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State Mandated Gender Diversity on Corporate Boards

Although many studies have shown that diversity on corporate boards of directors provides many corporate benefits, women continue to hold just a small number of corporate board seats. According to a recent report by PricewaterhouseCoopers, only twenty-five percent of S&P 500 companies have more than two women on their boards. To address this disparate representation, the California legislature has passed a new law that will require a minimum number of women directors on the boards of certain corporations. SB 826 (codified in Sections 301.3 and 2115.5 of the California Corporations Code), which was approved by Governor Brown on September 30, 2018, provides that by the close of the 2019 calendar year, certain corporations must have a minimum of one female on its board of directors. No later than the close of the 2021 calendar year, the bill increases the required minimum number to two female directors if the corporation has five directors or to three female directors if the corporation has six or more directors. This new law applies to California general corporations and foreign corporations that are publicly held, whose principal executive offices, as reported on the corporation's SEC form 10-K, are located in California.

The Secretary of State has been tasked with publishing various reports on its website documenting, among other things, the number of corporations in compliance with these provisions. The bill would also authorize the Secretary of State to impose fines for violations of the bill, and would provide that funds collected as a result of these fines are to be available, upon appropriation, to offset the cost of administering this new law.

Although the actions of the California legislature were undoubtedly made with the best intentions, SB 826 will certainly face legal challenges on several grounds. SB 826 will undoubtedly be challenged as an unconstitutional gender quota that violates the 14th Amendment's requirement of equal protection. The Supreme Court has previously struck down fixed diversity quotas as unconstitutional. See, e.g., Regents of the University of California v. Bakke (1978). Lower courts have also rejected the proposition that "diversity" justifies gender quotas. See, e.g., Lamprecht v. FCC, 958 F.3d 382 (1992). Notably, even California Constitution's own equal-protection clause prohibits race and gender proportionality requirements.

In order for SB 826 to survive strict scrutiny under the Equal Protection Clause, California must show that it has a compelling interest and the law itself is necessary in order to achieve California's diversity objective. If there is a less discriminatory means of achieving the same goal, the law will be struck down as unconstitutional. See, e.g., Loving v. Virginia, 388 U.S. 1 (1967). Due to the rigorous standard that California must satisfy, it is unlikely that SB 826 would survive an equal protection challenge.

Even if SB 826 does manage to survive such a legal challenge, it will also likely be challenged on constitutional grounds that it violates the Dormant Commerce Clause. The Dormant Commerce Clause (also known as the "Negative Commerce Clause") is a legal doctrine that courts have inferred from the Commerce Clause in Article I of the US Constitution, which provides "[t]he Congress shall have Power... [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes...". The Dormant Commerce Clause generally prohibits state legislation that discriminates against or unduly burdens interstate commerce.

Since SB 826 may apply to publicly traded corporations that are incorporated outside of the State of California, California's imposition of board composition mandates on such companies may be viewed as an undue burden on interstate commerce.

Lastly, SB 826 will also likely be challenged on the grounds that it violates the "internal affairs doctrine". The "internal affairs doctrine" is a legal principle that "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." Edgar v. MITE Corp. 457 U.S. 624, 645 (1982). Under the internal affairs doctrine, California is permitted to impose governance restrictions and mandates on corporations that are incorporated in the state. However, the internal affairs doctrine would generally prohibit California from imposing those same restrictions on corporations that are incorporated elsewhere, even if those corporations have a principal executive office in the state of California.

Nevertheless, the general rule of the internal affairs doctrine may not apply if a different state can show that it has a more significant relationship to the parties and the transaction. See e.g., Rest. 2d Conf. of Laws, § 309, p. 332. Thus, if California can make a compelling showing that its interests are stronger than those of the state of incorporation, it is possible that California may be able to assert power over the foreign (non-California) corporations. California would need to show that the location of a corporation's principal executive offices is more significant for purposes of board composition than the state of incorporation.

Aside from the legal challenges that SB 826 will likely face, there are non-legal concerns that have been raised as well. Some believe that quotas can be applied in order to correct a previous gender imbalance. However, others believe that gender quotas on boards may not be the best way of overcoming the effects of historic disproportionate representation. In fact, such a mandate may inadvertently create a further divide due to the involuntary nature of the government mandate, and the penalties that ensue for failure to comply. Women selected for the mandated positions may also be viewed as receiving the position because of their gender and not for their qualifications or merits.

Until the legal challenges to SB 826 are resolved, implementation of SB 826's diversity mandate will likely be suspended. While the likelihood of the law's survival remains dubious, board gender diversity is expected to remain an important issue for corporate stakeholders. Thus, publicly and privately held businesses may be well-advised to focus their efforts in this area, regardless of whether such a legal mandate ultimately survives legal scrutiny.

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