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New California Law Requiring Female Directors on Public Company Boards Becomes Effective

This client alert provides an update on the new legislation passed in California as it relates to the minimum number of female directors that must serve on the board of directors of each publicly held domestic or foreign corporation whose principal executive office is located in California. With these requirements taking effect in 2019, corporations subject to the new legislation need to start taking actions to comply as soon as possible.

On January 1, 2019, Senate Bill No. 826 took effect. The bill adds Section 301.3 and Section 2115.5 to the California Corporations Code and requires each publicly held domestic or foreign corporation with its principal executive office located within the State of California to have a minimum number of female directors serving on its board of directors. With this new law taking effect, the State of California became the first U.S. state to require public companies to have female directors on their boards of directors.

In the text of Senate Bill No. 826, the California legislature found that having more female directors serving on boards of directors of publicly held corporations would boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders, and retirees. Although the new law could achieve these benefits by accelerating the representation of female directors on public company boards and may also encourage other U.S. states to legislate similar requirements, it faces possible legal challenges. Notwithstanding these potential legal challenges, publicly held corporations with their principal executive office in California should start taking steps now to comply with the requirements under this new law.

Section 301.3—Publicly Held California Corporations and Foreign Corporations with Principal Executive Offices in California

Section 301.3(a) requires that no later than December 31, 2019, a publicly held California or foreign corporation whose principal executive office, according to the corporation's SEC Form 10-K, is located in California, must have at least one female director on its board.

Curiously, Section 301.3(a) adds the following: "A corporation may increase the number of directors on its board to comply with this section." This last sentence is a bit peculiar because it does not offer an expedited process for increasing the number of directors for these purposes. Therefore, a corporation seeking to increase its number of directors presumably must do so by following whatever process is set forth in its charter documents, including any requirements to obtain shareholder or stockholder approval. Thus, the question remains as to the purpose or point of the last sentence of Section 301.3(a).

Section 301.3(b) requires that no later than December 31, 2021, a publicly held California or foreign corporation whose principal executive office, according to the corporation's SEC Form 10-K, is located in California, must comply with the following:

i. if its number of directors is six or more, the corporation must have a minimum of three female directors;

ii. if its number of directors is five, the corporation must have a minimum of two female directors; and

iii. if its number of directors is four or fewer, the corporation must have a minimum of one female director.

For purposes of Section 301.3:

i. the term "female" is an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth; and

ii. the term "publicly held corporation" is a corporation whose shares are listed on a major United States stock exchange.

Also, it is worth noting that the location of a corporation's principal executive office may differ from the location of a corporation's principal place of business, meaning that the requirements of Section 301.3 would still apply to a publicly traded foreign corporation that maintains its principal executive office in California but has its principal place of business located in another U.S. state and does not otherwise conduct substantial business activities within the State of California.

Penalties for Noncompliance; Annual State Publications

The California Secretary of State is given the authority under Section 301.3(e) to adopt regulations to implement this section and to impose the following fines:

i. for any failure to timely file board member information with the California Secretary of State pursuant to a regulation adopted by the California Secretary of State, a fine of $100,000;

ii. for a first violation of the requirements of Section 301.3, a fine of $100,000; and

iii. for a second and each subsequent violation of the requirements of Section 301.3, a fine of $300,000.

Section 301.3(e)(2) specifically states that each director seat required to be held by a female and not held by a female for at least a portion of a calendar year counts as a separate violation. It also appears that compliance is to be determined each calendar year. Therefore, a corporation could be in compliance in one calendar year but become non-compliant in subsequent calendar years, depending upon the extent to which the composition of its board of directors changes from year to year.

In addition to the foregoing, Section 301.3 also requires the California Secretary of State to publish annually on its website a report documenting compliance information, including the number of public companies that were in compliance with Section 301.3 during the calendar year, the number of public companies that have moved their principle executive office from California to another U.S. state, and the number of publicly held corporations that were previously subject to Section 301.3 but are no longer publicly traded.

Statutory Ambiguities and Other Interpretation Issues

Although the new law provides the California Secretary of State the authority to adopt implementing regulations, it contains numerous ambiguities and interpretation issues that are unlikely to be addressed for at least the foreseeable future. For example, the new law does not address what constitutes a "major United States stock exchange," nor does it include transition provisions for companies that are publicly traded for only a small portion of a calendar year. Furthermore, the new law is unclear as to whether a corporation required to have multiple female directors on its board of directors must have multiple female directors serving at the same time or if board service by females during different periods of the calendar year is sufficient for compliance.

Ambiguities in the statutory language may also create uncertainty on how to calculate fines for noncompliance in any given calendar year. For example, if a corporation with no prior Section 301.3 violations has no female directors during a calendar year when it is required to have at least three board seats filled by female directors, one interpretation of Section 301.3 is that there is a first violation for each of the three board seats and therefore the corporation's total fine for that calendar year is $300,000 (i.e., each board seat violation is subject to a fine of $100,000). However, another interpretation of Section 301.3 is that the failure to fill the three board seats with female directors constitutes a first, second, and third violation, resulting in an aggregate fine of $700,000 (i.e., $100,000 for the first violation and $300,000 for each of the second and third violations).

As a result of the foregoing and other ambiguities in the new law, companies subject to the requirements of Section 301.3 should consult with legal advisers and monitor any implementing regulations adopted by the California Secretary of State.

Possible Issues Regarding the Legal Validity of Senate Bill No. 826

In signing the bill, Governor Brown issued a letter that acknowledged that there may be potential legal issues and challenges to the implementation of the new law:

> "There have been numerous objections to this bill and serious legal concerns have been raised. I don't minimize the potential flaws that indeed may prove fatal to its ultimate implementation. Nevertheless, recent events in Washington, D.C.—and beyond—make it crystal clear that many are not getting the message."

One of the potential legal challenges to Section 301.3 is that it violates the equal protection clause of both the U.S. Constitution and the California Constitution by creating a quota mandate based exclusively on gender classification.

It is also possible that Section 2115.5, which states that the requirements of Section 301.3 apply to foreign corporations that are publicly held to the exclusion of the law where they are incorporated, violates the internal affairs doctrine and is unconstitutional under the commerce clause of the U.S. Constitution. The Delaware Supreme Court in *VantagePoint Venture Partners 1996 v. Examen, Inc.*[1] held that a similar requirement in Section 2115 of the California Corporations Code violated "Delaware's well-established choice of law rules and the federal constitution," and found that the internal affairs of Delaware corporations (and, in particular, the voting rights of shareholders) are to "be adjudicated exclusively" in accordance with Delaware law. In late May 2012, a California court indicated for the first time that it would be unwilling to enforce Section 2115 as well. In that case, *Lidow v. Superior Court,*[2] the Second Appellate District of the California Court of Appeal, in the published portion of an opinion, stated in dicta that matters of internal corporate governance (such as the voting rights of shareholders) fall within a corporation's internal affairs and that only the laws of the corporation's state of incorporation should govern such matters.

The foregoing arguments against the enforceability of Section 2115 are even more pronounced when applied to Section 2115.5. Unlike Section 2115, whose application on a so-called "quasi-California corporation" requires more than one-half of that corporation's outstanding voting securities to be owned by persons

having addresses in California and for specific property, payroll, or sales factor tests to be satisfied, the only nexus to California required for the application of Section 2115.5 to a publicly traded foreign corporation is for that corporation's principal executive office to be located in the State of California. Thus, the arguments that Section 2115.5 violates the internal affairs doctrine and is unconstitutional under the commerce clause of the U.S. Constitution are even stronger than the argument that Section 2115 violates those legal doctrines, and there may be significant questions on whether the State of California has sufficient jurisdictional grounds to enforce the requirements of Section 301.3 on certain publicly traded foreign corporations where the only contacts with the State of California are that their principle executive offices are located in California.

Next Steps and Proactive Compliance Planning

Although the possibility exists that Senate Bill No. 826 may be held by a court to be invalid, either in whole or in part, no assurance can be given that a court challenge, even if instituted, would conclude with a final unappealable decision before the California Secretary of State begins enforcing the law and publishing its annual reports on compliance. To the extent officers and directors of a public company have an opportunity to explore legal grounds for challenging the legality of this new law, we believe the leadership of many (if not most) public companies ultimately will be reluctant to do so in order to avoid the accompanying reputational risks.

Studies cited in Senate Bill No. 826 indicated that as of June 2017, more than one quarter, numbering approximately 117 or 26 percent, of the Russell 3000 companies based in California had no female directors. Given the fact that public companies, whether having their principal executive office located in California or elsewhere, are generally seeking more diversity on their boards, including female directors, it can be expected that competition for female directors for companies having their principal executive office located in California will intensify in the coming months and years.

Based on the foregoing, we believe that public companies with a principle executive office in California should start taking steps now to comply with Section 301.3. These steps will likely include identifying qualified female director candidates to add to their boards and establishing sufficient board seat vacancies to be filled when female directors are identified and duly elected. For some publicly held corporations, these steps may also include proactively seeking shareholder or stockholder approval to increase their authorized number of directors to ensure they can accommodate the addition of new female directors.

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1. *871 A.2d 1108 (2005)*
2. *206 Cal.App. 4th 351 (2012)*