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Client Alert

Corporate, Finance and Investments

OCTOBER 5, 2018

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California Enacts Law Requiring Female Representation on Boards

On September 30, 2018, California Governor Jerry Brown signed into law Senate Bill No. 826 (SB 826). SB 826 adds Sections 301.3 and 2115.5 to the California Corporations Code to require that a publicly held company with a principal executive office in California include a minimum number of females on its board of directors. SB 826 instructs the Secretary of State of California to publish annual reports related to the adoption of SB 826 by corporations and gives the Secretary of State the power to levy certain fines for violations of Section 301.3.

SB 826's stated purpose is to boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders and retirees. Section 1 of SB 826 notes that, as measured in 2017, women held only 15.5% of the board seats of California public companies included in the Russell 3000 Index and that more than one fourth of California's public companies on the Russell 3000 Index have no women directors. SB 826 further notes that smaller companies with lower revenue are less likely to include a woman director. SB 826 cites several studies indicating that increased representation of women on boards of directors will further the statute's goals, and notes that gender parity on boards will take decades to accomplish without active intervention.

BOARD COMPOSITION REQUIREMENTS

SB 826 applies to all companies with outstanding shares listed on a major U.S. stock exchange and with a principal executive office located in California (as indicated on the company's annual report on Form 10-K).

The law anticipates a multi-year phase-in period. All covered companies will be required to have a minimum of one female director by December 31, 2019. By December 31, 2021, companies must be in full compliance with the law, which requires that:

- at least three directors be female if a company has six or more directors;
- at least two directors be female if a company has five directors; and

- at least one director be female if a company has four directors.

The law defines female in terms of gender self-identification rather than gender assigned at birth.

SECRETARY OF STATE REPORTS

SB 826 requires that the California Secretary of State publish, prior to July 1, 2019, a report documenting the number of domestic and foreign corporations with principal executive offices located in California and at least one female director. Further, SB 826 requires that the California Secretary of State begin publishing an annual report by March 1, 2020 setting forth, at a minimum, the following information:

- the number of corporations subject to the law that were in compliance with its requirements at some point during the preceding calendar year;
- the number of publicly held corporations that moved their headquarters to California from another state or out of California to another state during the preceding calendar year; and
- the number of publicly held corporations that were subject to the law during the preceding year but are no longer publicly traded.

PENALTIES FOR FAILURE TO COMPLY

In the discretion of the California Secretary of State, a corporation that fails to comply with the law may be subject to a fine of up to $100,000 for an initial violation and up to $300,000 for each subsequent violation. Each director seat that should be held by a female but is not during at least a portion of a calendar year constitutes a separate violation. In addition, a corporation that fails to timely file board member information may be subject to a $100,000 fine. Fines collected for such violations will be used to offset the cost of administering the law.

POTENTIAL CHALLENGES

Opponents of SB 826 argue that SB 826 violates the equal protection clause of each of the U.S. Constitution and the Constitution of the State of California, as well as the “internal affairs doctrine.”

Under equal protection clause jurisprudence, because SB 826 creates an express gender classification, it is likely to be subject to heightened scrutiny under the 14th Amendment of the U.S. Constitution and California Constitution Article 1, Section 7. Specifically, under the 14th Amendment, gender classifications like SB 826 are treated as quasi-suspect classes and are evaluated based on intermediate scrutiny. If challenged, the State of California will need to prove that the law serves important governmental objectives and is substantially related to those objectives. The California Constitution, on the other hand, imposes strict scrutiny on gender-based distinctions, an even greater burden for the government.

The internal affairs doctrine is a conflict-of-laws principle that holds that the state of incorporation should, in most cases, have authority to regulate the internal affairs of a corporation. California Corporations Code Section 2115 is a long-arm statute that purports to apply California law to foreign corporations with substantial operations in California, termed “quasi-California corporations.” SB 826 adds a provision to Section 2115 that applies California law to publicly held corporations incorporated outside of California but headquartered in California to the exclusion of the law of the jurisdiction in which they are incorporated. Prior to the enactment of SB 826, Section 2115 already purported to regulate foreign corporations operating in California, including requirements related to board composition and other matters related to internal corporate affairs.

While the U.S. Supreme Court has not directly addressed the constitutionality of Section 2115, the Delaware Supreme Court held in *VantagePoint Venture Partners 1996 v. Examen, Inc.* (Del. 2005) that Section 2115 violates the U.S.

Constitution. Regardless of the ruling in Delaware, it remains to be seen whether courts in California and other states will uphold SB 826 against an internal affairs challenge. Proponents of SB 826 point out that Section 2115 and other similar California statutes have largely been left alone by out-of-state courts and are regularly adhered to by out-of-state corporations.

PRACTICAL CONSIDERATIONS

Approximately 100 public companies currently headquartered in California have no female directors. Each of those companies will need to add at least one female director to its board by the end of 2019 to comply with SB 826, with additional female appointments to follow by the end of 2021 as applicable. Publicly held corporations with a principal executive office in California will need to determine how to comply with SB 826 and what corporate approvals may be needed to do so. While SB 826 allows a corporation to comply by expanding its board of directors, in doing so a corporation should be mindful of the requirements of its organizational documents, which may, for instance, require stockholder approval to increase the size of the board. Some have pointed out that the language of SB 826 is potentially ambiguous as to whether the number of female directors required is based on the total number of available seats (including vacancies) or the number of directors currently serving on the board. It is expected that the California Secretary of State will clarify this point in implementing regulations for SB 826.

FOREIGN PRECEDENT

Though the first of its kind in the United States, several European countries, as well as countries such as India and Israel, have mandated the inclusion of women on boards of directors of public companies for several years. Germany is the largest economy to mandate female directors of public companies, with a 30% representation requirement. Norway was the first to require 40% female representation on corporate boards, with France following in 2011. Since 2016, Italy has required that at least one third of a board's seats be held by women.

CONCLUSION

California's recent enactment of SB 826, requiring a publicly held corporation with a principal executive office in California to have a minimum number of female directors, will impact numerous corporations in various industries, including many not incorporated in California. The law will likely face significant opposition but, regardless of the outcome of any challenges, the law has succeeded in placing diversity in corporate governance at the forefront of public discussion. Public companies, both within California and without, should consult their advisors to determine what action is necessary.

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