, and better explains, existing empirical evidence from different corporate contexts, including: board independence, majority voting, cross-listing, and state competition).

237. *See* Adams & Ferreira, *supra* note 41, at 295.

238. *Id.*

239. See Barzuza, *supra* note 236.

240. *Id.*

241. *See* Michal Barzuza, *The Disappearing Negative Effect of Board Diversity on Firm Performance* (2024) (unpublished working paper) (on file with author).

242. *Id.*

243. *See, e.g.*, Emiliano Catan & Michael Klausner, *Board Declassification and Firm Value: Have Shareholders and Boards Really Destroyed Billions in Value?* (N.Y.U. L. & Econ., Working Paper No. 17-39, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2994559 (showing how time variant heterogeneity produced biased results for a fixed-effects analysis of staggered boards and firm value).

Finally, we would like to note that corporations are moving from a narrow focus on profit maximization and adopting a philosophy of corporate social responsibility (ESG), which appears to be the modern trend.[244] Board diversification may become a *sine qua non* for commercial success. Indeed, a recent study by Matthew Denes and Duane J. Seppi finds "a structural break in how stock prices respond to race-related events after widespread attention to the murder of George Floyd on May 25, 2020."[245] In particular, they find that the market responds to race-related events by rewarding firms that perform well regarding diversity and that this response has magnified following the murder of George Floyd.[246]

Our analysis of the empirical literature reveals significant challenges to test empirically the effects of board diversity on firm value. These problems are not unique to board diversity but rather are endemic to the study of corporate governance and its effects on firm performance. Overall, consistent with these challenges, evidence of the effect of board diversity on firm value is considered inconclusive. As the previous part has shown, however, evidence on the quality of minority directors is conclusive and consistent with a deep supply of qualified minority directors and no support for the concern that quotas will lower board quality.

D. The Virtue of Public Opinion

Third, our analysis demonstrates that popular opinion and ideology can improve efficiency when markets fail. There is no doubt that the public was an important force in the campaign for boardroom diversification. Critics of the campaign seized on this fact to argue that diversity supporters were pandering to the masses. Different variations of this argument were leveled at Nasdaq by the columnists of the *Wall Street Journal*.[247] We believe that the public should be commended, rather than criticized, for the role it played in the push for boardroom diversity. In this case, the public acted as an agent of change that would not have occurred without its involvement. When markets are locked into an inefficient equilibrium as a result of market failure, an external intervention is required to overcome the status quo. The economic literature assumes that it is the role of the government to correct market failures. The legislature itself or its regulatory agencies should intervene in failing markets to improve their operations. As we explained, this is what happened in several European countries: legislatures took action to achieve boardroom diversification. This is also what happened in California, but it did not happen in other states. Nor did it happen on the level of the federal government.

The question is: why? The answer is that political processes are belied by their deficiencies. As Mancur Olson powerfully demonstrated in his pioneering work, well-

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244. *See* Barzuza, Curtis & Webber, *supra* note 42; Sandeep Gopalan & Akshaya Kamalnath, *Mandatory Corporate Social Responsibility as a Vehicle for Reducing Inequality: An Indian Solution for Piketty and the Millennials*, 10 NW. J.L. & SOC. POL'Y 34, 45 (2015) ("[T]he millennial generation . . . has expressed overwhelming support for corporate social responsibility."); Douglas M. Branson, *Corporate Social Responsibility Redux*, 76 TUL. L. REV. 1207, 1217 (2002) ("In the late 1990s, a new corporate social responsibility movement gained momentum. Progressive corporate law is a reaction to the corporate law and economics and contractarian movements of the 1980s.").

245. Matthew Denes & Duane J. Seppi, Racial Dynamics in the U.S.: Evidence from the Stock Market 2 (Jan. 11, 2022) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4005677.

246. *Id.* at 33–34.

247. For discussion, *see supra* Part I.

organized, small groups can influence politicians to favor their own narrow interests over those of larger, non-coordinated groups and, in particular, the public at large.[248] Other public choice theorists, such as Gordon Tullock and James Buchanan, have proffered a more extreme view of the political arena, likening it to a market in which political services are bought and sold.[249] Given the political influence of corporate America and its contributions to political campaigns that determine the fate of political actors, it is not surprising that politicians have refrained from using their power to intervene in the internal affairs of corporations.

The limitations of regulatory agencies in going against industry interests are well-known and documented. Building on Olson's work, George Stigler, another Nobel laureate, noted that regulators are often captured by the very industries they are supposed to oversee. Regulated industries critically depend on their own ability to influence regulators and are therefore willing to expend considerable resources in affecting regulatory processes and work products.[250] The infamous "revolving doors" phenomenon contributes to the problem.[251] Regulators are often inclined to seek future employment in the industry they are charged with overseeing. In other cases, they come from the industry they are supposed to monitor, and their sympathies lie with it. In choosing between the public interest and that of the industry, regulators are predisposed to favor the latter. Stigler's work may explain why the SEC refrained from addressing the lack of diversity on corporate boards until the keynote address of Mary Jo White, the first woman to serve as SEC chair.[252] Even so, it is hard to say that the SEC used its regulatory powers to promote boardroom diversity.

Our political realities make the public an important agent of change. The emergence of social media has not only enabled the public to voice its opinions but also to overcome collective action problems that prevented it from acting in a concerted fashion.[253] These technological advancements allow the public to participate in public debates and policy discussions, without relying on its political representatives or traditional media outlets. The direct involvement of the public through the exercise of voice can remedy the failures of the market system and political process.[254] Public opinion is an outside force that can transform markets and lead them to more efficient equilibria. Popular intervention can succeed where the political process fails. Of course, it is of critical importance to ensure that the public is well-informed and that its preferences are not subject to manipulation. In the case of boardroom diversification, we believe, the involvement of the public was fully justified.

Economic theory maintains that markets reflect individual preferences as expressed by individual actors. In the corporate context, the voice of the public has been muffled for years on account of shareholders' rational apathy. Shareholders could not significantly

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248. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 2 (1965).

249. *See generally* Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967); James M. Buchanan, *Rent Seeking and Profit Seeking*, *in* TOWARD A THEORY OF THE RENT-SEEKING SOCIETY 3-15 (James M. Buchanan et al. eds., 1980); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 212–13 (1976).

250. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3 (1971).

251. *Id.*

252. White, *supra* note 57.

253. *See generally* Yafit Lev-Aretz, *Copyright Lawmaking and Public Choice: From Legislative Battles to Private Ordering*, 27 HARV. J.L. & TECH. 203 (2013) (discussing the impacts of social media on collective action).

254. *See generally* Albert O. Hirschman, EXIT VOICE AND LOYALTY: RESPONSE TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES (1970) (examining the use of voice as a choice mechanism).

affect the governance structures of public firms because the cost was prohibitive. This state of affairs is changing. Fund managers and exchanges can finally decipher the will of individual and retail investors. They are fully entitled—indeed, compelled—to act upon it. It should be noted that Nasdaq's new listing rules requiring companies to diversify their boards provide an opportunity to compare Nasdaq's performance to that of other exchanges.[255] We believe that receptiveness of public opinion will rebuild trust in financial markets and attract new investments.

III. THE BENEFITS OF BOARD DIVERSITY

Having elucidated the obstacles that stood in the way of diversity, we now proceed to discuss the potential gains from boardroom diversification. Board diversification can improve corporate performance in three important respects. First, diversification enhances the talent pool from which directors can be recruited. Second, diversification is believed to improve board monitoring of management. Third, diversification gives corporations a richer business perspective that is more responsive to the preferences of current consumers. We address each of these effects in order.

The first effect is straightforward. Opening boards up to women and minority candidates benefits not only the candidates themselves, but also the corporations for which they work. Diversification allows corporations to access a largely untapped pool of talent and draw individual directors from it. Members of minority groups and women are as talented as white men. Hence, *ceteris paribus*, the percentage of women and minorities who serve as directors should be roughly equal to their percentage in the population. Currently, however, women and minorities are underrepresented on corporate boards.[256] The addition of women and minorities to boards, even if it is forced, would result in new talent entering the corporate world.

Lisa Fairfax discussed this possibility but suggested the effect may be minimal because firms will turn to the same candidates to fill diversity positions, so overall board diversity will not be dramatically enhanced.[257] Fairfax is correct in stating that the same individuals can occupy board seats in more than one company. We submit, however, that the number of women and diverse directors will grow, nonetheless. First, there is a limit to the number of boards a single candidate can serve on. Holding too many board positions is bound to adversely affect performance. In the current business environment, the work of the board is becoming increasingly complex, and directors must allocate more time and effort to perform their responsibilities successfully. Second, and relatedly, several of the largest asset funds, among them Vanguard and BlackRock, have targeted the phenomenon

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255. Nasdaq, *supra* note 132.

256. Alisha Haridasani Gupta, *Surprise: Women and Minorities are Still Underrepresented in Corporate Board Rooms*, NY TIMES, (Oct. 12, 2021), https://www.nytimes.com/2021/06/07/us/women-minorities-underrepresented-corporate-boardrooms.html (on file with the *Journal of Corporation Law*).

257. *See* Fairfax, *supra* note 141, at 802 ("[W]hile relatively few whites hold multiple board positions, most of the board positions held by African Americans tend to be held by a subset of that group. This has led one commentator to note 'there is no real diversity in the diversity of corporate boards.'").

of "overboarding" and started opposing the nomination of candidates who serve on too many companies.[258]

Second, the diversification of boards is liable to improve corporate governance. An important function of the board is to monitor the management on behalf of the shareholders.[259] Effective monitoring involves "hiring and dismissing underperforming managers, evaluating their performance, and overseeing internal controls."[260] In light of the job description, one would expect boards to be proactive and entrepreneurial. The reality is rather different. Studies show, time and again, that boards tend to be "passive and subject to CEOs and executives' dominance."[261] Some scholars went as far as arguing that boards that were supposed to be the solution to the managerial agency problem have become part of it.[262] How could it happen? One part of the answer has to do with the fact that it is management that effectively appoints the board and sets its compensation. Naturally, this gives board members an incentive to avoid conflicts with the management. After all, presiding board members want to be reelected and rewarded.[263] A second part of the answer is the homogeneity of boards. Directors come from the same background as managers, interact with them, and share the same business philosophy. This undermines the ability of directors to engage in effective monitoring. To a meaningful extent, the sympathies of board members lie with management.

Changing this reality may be key to better corporate governance. As Lisa Fairfax suggested, diverse boards could have prevented many of the Enron-type corporate scandals of the early 2000s.[264] A growing literature in the field of business suggests that diversified boards monitor management better than homogeneous boards. One recent study summarizes the findings as follows:

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258. Kosmas Papadopoulos, *Director Overboarding: Global Trends, Definition, and Impact*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 5, 2019), https://corpgov.law.harvard.edu/2019/08/05/director-overboarding-global-trends-definitions-and-impact [https://perma.cc/8EA6-JHDT].

259. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 338 (1976) ("Because both the external and internal monitoring costs are imposed on the owner-manager it is in his interest to see that the monitoring is performed in the lowest cost way."); *see also* Eugene Fama & Michael Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 344–45 (1983) ("[L]ike open corporations and financial mutuals, donor nonprofits have boards of directors (or trustees) with the power to ratify and monitor important decisions and to hire, fire, and set the compensation of important decision agents.").

260. Daniel Tarus & Federico Aime, *Board Demographic Diversity, Firm Performance and Strategic Change: A Test of Moderation*, 37 MGMT. RSCH. REV. 1110, 1111 (2015).

261. Julio David Castellanos & Babu George, *Boardroom Leadership: The Board of Directors as a Source of Strategic Leadership*, 6 ECON. & BUS. REV. 103, 114 (2020); *see also* Tarus & Aime, *supra* note 260, at 1112 ("[E]xtant literature has generally assumed that boards of directors are passive in formulating corporate strategy.").

262. *See* Bebchuk & Fried, *supra* note 171, at 73 ("[D]irectors' behavior is also subject to an agency problem, which in turn undermines their ability to effectively address the agency problems in the relationship between managers and shareholders.").

263. *See id.* at 74 ("Because the CEO's influence over the board gives her significant influence over the nomination process, directors have an incentive to 'go along' with the CEO's pay arrangement, a matter dear to the CEO's heart . . . . Yet another reason to favor the CEO is that the CEO can affect directors' compensation and perks.").

264. Fairfax, *supra* note 141, at 797; *see also* Marleen A. O'Connor, *The Enron Board: The Perils of Group Think*, 71 U. CIN. L. REV. 1233, 1308 (2003) (pointing out that "diversity may increase board effectiveness").

> [F]emale directors have better monitoring ability as they think independently and board gender diversity also increases managerial accountability, such as improving board meeting attendance and CEO accountability. By improving board monitoring, female directors also perform the role of independent directors.[265]

Indeed, empirical research reporting a positive association between board diversity and firm performance attributes this result to diversified boards' ability to reduce the managerial agency problem. Female directors have been suggested to be more active,[266] cautious[267] and risk averse[268] than their male counterparts, leading to better corporate decision-making.

The third way in which diversified boards improve firm performance is related to strategy. In addition to monitoring management, boards have two other roles: first, the board is supposed to connect the corporation to its external environment;[269] second, it is responsible for shaping the firm's strategy and overseeing the implementation thereof.[270] Boards that include women and minority directors are better suited for performing these roles. Directors bring their backgrounds and experiences to the boardroom. Diversified boards can, therefore, take advantage of a wealth of perspectives and life experiences. This, in turn, enables them to better understand the divergent preferences of consumers and the public at large. In today's business world, corporations can ill-afford to maintain a narrow focus on profit maximization. The interconnected environment in which companies operate requires firms to monitor public sentiment and respond to it. Corporations must also be attuned to the needs and preferences of their workforce. As the example of Google's workers' unionization illustrates, employees in the modern corporate world do not settle for high salaries and satisfactory working conditions. Rather, they want their political views to be heard.[271]

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265. Brahma, Nwafor & Boateng, *supra* note 177, at 5707 (citation omitted).

266. *See* Adams & Ferreira, *supra* note 41, at 301 ("Our evidence on board inputs shows that women attend more meetings and are more likely to be assigned to monitoring-related committees than men."); Schwartz-Ziv, *supra* note 207, at 753 ("The empirical results indicate that boards are most active when they are relatively gender balanced, that is, when at least 3 men and 3 women directors are in attendance."); Akshaya Kamalnath, *Corporate Governance Case for Board Gender Diversity: Evidence from Delaware Cases*, 82 ALB. L. REV. 23, 33–34 (2018) ("[W]omen directors strengthen board monitoring by being more active in processes that are associated with board independence.").

267. *See* Kamalnath, *supra* note 266, at 38 ("[S]tudies suggest that women directors tend to be more cautious while making public disclosures.").

268. *See* O'Connor, *supra* note 264, at 1307–08 ("Overall, women are less affected than men by the over-optimism bias that leads to excessive risk-taking."); Véronique Magnier & Darren Rosenblum, *Quotas and the Transatlantic Divergence of Corporate Governance*, 34 NW. J. INT'L L. & BUS. 249, 296 (2014) ("Some quota advocates have argued that women's differences will shift corporate culture in a positive fashion. Such traits include process elements such as women's purported penchant for detail and aversion to risk.").

269. *See* Amy J. Hillman, Albert A. Cannella & Ramona L. Paetzold, *The Resource Dependence Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change*, 37 J. MGMT. STUD. 235, 236 (2000) ("Another distinct role that directors play is that of providing essential resources or securing those resources through linkages to the external environment." (citations omitted)).

270. Fama & Jensen, *supra* note 256.

271. *See* Sarah E. Needleman, *Google Employees Form Union to Push for Changes*, WALL ST. J. (Jan. 4, 2021), https://www.wsj.com/articles/google-employees-form-union-to-push-for-changes-11609782619 (on file with the *Journal of Corporation Law*) ("A group of Google employees has formed a union to organize workers

Again, we are not the first to make this point. As more Americans value diversity and are willing to pay more to transact with businesses that share their values, the profits of firms with a diversified workforce will grow at the expense of those who refuse to diversify their ranks. Business consulting firms have long recognized this.[272] Diversified boards are better at identifying business opportunities, relating to their customer base, and piloting their firms through the ebbs and flows of the business world.[273]

IV. NORMATIVE IMPLICATIONS

Our analysis implies that the decisions in *Crest v. Padilla* cases and in *The Alliance for Fair Board Recruitment v. Weber* are misguided. These decisions held that the use of mandatory quotas to achieve board diversity was unconstitutional both under the California and the United States Constitution.[274] The California state courts reasoned that the use of gender, race, and sexual orientation triggers strict scrutiny, requiring the State of California to demonstrate a compelling state interest for the legislation to survive.[275] The district court

across the technology company's sprawling global operations, a rare move within Silicon Valley and one that reflects growing employee activism in the sector."); Bobby Allyn, *Google Workers Speak Out About Why They Formed A Union: 'To Protect Ourselves'*, NPR (Jan. 8, 2021), https://www.npr.org/2021/01/08/954710407/at-google-hundreds-of-workers-formed-a-labor-union-why-to-protect-ourselves [https://perma.cc/B5RC-E7X4] ("Unlike traditional unions, [the Alphabet Workers Union] is a so-called 'minority union' and does not have the power to force the company to collectively bargain over pay and benefits . . . . This movement, they say, is to examine Google's role in society and help reshape the company's culture.").

272. VIVIAN HUNT, DENNIS LAYTON & SARA PRINCE, WHY DIVERSITY MATTERS 1 (2015), https://www.mckinsey.com/~/media/mckinsey/business%20functions/organization/our%20insights/why%20diversity%20matters/why%20diversity%20matters.pdf [https://perma.cc/65NV-KJ2R] (stating that "[n]ew research makes it increasingly clear that companies with more diverse workforces perform better financially" and noting that "[o]ur latest research finds that companies in the top quartile for gender or racial and ethnic diversity are more likely to have financial returns above their national industry medians. Companies in the bottom quartile in these dimensions are statistically less likely to achieve above-average returns. And diversity is probably a competitive differentiator that shifts market share toward more diverse companies over time").

273. *Id.* ("More diverse companies, we believe, are better able to win top talent and improve their customer orientation, employee satisfaction, and decision making, and all that leads to a virtuous cycle of increasing returns. This in turn suggests that other kinds of diversity—for example, in age, sexual orientation, and experience (such as global mind-set and cultural fluency)—are also likely to bring some level of competitive advantage for companies that can attract and retain such diverse talent."); *see also* Rocío Lorenzo et al., *How Diverse Leadership Teams Boost Innovation*, BCG (Jan. 23, 2018), https://www.bcg.com/en-us/publications/2018/how-diverse-leadership-teams-boost-innovation [https://perma.cc/5ZA4-7M84] ("Companies that reported above-average diversity on their management teams also reported innovation revenue that was 19 percentage points higher than that of companies with below-average leadership diversity—45% of total revenue versus just 26%.").

274. Crest v. Padilla, No. 20STCV37513, 2022 WL 1073294, at *19–20 (Cal. Super. Ct. Apr. 1, 2022); Crest v. Padilla, No. 19STCV27561, 2022 WL 1565613, at *12 (Cal. Super. Ct. May 13, 2022); Alliance For Fair Board Recruitment v. Weber, No. 21-CV-01951, 2023 WL 3481146 (E.D. Cal. May 15, 2023).

275. *Crest*, 2022 WL 1073294, at *8; *Crest*, 2022 WL 1565613, at *4. It should be noted that Prof. Joseph Grundfest argued that S.B. 826 is unconstitutional for yet another reason: it violates the commerce clause. Under the internal affairs doctrine, matters such as board composition are governed by the law of the state of incorporation, which in the vast majority of the corporations targeted by California is not California law. *See* Joseph A. Grundfest, *Mandating Gender Diversity in the Corporate Boardroom: The Inevitable Failure of California's SB 826* (Rock Ctr. for Corp. Governance at Stan. Univ., Working Paper No. 232, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3248791. Since the court decisions we analyze did not take issue with this argument, we leave it for another time.

similarly ruled the legislation was unconstitutional on its face.[276] Although there are differences among the three decisions, they are predicated on the assumption that the burden of justifying the use of mandatory quotas based on gender, race, or sexual orientation lies with the state. The burden is a dual burden: the burden of production of evidence and the burden of persuasion. The California courts required the state to adduce evidence of a discriminatory motif that led to the exclusion of under-represented groups from corporate boards,[277] as well as evidence establishing that there were as many members of under-represented groups that qualified to serve as white males.[278] In addition, the state was expected to provide evidence that the legislation would improve the state economy.[279] Then, based on the evidence it provided, the state had to lift the burden of persuading the court by the preponderance of evidence of its position.[280] These are Herculean tasks. The District Court for the Eastern District of California went even further in ruling that A.B. 979 was unconstitutional on its face.[281]

We argue that the courts should have borrowed a page from the Supreme Court's Title VII jurisprudence, and in light of the *massive under-representation* of women and members of minority groups of corporate boards, should have shifted the burden of production, if not the burden of persuasion, to the plaintiffs. As our discussion demonstrates, there were no economic reasons for excluding women and minorities from corporate boards. On the contrary, labor economics teaches that the exclusion of any group from the market detracts from economic efficiency.[282] The extreme under-representation of the majority of the population on corporate boards is attributable to profound market failures that have entrenched themselves in our corporate culture. None of the three decisions analyzes the reasons for the persistent massive over-representation of white men on corporate boards. This statistical skew merited careful consideration in and of itself—alas, none has taken place. Nor do the judges explain why white men, prima facie, are more skilled than members of other groups to serve as directors.

The extreme statistical disparity between white men and members of other groups should have prompted courts to request those who challenged California's legislation to adduce evidence showing that the gap is due to the special qualifications of white men. This is exactly what the Supreme Court did in *Texas Dept. of Community Affairs v. Burdine*. In this case, Burdine filed a suit against her employer, alleging that she was not

276. Alliance For Fair Board Recruitment, 2023 WL 3481146, at *3 ("The Court does not reach the parties' strict scrutiny arguments because the facial challenge to AB 979 is dispositive.").

277. *See Crest*, 2022 WL 1565613, at *4 ("The state also must show purposeful or intentional, unlawful discrimination by the entity employing the suspect classification to assert a compelling governmental interest in remedying discrimination.").

278. *See Crest*, 2022 WL 1073294, at *15 ("[T]he Secretary has not produced evidence of discrimination which this court could find 'convincing' under Connerly. Their statistics do not have a proper comparison group—they have no measurement of the qualified talent pool, and thus they cannot show a proper statistical disparity.").

279. *See Crest*, 2022 WL 1565613, at *6 ("[T]he studies cited in S.B. 826 failed to sufficiently show a causal connection between women on corporate boards and corporate governance and did not otherwise provide reliable conclusions, negating claims that S.B. 826's use of a gender-based classification is necessary to boost California's economy.").

280. *See id.* at *4.

281. Alliance For Fair Board Recruitment v. Weber, No. 21-CV-01951, 2023 WL 3481146, at *3 (E.D. Cal. May 15, 2023).

282. See discussion, *supra* Part II.A.

promoted, terminated, and then replaced by a male employee because of gender discrimination in violation of Title VII of the Civil Rights Act of 1964.[283] The District Court for the Western District of Texas dismissed the suit, reasoning that there was no evidence to substantiate the gender discrimination complaint.[284] On appeal, the Fifth Circuit reversed in part.[285] It stated that in a Title VII case, the employer "bears the burden of proving by a preponderance of the evidence the existence of legitimate nondiscriminatory reasons for the employment action and that the [employer] also must prove by objective evidence that those hired or promoted were better qualified than the plaintiff."[286] Applying this standard, the Fifth Circuit concluded that the testimony adduced by the defendant failed to meet this standard. The decision was appealed to the Supreme Court.

A unanimous Supreme Court ruled that the Fifth Circuit erred in placing the burden of proof squarely on the employer-defendant.[287] Citing its opinion *McDonnell Douglas Corp. v. Green*, the Court, per Justice Powell, explained that in employment discrimination cases under Title VII, the plaintiff bears the initial burden of proving "prima facie discrimination" by a preponderance of the evidence.[288] The Court emphasized that this initial burden is "not onerous,"[289] rather, it only requires a plaintiff to show that she applied for a job for which she was qualified but was not hired. The Court went on to explain that:

> Establishment of the prima facie case in effect creates a presumption that the employer unlawfully discriminated against the employee. If the trier of fact believes the plaintiff's evidence, and if the employer is silent in the face of the presumption, the court must enter judgment for the plaintiff because no issue of fact remains in the case.[290]

Thereafter, the burden shifts to the employer-defendant to "rebut the presumption of discrimination by producing evidence that the plaintiff was rejected, or someone else was preferred, or a legitimate, non-discriminatory reason."[291] To meet this burden, the employer must introduce admissible evidence setting forth the "reasons for the plaintiff's rejection."[292] Importantly, the Court went on to explain that the rationale behind putting the burden of production on the defendant-employer is that "[p]lacing th[e] burden of production of the defendant thus serves simultaneously to meet the plaintiff's *prima facie* case by pressing a legitimate reason for the action and to frame the factual issue with sufficient clarity so that the plaintiff will have a full and fair opportunity to demonstrate pretext."[293] The Court further clarified that the burden of persuasion remains with the plaintiff, and so, to win the case she must either convince the court that "a discriminatory reason more likely

283. Texas Dep't of Community Affairs v. Burdine, 450 U.S. 248, 250 (1981).
284. *Id.* at 251.
285. *Id.* at 252.
286. *Id.*
287. *Id.* at 260.
288. Texas Dep't of Community Affairs v. Burdine, 450 U.S. 248, 252–54 (1981).
289. *Id.* at 253.
290. *Id.* at 254.
291. *Id*.
292. *Id.* at 255.
293. Texas Dep't of Community Affairs v. Burdine, 450 U.S. 248, 255–56 (1981).

motivated the employer or indirectly by showing that the employer's proffered explanation is unworthy of credence."[294]

In *Price Waterhouse v. Hopkins*, the Court went a step further and shifted the burden of persuasion to the employer. In this case, Hopkins was employed as a senior manager by Price Waterhouse.[295] Despite her stellar job performance, her admission to the partnership was being held for reconsideration for over a year.[296] Hopkins sued Price Waterhouse under Title VII, alleging sex discrimination.[297] The district court ruled for Hopkins, reasoning that she was subjected to sexual stereotyping.[298] On appeal, the D.C. Circuit affirmed.[299] Both courts not only shifted the burden of persuasion to the employer but also ruled that to win the employer must prove by "clear and convincing" evidence that it would have reached the same decision even in the absence of discrimination.[300] The Supreme Court affirmed that the burden of persuasion lies with the employer, but overturned the lower courts insofar as the standard of proof is concerned, requiring the employer to prove by the preponderance of the evidence—as opposed to clear and convincing evidence—that it would have made the same decision under non-discriminatory circumstances as well.[301]

Formally, board nominations do not come under Title VII because directors are not considered employees. Yet, given the undeniable legitimacy of the egalitarian goals and policies, it is difficult to defend this distinction on substantive grounds. Congress enacted Title VII "to improve the economic and social conditions of minorities and women by providing equality of opportunity in the workplace."[302] Not only are directors part of the workplace; they also occupy leadership positions and as such serve as role models. For decades, minorities and women could not break the glass ceiling that prevented them from being appointed to boards in numbers that approximate, even remotely, their percentage in the population. Therefore, we think that the same logic that led to the enactment of the Civil Rights Act should have been extended to corporate boards.

This takes us to the matter of quotas. The use of quotas has always been considered a taboo in the eyes of the courts. Alexander Bickel has famously declared that "a racial quota derogates the human dignity and individuality of all to whom it is applied; it is invidious in principle as well as in practice."[303] Bickel's argument has been quoted by Justice Scalia in his concurrence in *City of Richmond v. Croson*,[304] and inspired Justice Thomas to write in his concurrence in *Adarand Constructors v. Pena* that "government sponsored racial discrimination based on benign prejudice is just as noxious as discrimination inspired by malicious prejudice."[305] Quotas are also suspect under Title VII jurisprudence.

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294. *Id.* at 256 (citing McDonnell Douglas Corp. v. Green, 411 U.S. 792, 804–05).

295. Price Waterhouse v. Hopkins, 490 U.S. 228, 231 (1989).

296. *Id.*

297. *Id.* at 232.

298. *Id.*

299. *Id.*

300. Price Waterhouse v. Hopkins, 490 U.S. 228, 237 (1989).

301. *Id.* at 253 ("We are persuaded that the better rule is that the employer must make this showing by a preponderance of the evidence.").

302. Statement of Purpose, 29 CFR § 1608.1(b).

303. ALEXANDER M. BICKEL, THE MORALITY OF CONSENT 133 (1974).

304. City of Richmond v. J.A. Croson Co., 488 U.S. 469, 527 (1989) (Scalia J., concurring).

305. Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 241 (1995) (Thomas J., concurring).

Yet, as Julie Suk has convincingly argued discrimination should not be analyzed from an individual perspective, but rather from a societal one. She astutely observes "the positions for which people are competing (jobs, university spots, political offices) are understood not as serving the occupants or winners of these jobs, but the public. The public is wronged by discriminatory practices, of which racial segregation can be treated as a paradigmatic example."[306] Once one adopts a consequentialist view, as we do in this article, Bickel's argument loses much of its force. Furthermore, as we noted, in the case of corporate boards, the minority and female candidates who were rejected were as qualified for the position as the white males who ultimately got them. Hence, Bickel's argument that quotas "derogate human dignity" is wrong on its face in our case. The opposite is true. The quotas established by California were intended to secure minimal representation for minority groups and women. Think about it: it is impossible to ensure minimal representation on boards without setting forth a requirement for *at least one member*, but once you do that you have set a quota. It should be noted in this respect that in many other countries, including Norway,[307] Spain,[308] France,[309] Italy[310] and the Netherlands,[311] quotas are used as a matter of course to ensure diversification of the workforce and inclusion of minorities and women in leadership positions.

In light of the foregoing, we contend that the California and federal courts should have placed both the burden of production and the burden of persuasion on those who challenged the legislation. In all likelihood shifting the burdens to the plaintiffs would have led the courts to uphold the legislation. Economic theory demonstrates that the exclusion of women and members of minority groups was inefficient. Moreover, recent empirical studies show that women and minority members who have been recently appointed to boards are at least as qualified as their white male peers.[312] Challengers of the legislation would have thus faced an uphill battle invalidating the legislation.

More importantly, the individual women and members of minority boards who were denied board seats over the years would be well-advised to bring individual suits against the corporations that chose not to appoint them and preferred to appoint white men instead. These suits should proceed along the lines of *Burdine* and *Price Waterhouse*. Such individual suits are independent of the legislation California passed and thus they are not affected by its invalidation. To succeed, however, the plaintiffs will have to convince the courts to shift the burden of proof to the corporations, as is customary in Title VII litigation. We believe that they will be successful.

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306. Julie C. Suk, *Quotas and Consequences: A Transnational Re-evaluation*, *in* PHILOSOPHICAL FOUNDATIONS OF DISCRIMINATION LAW 228, 248 (Deborah Hellman & Sophia Moreau eds., 2013).

307. Ot.prp. No. 97 (2002–2003) (Nor.).

308. Ley Orgánica Para La Igualdad Efectiva de Mujeres y Hombres [Organic Law for the Effective Equality of Women and Men] (B.O.E. 2007, 71), páginas 12611 a 12645 (Spain).

309. Loi 2011-103 du 27 janvier 2011 Relative à La Représentation Équilibrée des Femmes et des Hommes au Sein des Conseils d'administration et de Surveillance et à L'égalité Professionnelle [Law 2011-103 of Jan. 27, 2011 relating to the Balanced Representation of Women And Men on Boards of Directors and Supervisory Boards and to Professional Equality], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], July 27, 2011, p. 1680.

310. In Italy, the law is called "Equilibrio Tra i Generi Negli Organi delle Societa' Quotate" or "Gender Balance in The Bodies of Listed Companies". Legge 12 luglio 2011, n. 120, G.U. July 27, 2011, p. 1 (It.).

311. Act to Amend Book 2 of the Dutch Company Act, Stb. 2011, 275 (Neth.).

312. *See* discussion *supra* Part II.B.

Critically, because the individual suits do not stem out of the California legislation, they will not face the hurdle of justifying the use of quotas, as the State of California had to do. The only challenge that individual plaintiffs will have to overcome is to convince courts to extend the Supreme Court rulings in the context of Title VII to board appointments. We believe that such an extension is essential in light of the grave injustices that have been inflicted on women and minority members. If individual suits prove successful, states will not need to pass legislation mandating the inclusion of women and minority members on boards.

Finally, the case of *Alliance for Fair Board Recruitment v. SEC* is currently pending before the Fifth Circuit. The petitioners allege that the SEC's approval of Nasdaq's listing rules constitutes "state action" that violates equal protection as it "encourages discrimination against potential board members and also by current board members and shareholders, and it stigmatizes board members who identify as one of the preferred demographics."[313] Petitioners also contend that the SEC violated the First Amendment by mandating disclosure of protected information without a compelling state interest and narrow tailoring.[314] There are two critical differences between this case and the cases that were brought against the Secretary of State of California. First, the Nasdaq listing rules are not mandates; rather, Nasdaq employed a disclosure mechanism that allowed corporations to explain non-compliance. Second, the role of the SEC is limited to ensuring that Nasdaq's listing rules are consistent with the law. These differences may suffice to distinguish this case from *The Alliance for Fair Board Recruitment v. Weber*. If the Fifth Circuit rules for the SEC, it would cement the diversification of corporate boards.

But even if the Fifth Circuit invalidates Nasdaq's rules, we do not think that it will lead to a reversal of the current trend to diversify the corporate boardroom. The actions of the institutional investors, proxy advisory firms, and exchanges, together with public opinion have anchored a new norm—a norm of inclusion. The message is reverberating throughout the corporate world, and it is loud and clear.

Before concluding, we would like to emphasize that we did not go into the Supreme Court's ruling on affirmative action because we do not believe that it is relevant to our case. Our analysis suggests that the women and members of minority groups who were denied board seats were fully qualified for these positions. They did not get them because they were discriminated against. They were wronged. Framing the matter in terms of affirmative action would wrong them twice.

CONCLUSION

In this Article, we set out to establish an efficiency case for boardroom diversity. We demonstrated that the underrepresentation of women and members of minority groups on corporate boards is a clear form of market failure. Accordingly, the arguments of diversity critics that board diversification will harm firm performance are baseless. We believe that enhancing boardroom diversity will improve the economic performance of firms. The push to increase minority and gender representation on boards will attract new talent to corporations, improve corporate governance, and enable firms to adopt innovative business

313. Brief for Petitioner at 1, Alliance for Fair Board Recruitment v. SEC, No. 21-60626 (5th Cir. 2023).

314. *Id.* at 42 (explaining that petitioners assert violations of the Administrative Procedure Act and the Vesting Clause in Article I of the Constitution).

strategies. It will also allow companies to align themselves more closely with their customer base and promote valuable societal goals. The inclusion of individuals from underrepresented groups in corporate boards should not be viewed as a form of preferential treatment. Rather, it should be perceived as a step that is fully consistent with the best interests of companies and their shareholders. For the same reason, new board members should not feel stigmatized. On the contrary, they are fully qualified for their positions and would have occupied them long ago, had the appointments process been based on merit instead of social ties. While in this Article we developed an efficiency-based justification of diversity, we are fully cognizant that diversity is an important value in and of itself. It is a critical aspect of an egalitarian society that respects the integrity of others. Our decision to defend diversity on efficiency-based grounds was dictated by critics' reliance on the same in their attempt to reverse board diversification trends. We predict that the trend will not be reversed. For all the right reasons.