

# California Enacts Novel Female Board Quota Legislation

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Until this year, there was only one eligibility requirement for directors of a California corporation—they had to be natural persons.<sup>1</sup> Although California has long imposed a variety of governance requirements on foreign corporations, it imposed no eligibility requirements for directors of foreign corporations.<sup>2</sup> That changed in 2018, with the enactment of Senate Bill 826 (Jackson),<sup>3</sup> reportedly the first state statute to impose a gender quota on corporate boards of certain California and foreign corporations.<sup>4</sup>

## Background of Senate Bill 826

Senate Bill 826 is not California’s first attempt to increase the number of women directors. In 1993, the Legislature enacted a law requiring the Secretary of State to develop and maintain a registry of “distinguished women and minorities” who are available to serve on corporate boards of directors.<sup>5</sup> In 1998, the Legislature authorized the Secretary of State to transfer this responsibility to a campus of either the University of California or California State University.<sup>6</sup> In 1999, California State University, Fullerton took over the registry and maintained it until 2005, when the registry was discontinued.<sup>7</sup> Although the Legislature required the Secretary of State to submit reports every three years, the Secretary of State never fulfilled that requirement.<sup>8</sup>

In 2011, California’s two largest public employee pension funds, the Public Employees Retirement System and the State Teachers Retirement System, announced their intention to establish their own registry, to be known as the “Diverse Director DataSource.”<sup>9</sup> In 2016, the two funds announced that the Diverse Director DataSource would be available through the Equilar Diversity Network.<sup>10</sup>

In 2013, Senator Hannah-Beth Jackson authored Senate Concurrent Resolution (SCR) 62, which urged that:

within a three-year period from January 2014 to December 2016, inclusive, every publicly held corporation in California with nine or more director seats have a minimum of three women on its board, every publicly held corporation in California with five to eight director seats have a minimum of two women on its board, and every publicly held corporation in California with fewer than five director seats have a minimum of one woman on its board.

Senator Jackson introduced Senate Bill 826 as a “follow-up” to SCR 62.<sup>11</sup> The National Association of Women Business Owners (NAWBO), which had supported SCR 62, sponsored Senate Bill 826.<sup>12</sup> The California Chamber of Commerce, numerous local chambers of commerce, and other business organizations opposed the bill.<sup>13</sup> Nonetheless, both houses of the California Legislature passed Senate Bill 826, and Governor Jerry Brown signed it into law on September 30, 2018.

The bill consists of only three sections. Section 1 consists of a series of legislative findings and declarations. Section 2 adds a new section 301.3 to the Corporations Code, imposing deadlines and minimum numbers of female directors. Section 3 adds a new section 2115.5 to the Corporations Code, providing that section 301.3 applies to a foreign corporation that is a publicly held corporation “to the exclusion of the law of the jurisdiction in which the foreign corporation is incorporated.” The

brevity of the bill belies the number of questions that it engenders.

### Scope of Senate Bill 826

Section 301.3 does not purport to apply to all incorporated entities. Rather, the statute applies to an entity that is a “publicly held domestic or foreign corporation.” The use of the term “domestic” suggests that the Legislature intended the statute to apply to corporations formed under California law, and not simply “corporations” as defined in section 162 of the Corporations Code.<sup>14</sup> Section 301.3(f)(2) defines “publicly held corporation” for purposes of section 301.3. This is odd, because the gender quota requirements apply to a “publicly held domestic or foreign corporation,” a term that is not defined in the statute.<sup>15</sup>

As defined, a “publicly held corporation” is “a corporation with outstanding shares listed on a major United States stock exchange.”

Because the General Corporation Law defines “corporation” as a corporation organized under that law, the statutory definition of “publicly held corporation” would appear limited to those corporations.<sup>16</sup> Finally, Senate Bill 826 fails to define what makes a stock exchange “major.” Other sections of the General Corporation Law identify subject exchanges by name rather than leave the meaning open to question.<sup>17</sup>

Section 301.3 applies to “publicly held domestic or foreign corporations whose principal executive offices, according to the corporation’s SEC 10-K form, are located in California.”<sup>18</sup> The General Corporation Law does not require that a corporation maintain a principal executive office in California. Thus, it is possible that a domestic corporation will maintain its principal executive office in another state. It is unclear whether the statute’s requirement that the principal executive office be in California applies only to foreign corporations or both foreign corporations and domestic corporations.

Senate Bill 826 also added a new section 2115.5 to the Corporations Code. Section 2115.5(a) states that section 301.3 applies to a “foreign corporation” that is a “publicly held corporation” to the exclusion of the law of the jurisdiction in which the foreign corporation is incorporated. Section 2115.5(b) defines “publicly held corporation” for purposes of section 2115.5 as a “foreign corporation with outstanding shares listed on

a major United States stock exchange.” Remarkably, section 2115.5 does not include a requirement that a foreign corporation have its principal executive office in California. Therefore, if section 2115.5 is read literally, it imposes section 301.3 on all foreign corporations that are publicly held corporations (as defined) and not simply those maintaining their principal executive offices in California. Presumably, however, the Legislature did not intend to apply section 301.3 to foreign corporations with no nexus to California.

It is unlikely that “foreign private issuers,” as defined by the Securities and Exchange Commission, will be subject to section 301.3 or section 2115.5.<sup>19</sup> These issuers may file annual reports on Form 20-F rather than a Form 10-K. Section 301.3 makes no reference to Form 20-F. Further, these issuers may list American Depositary Receipts, rather than their shares, on a United States stock exchange.<sup>20</sup> Thus, they would not have shares listed on a major United States stock exchange.

### Upcoming Gender Quota Mandates

Section 301.3 imposes two separate deadlines. First, a subject corporation must have at least one female director on its board no later than the close of the 2019 calendar year. Second, a subject corporation must, by the close of the 2021 calendar year, comply with the following:

- If the number of directors is six or more, the corporation must have at least three female directors;
- If the number of directors is five, the corporation must have a minimum of two female directors;
- If the number of directors is four or fewer, the corporation must have a minimum of one female director.

The statute defines “female” as an individual who “self-identifies her gender as a woman, without regard to the individual’s designated sex at birth.”<sup>21</sup> This does not account for previously enacted California legislation equally recognizing three gender categories: female, male, and nonbinary.<sup>22</sup> The Senate Judiciary Committee noted this omission, but the bill was not amended to include nonbinary persons.<sup>23</sup>

For purposes of determining violations, each director seat required to be held by a female that is not held by a female during at least a portion of a calendar

year counts as a violation.<sup>24</sup> It is unclear, however, when the number of directors is to be determined. For example, a corporation with four directors at the beginning of the year may amend its bylaws to increase the number of authorized directors to six. If one director is a female during the time when the corporation had four directors, would the corporation be counted as in compliance or would it need to have had at least three female directors during the period when it had six directors?

Another ambiguity in the statute arises from its failure to specify whether the number of directors is the number of directors then in office or the number of authorized directors. For example, a corporation may have five authorized directors with one seat unfilled. Does this mean that for purposes of section 301.3 the number of directors is four or five?

Section 301.3 states that a corporation “may increase the number of directors on its board to comply with this section.” NAWBO, the bill’s sponsor, seemed to assume that a board could simply add a director seat in all cases: “[I]f there’s not a retirement or other open seat in 2019, then the board must simply ‘add a seat for a woman director.’ Boards add or reduce seats whenever they choose.”<sup>25</sup> However, corporations do not have the power *in proprio motu* to change the number of directors. Under the California General Corporation Law, the number of directors is ultimately determined by the shareholders or the directors.<sup>26</sup>

Some corporations may choose to increase the authorized number of directors in lieu of replacing an incumbent director. However, expanding the board by one seat and filling that seat with a female director will not necessarily satisfy the statute. For example, assume a corporation has four directors and no female directors. By year-end 2021, one of the corporation’s male or non-binary directors must be replaced by a female director so that it has at least one female director. Alternatively, the number of authorized directors could be increased, and a female director elected or appointed to fill the resulting vacancy. However, the statute would then require the corporation to have two female directors, because it would then have a five-member board.<sup>27</sup> Thus, it could either replace one of the incumbent non-female directors or increase the number of directors to six. If it chooses the latter, however, Senate Bill 826 would then require three female directors. If the corporation did not want

to shed any of its non-female directors, it would have to increase the number of directors to seven. Thus, Senate Bill 826 may have the negative effect of either displacing qualified directors (including minority male and non-binary directors) or imposing additional costs on the shareholders as a result of a larger number of directors.

### Secretary of State Responsibilities

Section 301.3 imposes several new reporting and enforcement responsibilities upon the Secretary of State. The Secretary of State must publish on its Internet website by July 1, 2019, a report documenting the number of domestic and foreign corporations whose principal executive offices, according to the corporation’s Form 10-K, are located in California and who have at least one female director. It is unclear how the Secretary of State will accomplish this task, because the determination of who is female, as defined by the statute, rests on self-identification and neither the General Corporation Law nor the Securities and Exchange Commission require a director to disclose his or her gender identification.

No later than March 1, 2020, and annually thereafter, the Secretary of State must publish on its Internet website a report disclosing at least the following:

- The number of corporations subject to section 301.3 that were in compliance with the requirements of section 301.3 during at least one point during the preceding calendar year.
- The number of publicly held corporations that moved their United States headquarters to California from another state or out of California into another state during the preceding calendar year.<sup>28</sup>
- The number of publicly held corporations that were subject to this section during the preceding year, but are no longer publicly traded.<sup>29</sup>

The Secretary of State is empowered to adopt regulations implementing Section 301.3 and to impose fines for violations.<sup>30</sup> The statute prescribes the following schedule of fines:

- For failure to timely file board member information with the Secretary of State pursuant to regulation, the amount of \$100,000.
- For a first violation, the amount of \$100,000.

- For a second or subsequent violation, the amount of \$300,000.

Each director seat required by section 301.3 to be held by a female that is not held by a female during at least a portion of a calendar year counts as a violation.<sup>31</sup> However, no violation is counted if a female holds a seat for at least a portion of the year.<sup>32</sup> These fines appear to be administrative in nature and subject to the formal adjudication provisions of Chapter 5 of the California Administrative Procedure Act.<sup>33</sup> Notably, the Legislature did not empower the Secretary of State to apply to the superior court for a judgment in the amount of any fine levied.<sup>34</sup> Fines collected by the Secretary of State under the statute are available upon legislative appropriation for use by the Secretary of State to offset the costs of administering section 301.3.<sup>35</sup>

### Constitutional Questions

Even before Governor Brown signed Senate Bill 826 into law, questions were raised concerning its constitutionality. Expectedly, some expressed concern that by imposing gender quotas the law would violate the equal protection clauses of the United States and California Constitutions.<sup>36</sup> The bill analysis prepared for the Senate Judiciary Committee noted:

“Since a statute cannot supersede constitutional mandates, if there are indeed conflicts, then this bill would be unenforceable, at least to the degree of the conflict. If enacted, it is possible that this bill would face constitutional challenge in court.”<sup>37</sup>

Similarly, the bill analysis prepared for the Assembly Judiciary Committee on Judiciary included a discussion of the equal protection jurisprudence and concluded “SB 826 would likely be challenged on equal protection grounds and the means that the bill uses, which is essentially a quota, could be difficult to defend.”<sup>38</sup> Noting these constitutional concerns, Professor Joseph A. Grundfest predicted:

Opponents of all forms of affirmative action will likely characterize SB 826 as an example of the potential over-reach of race-based and gender-based statutory distinctions. They will likely argue that if SB 826 is allowed to stand, then the federal government, states, and local authorities

will be able to mandate racial and gender quotas across a broad range of private sector activities.<sup>39</sup>

The Legislature also recognized that Senate Bill 826 might be challenged under the internal affairs doctrine.<sup>40</sup> The United States Supreme Court has explained this doctrine as follows:

The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation’s internal affairs -- matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders -- because otherwise a corporation could be faced with conflicting demands.<sup>41</sup>

According to Professor Grundfest, “A board’s gender diversity is a matter of internal corporate governance, as is shareholder voting, and SB 826 interferes with both.”<sup>42</sup> Accordingly, he concludes: “There is no escape from the internal affairs doctrine or from the fact that SB 826, if it has any effect at all, will be limited to corporations chartered and headquartered in California.”<sup>43</sup>

Opponents of Senate Bill 826 will likely cite a 2005 opinion by the Delaware Supreme Court holding that Corporations Code section 2115 violates “Delaware’s well-established choice of law rules and the federal constitution.”<sup>44</sup> Section 2115 imposes numerous provisions of California’s General Corporation Law on foreign corporations that based on specified factors have their most significant contact with the State of California. However, a California court of appeal has upheld section 2115 as not violating the Commerce Clause, Equal Protection, and Impairment of Contract provisions of the United States Constitution.<sup>45</sup> Senate Bill 826 may nonetheless be more vulnerable than section 2115 to a successful challenge, because the required jurisdictional nexus is much less than that of section 2115.<sup>46</sup>

### The Impact of Senate Bill 826

While the impact of Senate Bill 826 remains to be seen, it is already the subject of significant debate. Professor Grundfest predicts that as a result of the limitations of the internal affairs doctrine, any gain in the number of female directors will be “trivial.”<sup>47</sup> Two teams of academics have conducted event studies in an effort to determine the effect of the enactment of Senate Bill 826 on shareholder value. Three professors at the

University of North Carolina’s Kenan-Flagler Business School concluded that the enactment of Senate Bill 826 “is associated with a significant negative impact on shareholder value.”<sup>48</sup> These professors hypothesize that an important reason for this result is the limited supply of qualified female directors. Another study found that “the adoption of the California mandatory gender quota law is associated with negative and significant announcement returns.”<sup>49</sup> They suggest that the quota imposes significant costs on California headquartered firms and their shareholders.

Aside from the effects on shareholders, there is also a question of what the effects of imposing a gender quota will be on women generally. Several European countries previously enacted gender quotas on companies. One study found that seven years after Norway’s implementation of a 40% gender quota for listed companies, the requirement “had very little discernible impact on women on business beyond its direct effect on the women who made it into boardrooms.”<sup>50</sup>

Section 1 of Senate Bill 826 includes a number of legislative and findings regarding the benefits of women serving on boards of directors.<sup>51</sup> The bill includes no findings or declarations concerning the benefits of minority representation on boards of directors.<sup>52</sup> The Senate Banking & Financial Institutions Committee also questioned the bill’s impact on minorities: “Will any men of color fail to be offered board seats, so that corporations can add women to their boards?”<sup>53</sup> In opposing the bill, the California Chamber of Commerce argued:

“Gender is an important aspect of diversity, as are the other protected classifications recognized under our laws. We are concerned that the mandate under SB 826 that focuses only on gender potentially elevates it as a priority over other aspects of diversity.”<sup>54</sup> It remains to be seen whether Senate Bill 826 will negatively impact board memberships of minority groups.

Should Senate Bill 826 survive constitutional scrutiny, scholars, shareholders, and directors will undoubtedly continue to debate all of these questions.

## Endnotes

1 CAL. CORP. CODE § 164. *See Does The Corporations Code Permit “Boards R Us”?*, CALCORPORATELAW.COM (Sept. 4, 2014), <http://www.calcorporatelaw.com/2014/09/corporations-code-permit-boards-r-us>.

- 2 *See, e.g.*, CAL. CORP. CODE §§ 800 (derivative actions), 1501 (annual report), 1601 (inspection of shareholder list). California’s most ambitious effort to regulate foreign corporations is Corporations Code section 2115, which imposes a long list of requirements on foreign corporations that meet specified tests.
- 3 2015 Cal. Stat. Ch. 954.
- 4 Vanessa Fuhrmans, *California Becomes First State to Mandate Female Board Directors*, THE WALL STREET J. (Sept. 30, 2018), <https://www.wsj.com/articles/california-becomes-first-state-to-mandate-female-board-directors-1538341932>. Numerous other countries, beginning with Norway in 2003, have imposed gender quotas on company boards. Felix von Meyerinck, Alexandra Niessen-Ruenzi, Markus Schmid & Steven Davidoff Solomon, *As California Goes, so Goes the Nation? The Impact of Board Gender Quotas on Firm Performance and the Director Labor Market* (Dec. 19, 2018) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3303798](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3303798) (“Meyerinck et al.”) (reporting that Belgium, France, Germany, Iceland, India, Israel, Italy, Norway, and Spain have imposed quotas).
- 5 CAL. CORP. CODE § 318; S.B. 545, 1993 Cal. Stats. Ch. 508.
- 6 1998 Cal. Stats. Ch. 829.
- 7 Marc Ballon, *Registry to List Minority Board Candidates*, L.A. TIMES (Aug. 11, 1999).
- 8 *Assembly Committee on Judiciary, Bill Analysis, S.B. 826*, 2017-2018 Leg. Sess. (Cal. June 26, 2018).
- 9 *Diverse Director “DataSource” Announced, Dogged by Questions*, CALCORPORATELAW (Apr. 6, 2011), <http://www.calcorporatelaw.com/2011/04/calpers-and-calstrs-announce-diverse-director-datasource>.
- 10 Press Release, Public Employees Retirement System, State Teachers Retirement System (Oct. 24, 2016) <https://www.calstrs.com/news-release/diverse-director-datasource-joins-equilar-diversity-network>.
- 11 *Senate on Banking and Financial Institutions, Bill Analysis, SB 826*, 2017-2018 Leg. Sess. (Cal. Apr. 18, 2018).
- 12 *Id.*
- 13 *Id.*
- 14 CAL. CORP. CODE § 167.
- 15 Section 301.3 employs the term “publicly held corporation” only in connection with the Secretary of State’s reporting obligation discussed below.
- 16 CAL. CORP. CODE § 162.
- 17 *See, e.g.*, CAL. CORP. CODE §§ 301.5, 2115.
- 18 A Form 10-K is the form used for by domestic issuers pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934. The cover page of the Form 10-K requires disclosure of the location of the registrant’s principal executive office.
- 19 17 C.F.R. § 240.3b-4(c).
- 20 An American Depositary Receipt, or ADR, is a negotiable certificate that evidences an ownership interest in American Depositary Shares which, in turn, represent an interest in the shares of a non-U.S. company that have been deposited with a United States bank. As such, an ADR is not a “share” as defined in Corporations Code section 184 (“the units in which the proprietary interests in a corporation are divided in the articles”).

- 21 CAL. CORP. CODE § 301.3(f)(1). In 2011, the Legislature amended many of California’s antidiscrimination statutes in attempt to clarify the meaning of “gender.” A.B. 887 (Atkins), 2011 Cal. Stats. Ch. 718 . Under this legislation, “gender” means “sex, and includes a person’s gender identity and gender expression. ‘Gender expression’ means a person’s gender-related appearance and behavior whether or not stereotypically associated with the person’s assigned sex at birth.” CAL. CIV. CODE § 51(e)(5). The Corporations Code, however, does not define “gender.” Because the definition of “female” in section 301.3 does not refer to either sex assigned at birth or an individual’s gender expression, the only relevant consideration for determining whether a director is female for purposes of section 301.3 is whether the director identifies herself as a female.
- 22 S.B. 179 (Atkins), 2017 Cal. Stats. Ch. 853.
- 23 *Bill Analysis, supra* note 11 (“This effort to provide gender diversity on our corporate boards is arguably leaving out nonbinary, gender nonconforming, and transgender Californians.”).
- 24 CAL. CORP. CODE § 301.3(e)(2)-(3).
- 25 *Senate Judiciary Committee, Bill Analysis, SB 826 2017-2018 Leg. Sess. (Cal. Apr. 24, 2018).*
- 26 The bylaws must set forth the number of directors or that the number of directors will be not less than a stated minimum nor more than a stated maximum (which may not be more than two times the minimum) with the exact number to be fixed within those specified limits by approval of the board or the shareholders. CAL. CORP. CODE § 212(a). Alternatively, this provision may be included in the articles. *Id.* After shares have been issued, a bylaw specifying or changing a fixed number of directors or the maximum or minimum number or changing from a fixed to a variable board or *vice versa* may only be adopted by approval of the outstanding shares. *Id.*
- 27 As noted above, it is unclear whether the corporation would be required to meet the higher quota in the year in which the size of the board increased or in the subsequent year.
- 28 The statute inconsistently refers to “headquarters” rather than “principal executive offices.”
- 29 This portion of the statute refers only to “corporations,” and makes no mention of foreign corporations.
- 30 The statute does not expressly empower the Secretary of State to adopt regulations implementing new section 2115.5.
- 31 CAL. CORP. CODE § 301.3(e)(2).
- 32 § 301.3(e)(3).
- 33 CAL. GOV’T CODE § 11500.
- 34 *Cf.* CAL. CORP. CODE § 25252(e) (authorizing the Commissioner of Business Oversight to apply to the Superior Court for a judgment after exhaustion of all review procedures in accordance with the Administrative Procedure Act).
- 35 CAL. CORP. CODE § 301.3(e)(4).
- 36 U.S. CONST. amend. XIV; CAL. CONST. art. I, § 7 (“A person may not be . . . denied equal protection of the laws.”).
- 37 *Senate Judiciary Committee, supra* note 25. The analysis also noted that Senate Bill 826 might be challenged under article I, section 8 of the California Constitution, which provides: “A person may not be disqualified from entering or pursuing a business, profession, vocation, or employment because of sex, race, creed, color, or national or ethnic origin.”
- 38 *Assembly Committee on Judiciary, supra* note 8. *See also Senate on Banking and Financial Institutions, supra* note 11 (“According to informal advice provided to Committee staff by the Office of the Legislative Counsel, California court rulings on the constitutionality of laws that require differential treatment based on gender have identified gender as a suspect classification subject to strict scrutiny review.”).
- 39 Joseph A. Grundfest, *Mandating Gender Diversity in the Corporate Boardroom: The Inevitable Failure of California’s SB 826* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 232, p. 7, Sept. 12, 2018) (“Grundfest”).
- 40 *Senate Judiciary Committee, supra* note 25; *Assembly Committee on Judiciary, supra* note 8.
- 41 *Edgar v. Mite Corp.*, 457 U.S. 624, 645 (1982).
- 42 Grundfest, *supra* note 39, at 3.
- 43 *Id.*
- 44 *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1116 (Del. 2005).
- 45 *Wilson v. Louisiana-Pacific Res., Inc.*, 138 Cal. App. 3d 216 (1982).
- 46 *Why California’s Gender Quota Bill Is More Likely to Be Unconstitutional than California’s Pseudo-Foreign Corporation Statute*, CALCORPORATELAW (Sept. 4, 2018), <http://www.calcorporatelaw.com/why-californias-gender-quota-bill-is-more-likely-to-be-unconstitutional-than-californias-pseudo-foreign-corporation-statute>.
- 47 Grundfest, *supra* note 39, at 2.
- 48 Sunwoo Hwang, Anil Shivdasani & Elena Simintzi, *Mandating Women on Boards: Evidence from the United States* (Kenan Instit. of Private Enter., Research Paper No. 18-34, Nov. 18, 2018) (unpublished paper), <https://ssrn.com/abstract=3265783> or <http://dx.doi.org/10.2139/ssrn.3265783>.
- 49 Meyerinck et al. *supra* note 4.
- 50 Marianne Bertrand, Sandra E. Black, Sissel Jensen & Adriana Lleras-Muney, *Breaking the Glass Ceiling? The Effect of Board Quotas on Female Labor Market Outcomes in Norway*, 86 REV. OF ECON. STUDIES 191 (2019).
- 51 Section 1 refers to “women,” while the operative sections of the bill refer to “female” directors.
- 52 According to the United States Census Bureau, a majority of California’s population is female. <https://www.census.gov/quickfacts/ca>. Thus, Senate Bill 826 imposes a quota in favor of the majority.
- 53 *Senate Banking & Financial Institutions, supra* note 11.
- 54 *Assembly Committee on Judiciary, supra* note 8.