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California gender diversity bill faces legal challenge

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As many will recall, in 2018 then-California Gov. Jerry Brown signed into law Senate Bill 826, which instituted gender quotas at public corporations headquartered in the state. Each California-headquartered public corporation must include:

- at least one female director on its board of directors by Dec. 31, 2019; and
- at least two female directors if the board has five directors, and three female directors for boards of six or more by Dec. 31, 2021.

Noncompliance will result in a fine of \$100,000 in the first year of violation and \$300,000 each year thereafter until corrected, with a separate \$100,000 fine for failing to provide required information to the state.

The California secretary of state's office issued its first report, as mandated by SB 826, last month. Earlier this month, Judicial Watch, a conservative activist group, filed the first legal challenge to the bill in California state court. The complaint (*Crest v. Padilla*, filed Aug. 6) was filed in Los Angeles County Superior Court on behalf of three California tax payers alleging that SB 826 is illegal under the California Constitution because "a quota system for female representation on corporate boards employs express gender classifications."

The legal challenge is not surprising, as early opponents of the bill had argued that SB 826 violates the U.S. Constitution, the California Constitution and California civil rights laws based on equal protection grounds. In fact, Brown's letter issued in connection with signing the bill into law recognized that "[t]here 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," he continued, "recent events in Washington, D.C. — and beyond — make it crystal clear that

many are not getting the message. As far back as 1886, and before women were even allowed to vote, corporations have been considered persons within the meaning of the Fourteenth Amendment. ... Given all the special privileges that corporations have enjoyed for so long, it's high time corporate boards include the people who constitute more than half the 'persons' in America."

Because the plaintiffs have argued that the law creates a suspect gender classification under the California Constitution, SB 826 may be subject to the strict scrutiny standard of review. *See Connerly v. State Personnel Bd.*, 92 Cal. App. 4th 16, 39-40 (2001). Under the strict scrutiny standard, the plaintiff bears the burden of proof; however, once the plaintiff has triggered strict scrutiny review, the burden of justification shifts to the government. *Id.* at 43. Further, where a law employs a suspect classification, it is presumed to be invalid. *Id.* at 44. The gender classification must be justified by a compelling governmental interest, and its use must be narrowly tailored to serve that interest. *Id.* at 44. In the complaint, the plaintiffs claim standing under "California's common law taxpayer standing doctrine and Code of Civil Procedure Section 526a, which grants California taxpayers the right to sue government officials to prevent unlawful expenditures of taxpayer funds and taxpayer-financed resources." The complaint seeks to enjoin the California secretary of state from expending taxpayer funds and taxpayer-financed resources to enforce or otherwise carry out SB 826.

The Assembly Judiciary Committee's analysis of the bill recognized that should SB 826 be challenged in California state court, "the State would confront a difficult challenge in showing a compelling interest in requiring a gender-based quota system for a private corporation" and suggested that "[t]o defend the constitutionality of this bill, it would not appear to be enough to simply cite statistics showing that women are grossly

underrepresented on corporate boards. The defenders of the bill would most likely need to show specific evidence of discriminatory behavior, rather than simply inferring discrimination from the disproportionate numbers." The analysis continued that "because courts have held in some cases that past discrimination and differences in opportunity, when demonstrated with specificity, can justify gender classification, this may be a potentially promising strategy for supporters of the measure."

Notably, the complaint by Judicial Watch does not challenge SB 826 on the basis that it violates the "internal affairs doctrine," which generally provides that the laws of the state of incorporation govern the internal actions of a corporation. Commenters had remarked that SB 826 attempts to dictate actions taken by directors of corporations that may be incorporated outside of California.

While the legal challenge to SB 826 was likely inevitable, California's SB 826 is part of an international trend that has taken hold among U.S. investors and which has also gained the attention of U.S. boards of directors. Whether or not the California gender diversity bill is upheld, U.S. investors will continue to push for greater diversity among directors on public company boards. For instance, there are no longer any all-male boards among S&P 500 companies, a change from 2012, when one in eight S&P 500 boards were all-male.

Blackrock states that it "encourage[s] companies to have at least two women directors on their board." State Street has stated that,

starting in 2020, it will vote against the entire nominating committee "if a company does not have at least one woman on its board, and has not engaged in successful dialogue on State Street Global Advisors' board gender diversity program for three consecutive years." Stockholder advisory groups have also adopted voting recommendations pushing for greater gender diversity on boards. Institutional Shareholder Services has adopted a policy that, effective for meetings on or after Feb. 1, 2020, for companies in the Russell 3000 or S&P 1500 indices, it will generally vote against or withhold from the chair of the nominating committee (or other directors on a case-by-case basis) at companies without women on the board. Similarly, beginning for stockholder meetings in 2019, Glass Lewis has a policy of generally recommending a vote against the nominating committee chair of a board that has no female members and may extend this recommendation to vote against other nominating committee members.

Given these trends, and regardless of whether or not SB 826 is upheld, companies increasing the diversity of their boards will be better prepared to respond to the demands of their investors, shareholders and constituents.

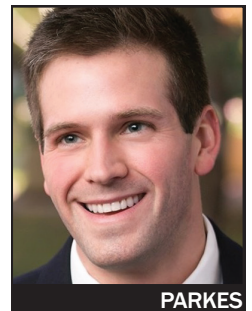
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