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New California Law Imposing Gender Diversity on Boards of Publicly Held Corporations Raises Constitutional Concerns

On Sept. 30, 2018, Gov. Jerry Brown signed into law Senate Bill No. 826 (SB 826), California's new legislation promoting gender balance on the boards of directors of publicly held corporations headquartered in California. The legislation is designed to encourage gender diversity in corporate boardrooms, boost the California economy, and improve opportunities for women in the workplace. The new law requires publicly held domestic California corporations and foreign corporations headquartered in California to have a minimum of one female board member by the end of 2019, and a representative number of female board members by the end of 2021.

California's new law is facing pushback from California businesses and commentators on various grounds. Some argue the law violates the U.S. and California Constitutions by establishing an express gender classification and requiring companies to select board members based on gender. The law also raises potential conflict-of-laws concerns by requiring foreign corporations with principal executive offices in California, whose internal affairs are generally governed by the laws of their state of incorporation, to alter the structure of their boards to comply with California law. This creates a potential conflict between the laws of a foreign corporation's state of incorporation and the laws of California. The law may also result in disparate treatment of publicly held domestic California corporations based on the location of their principal executive offices.

Overview of SB 826

SB 826 adds a new section to the California Corporations Code, which requires any publicly held domestic or foreign corporation whose principal executive offices are located in California (according to the corporation's annual 10-K report filed with the Securities and Exchange Commission) to have at least one female director on its board of directors no later than Dec. 31, 2019. By Dec. 31, 2021, a publicly held corporation headquartered in California must have at least three female directors if there are six or more directors on its board, at least two female directors if there are five directors on its board, or at least one female director if there are four or fewer directors on its board.

The law defines "female" as an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth. "Publicly held corporation" is defined as a corporation with outstanding shares listed on a "major United States stock exchange."

Pursuant to the law, the California Secretary of State will be required to publish reports on its website documenting, among other things, the number of domestic and foreign corporations with principal executive offices located in California that are in compliance with the statute, the number of publicly held corporations that have moved their corporate headquarters from another state to California, and the number of publicly held corporations that have moved their corporate headquarters from California to another state.

In passing this legislation, the California Legislature cites numerous independent studies concluding that publicly held companies perform better when women serve on their boards of directors. The legislative findings declare that more women serving as directors of publicly held corporations will boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders, and retirees. The findings note further that several foreign countries, including Germany, Norway, Spain, and France, have taken similar measures to address the lack of gender diversity on corporate boards by instituting quotas mandating 30 to 40 percent of public company board seats be held by women. The Legislature has taken the position that, if such proactive measures are not taken, it may take as many as 40 or 50 years to achieve gender parity among directors. Legislative findings indicate that as of June 2017, more than 25 percent of publicly held companies headquartered in California had no females serving on their boards of directors.

Compliance Considerations and Costs of Non-Compliance

A corporation subject to the new law will be in violation of the law if a director seat required to be held by a female is not held by a female during at least a portion of the calendar year. The Secretary of State may impose a $100,000 fine for the first violation, and a $300,000 fine for any subsequent violation. The Secretary of State also has the authority to adopt regulations to implement the statute, and may impose a $100,000 fine for failure to timely file board member information with the Secretary of State pursuant to a regulation adopted pursuant thereto.

Compliance with California's new law may require publicly held corporations headquartered in California to amend the provisions in their corporate charters, bylaws, and other internal governance documents relating to the election, removal, and replacement of directors in order to satisfy the minimum requirements of the law. Counsel can assist in determining what changes need to be made, if any, and what approvals may be required to effect such changes and ensure compliance before the 2019 and 2021 deadlines.

Publicly held corporations headquartered in California are advised to ensure compliance in advance of the initial 2019 deadline. Privately held companies considering going public should also be aware of these requirements and consider appropriate amendments to their charters and organizational documents in light of the recent changes in the law.

Potential Litigation Implications

In signing the bill, Gov. Brown acknowledged that the law faces potentially "fatal" legal problems in the future. Legal scholars agree with Gov. Brown's assessment: by demonstrating a clear gender preference, the law is potentially unconstitutional.

Both Article I of the California Constitution (which prohibits disqualifying a person from employment on the basis of their sex) and the equal protection clause in the 14th Amendment of the U.S. Constitution might pose a challenge. Under the equal protection clause, laws involving gender classifications, like SB 826, are subject to a heightened level of scrutiny. In other words, the state must demonstrate that the law serves an important (under intermediate scrutiny) or compelling (under strict scrutiny) state interest, and that it is narrowly tailored to be the least restrictive means of meeting the state's goal. Whether California will be able to make that showing is not yet clear. If challenged in court, which seems all but certain, California would likely need to offer evidence of discriminatory behavior, demonstrating that an important or compelling government interest is at stake. Some courts have considered evidence of past discrimination against women and differences in opportunity as sufficient to pass constitutional muster. Even if this initial constitutional hurdle is passed, California would also need to show that the use of a quota system is the least restrictive means of achieving the state's interest in remedying past discrimination.

Another, and potentially more problematic, constitutional challenge might come via the internal affairs doctrine. The internal affairs doctrine is a legal precedent derived from the commerce clause of the U.S. Constitution, which recognizes that only one state should have the authority to regulate a company's internal affairs, including the composition and election of its board of directors. The U.S. Supreme Court has held that a corporation's state of incorporation – not the state where it is headquartered – regulates its internal affairs.

The implications of that Supreme Court precedent are significant: SB 826 purports to apply to corporations headquartered in California, regardless of where they are incorporated. The vast majority of corporations headquartered in California are incorporated in other states where there is no such board diversity mandate. Indeed, because SB 826 would be the first and only mandatory board diversity requirement in the United States, the bill creates a conflict between California and the chartering laws of every other state in the nation. And the Supreme Court has been clear that in situations of conflict, the chartering state's laws win.

In his signing statement, Gov. Brown wrote that recent events in Washington, D.C. and elsewhere make it clear "that many are not getting the message," concluding that "it's high time" corporate boards better reflected the gender diversity of the nation overall. Although its goals may be seen as laudable, it is unclear whether SB 826 will withstand potential constitutional challenges.

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