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Legal or not, it's working: Mandatory board diversity for publicly-held companies headquartered in the Golden State

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APRIL 7, 2021

Public companies are running a gauntlet of corporate governance hazards these days concerning board diversity based on gender, race, sexual identity and sexual preference. Those hazards include new diversity disclosure laws proposed by NASDAQ and the SEC, shareholder derivative suits filed by fee-hungry plaintiffs' class action lawyers against "apparently" non-diverse boards, sharp-penciled institutional investors eyeing higher returns, and — in California — a state legislature seeking to speed up the pace of social change in corporate America, starting with the Golden State.[1]

We have previously written[2] on the advent of private shareholder derivative suits targeting boards of companies apparently lacking in racial diversity, while touting inclusive cultures.[3] These derivative suits generally lack much by way of real financial risk to the defendants, but are a form of public-shaming designed to elicit a prophylactic compromise — and an attorney's fee.

This article focuses on California's unique new corporate laws mandating board diversity. The diversity mandates were heralded into law with worried acknowledgements by the California legislature and two governors of the possibility of strong legal challenges ahead.

We discuss the status of the existing legal challenges, the not-yet-invoked internal affairs doctrine defense for companies headquartered in California but incorporated elsewhere, and how companies are reacting to the new board composition requirements, as illuminated in public reports filed by the California Secretary of State ("Secretary").

BOARD DIVERSITY QUOTAS FOR CALIFORNIA-HEADQUARTERED PUBLIC COMPANIES

In September 2020, California's Governor signed AB 979,[4] a bill that requires boards of directors of California-headquartered, publicly-held companies to include members of defined "underrepresented communities" as directors on their boards.[5]

The law requires compliance not only by companies incorporated in California, but companies incorporated elsewhere — such as Delaware — and expressly applies "to the exclusion" of the laws of the state of incorporation.[6]

The newly enacted law requires boards to have at least one such director by December 31, 2021. By the end of 2022, boards with four to eight directors must have two such members and boards with nine or more directors must have at least three such members.

The law defines a member of an "underrepresented community" as "Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual, or transgender" (shorthanded here as "diverse").

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The mandated board composition applies to "publicly-held" corporations (defined as those whose securities trade on one of three national exchanges) that report having a principal executive office in California on their federal Form 10-K filed with the SEC.[7]

Privately held companies and those whose securities are traded on smaller exchanges or over the counter are not required to comply. The Secretary is authorized, but not required, to promulgate regulations enforcing the law and may impose a $100,000 fine for the first offense, with each subsequent violation carrying a potential $300,000 fine.

The Secretary must file annual reports tallying the companies that have complied based on annual California Corporate Disclosure Statements, the form for which has been revised to capture board composition compliance.[8]

The diversity mandate is a follow-on to the groundbreaking 2018 California law, SB 826,[9] that requires the same group of publicly held companies headquartered in California to include at least one female director on their boards.

The law applies to companies formed under the laws of other states "to the exclusion" of the laws of the state of incorporation — the same language adopted by AB 797.[10] The Secretary's authorities and duties — including the ability but not the obligation to impose regulations and fines — are also the model for AB 797's diversity mandate.[11]

LEGAL CHALLENGES TO THE BOARD DIVERSITY QUOTA LAWS

Companies themselves understandably have been reluctant to go on public record with lawsuits challenging the board diversity mandates. There have been two types of court challenges to date, however, with the most successful being a taxpayer action in California state court.

In that case, *Crest v. Padilla* (*Crest I*), a taxpayer seeks an injunction against the Secretary's allegedly unlawful expenditure of public funds to enforce the "gender quota" as an allegedly invalid classification in violation of the Equal Protection clause of the California Constitution.[12]

In June 2020, the superior court overruled the Secretary's demurrer and upheld the taxpayer plaintiff's statutory standing to challenge an allegedly illegal use of public funds.[13] The case is headed for trial in late 2021. The same plaintiff and law firm filed a nearly identical action, *Crest II*, on the heels of the 2020 diversity mandate legislation.[14]

In both cases, the lead issue for trial will be whether the "quota-like" board mandates violate the California Constitution, which provides: "The State shall not discriminate against, or grant preferential treatment to, any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting."[15]

The level of scrutiny to be applied by the trial court depends on the classification at issue. The 2020 diversity mandate includes race-based classifications that likely would trigger strict scrutiny requiring the government to show that the law is narrowly drawn and necessary to achieve a compelling state interest.

The 2019 gender-based mandate, on the other hand, likely would trigger a lesser level of intermediate scrutiny under federal law (requiring the government to demonstrate that the law is substantially related to an important government interest) but strict scrutiny under California law, which recognizes sex as a suspect class.

The second type of court challenge is reflected in a federal action brought by a single stockholder of an affected publicly-held corporation headquartered in California, and incorporated in Delaware.[16]

In *Meland v. Padilla*, the stockholder sued then-Secretary Padilla under a federal civil rights statute, 42 U.S.C.A. § 1983, claiming that the female director mandate is an unconstitutional violation of Equal Protection under the Fourteenth Amendment of the United States Constitution, and seeking declaratory and injunctive relief against enforcement of the statute. The plaintiff's theory is that, although the law applies to corporations, it is the stockholders who are forced to consider gender when electing members to the board.

The Secretary moved to dismiss, asserting lack of standing, ripeness, and mootness, arguing that the plaintiff could not demonstrate a concrete and particularized injury in fact.[17]

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The Secretary argued that the plaintiff had no standing as a stockholder because he could not demonstrate any injury distinct from the corporation as a whole, that the action was unripe because the Secretary had not levied any fines or taken any enforcement action, and that the claim was moot because the corporation had elected a woman to its board and was in compliance.[18]

The Eastern District of California agreed with the Secretary, finding that the stockholder lacked standing, as nothing in the statute requires stockholders to vote based on sex, or punishes them for voting against a female candidate. The stockholder appealed. The case is pending in the Ninth Circuit, where the issues have been fully briefed and were argued on March 10, 2021.[19]

The parties acknowledge that a company itself would have standing to challenge the law, but no company has done so. Perhaps, as the Secretary argued, the issue simply is not ripe, as the only enforcement action taken so far has been sending letters to affected companies and issuing annual compliance reports, although the plaintiff argued that these actions *are* enforcement.

If the stockholder-plaintiff in the *Meland* appeal prevails, the case would be remanded for trial where the primary issue would be, as in the taxpayer action, whether the gender-based mandate passes constitutional scrutiny.

CORPORATE RESPONSE

Publicly available information suggests that companies are largely complying with the law, despite costs of compliance and the absence of any immediate threat of fines. The Secretary issued a baseline report on compliance with the female director mandate in July 2019, and has now issued annual reports in March 2020 and March 2021 identifying compliant and non-compliant companies as of the prior year-end.[20]

The reports suggest that while a large number of public companies report having principal California offices in their federal Form 10-Ks, far fewer file California Disclosure Statements, which reports board composition.

Of those companies that are affected and report (*i.e.*, are "publicly held," report being headquartered in California in their federal Form 10-K, and file a California Corporate Disclosure Statement), the law appears to be having a significant impact. Whereas the legislative history of SB 826 reported that 26 percent of regulated companies had no women on their boards at the kickoff prior to enactment of the new law, that percentage plummeted to 14.5 percent in 2019 and 2.2 percent in 2020.[21]

INTERNAL CORPORATE AFFAIRS — CALIFORNIA CAMPING AGAIN ON DELAWARE'S LAWN

For corporations incorporated in states other than California, there is a potentially potent defense based on what is known as the "internal affairs doctrine," a principle that internal corporate governance matters must be controlled by the law of the corporation's state of incorporation.

The doctrine is near-universally recognized, even if the corporation has limited or no connection to the state of incorporation other than the fact of incorporation itself. Matters concerning the number, qualifications, and election of directors have historically been viewed as subject to the internal affairs doctrine.[22]

The state most likely to cross swords on the issue, if raised, is Delaware, given that it is home to more than two-thirds of Fortune 500 companies, including many based in California.[23] If a Delaware corporation were to mount a challenge to enforcement of the California long-arm corporate law outreach under internal affairs principles, it would not be the first time.

In a landmark 2005 case, *VantagePointe Venture Partners*,[24] a Delaware corporation challenged California Corporations Code section 2115 — known as the "quasi-California corporation" law — which expressly applies many sections of the California Corporations Code to "foreign corporations" that are more than 50 percent owned by California residents or conduct more than 50 percent of their business from California (measured by property, payroll or sales).[25]

In *VantagePoint*, section 2115's long-arm would have given a class of preferred stock the right to vote separately on a proposed merger (effectively giving the preferred stockholders a blocking vote) — even though Delaware law would permit the class of preferred stock only a collective vote with all other classes.

The corporation sued in the Delaware Court of Chancery, seeking a declaration that the application of section 2115 would be an unconstitutional violation of the internal affairs doctrine recognized by the United States Supreme Court.[26] The Delaware Supreme Court agreed, holding that the enforcement of section 2115 in that case would violate the Due Process Clause:

The internal affairs doctrine is not, however, only a conflicts of law principle. Pursuant to the Fourteenth Amendment Due Process Clause, directors and officers of corporations "have a significant right … to know what law will be applied to their Actions" and "stockholders … have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs." Under the Commerce Clause, a state "has no interest in regulating the internal affairs of foreign corporations." Therefore, this Court has held that an "application of the internal affairs doctrine is mandated by constitutional principles, except in the 'rarest situations,'" e.g., when "the law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce." (citations omitted).

Despite this ruling, now more than 15 years ago, California has never taken action to reduce or limit the reach of its quasi-California corporation long-arm statute and, in the context of the recent board diversity legislation, has stated unequivocally that California law applies to the "exclusion" of the law of the state of incorporation.[27] As our Delaware colleagues have noted,[28] the rift between California and Delaware on internal affairs was recently revived in an August 2020 decision.[29]

In *JUUL Labs*, the Delaware Court of Chancery held that disputes concerning the internal affairs of a Delaware corporation — that case, a stockholder's right to inspect corporate books and records — are controlled exclusively by Delaware law, even where another state's law (there, California) purports to govern the subject-matter of the internal affairs at issue.[30]

CONCLUSION

It will be some time before the current legal challenges to California's board diversity mandates wind their way through the courts. In the meantime, progressive changes in board composition appear to be taking hold and facing few headwinds.

With investors, consumers, stock exchanges and federal and state regulators singing in unison in favor of diversity

and inclusion as a good thing for companies, the technical legalities may not matter.

Notes

[1] The NASDAQ proposed rules may be found here: https://bit.ly/2PWgywy. The SEC rules may be found here: https://bit.ly/3moUA1f. Additionally, the SEC's Office of Minority and Women Inclusion has developed a Diversity and Assessment Report that it encourages regulated entities with more than 100 employees to complete and submit to the SEC. These reports allow the SEC to "monitor trends in diversity-related policies and programs[,]" and ultimately publish an anonymized report of the information collected. Among the institutional investors pushing for change, is Blackrock, Inc. *See* Saijel Kishan, BlackRock to Push Companies on Racial Diversity in 2021, Bloomberg (December 9, 2020, updated December 10, 2020) https://bloom.bg/3urzdiF (last visited March 22, 2021). The interests of institutional investors harken back to a McKinsey study, recently updated, finding that diversity and inclusion on boards drives higher return on investment. https://mck.co/3uwT7sN)

[2] https://bit.ly/3dIgClo

[3] P. Palmer, A. Peurach, H. Privette, B. DiBella, and S. Burdick, A New Wave of Board Diversity Derivative Litigation (Oct. 21, 2020) https://bit.ly/2PIr0rD.

[4] https://bit.ly/3wwpcCL

[5] Cal. Corp. Code § 303.4.

[6] Cal. Corp. Code § 2115.6(a).

[7] Cal. Corp. Code § 301.4(a).

[8] *See* https://bit.ly/2RcTv1d (last visited March 23, 2021).

[9] https://bit.ly/3dB2H7a

[10] Cal. Corp. Code § 2115.6(a).

[11] The California legislature is also considering a new bill, AB 105, that would require state boards and commissions to have minimum numbers of members of "underrepresented communities."

[12] *Crest et al. v. Padilla (Crest I)*, C.A. No. 19STCV27561 (Cal. Super. Ct.).

[13] Cal. Code Civ. P. § 526a.

[14] *Crest et al. v. Padilla (Crest II)*, C.A. No. 20STCV37513 (Cal. Super. Ct.).

[15] Cal. Constit, Art. I, Sec. 7 & Sec. 31a.

[16] *Meland v. Padilla*, C.A. No. 2:19-cv-2288 (E.D. Cal.).

[17] *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61 (1992).

[18] Cal. Corp. Cod. § 301.3(e)(1) ("The Secretary of State may impose fines for violation of this Section[.]").

[19] *Meland v. Padilla*, C.A. No. 2:19-cv-2288.

[20] *See* https://bit.ly/3wFLa6z (last visited March 23, 2021).

[21] *See* https://bit.ly/3fIVzrW (last visited March 23, 2021).

[22] *Rosenmiller v. Bordes*, 607 A.2d 465, 469 (Del. Ch. 1991); 10 Del. C. § 145.

[23] https://bit.ly/3fN1rjK (last visited March 23, 2021).

[24] *VantagePointe Venture Partners 1996 v. Examen, Inc.*,871 A.2d 1108 (Del. 2005).

[25] Cal. Corp. Code § 2115.

[26] *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

[27] Cal. Corp. Code §§ 2115.5, 2115.6. The board diversity mandate does not turn on the two pronged test of 2115, but rather on a publicly held company's disclosure in its federal Form 10-K that it is headquartered in California. Cal. Corp. Code §§ 301.3(b), 301.4(b).

[28] https://bit.ly/3sVe3JF

[29] C. Chuff, Cline, M. Greenberg, B. Taylor, Delaware Court of Chancery tells California to Get Off its Lawn (Aug. 17, 2020) https://bit.ly/31Qtwi5; JUUL Labs, Inc. v. Grove, C.A. No. 2020-0005-JTL (Del. Ch. Aug. 13, 2020).

[30] *JUUL Labs, Inc. v. Grove*, C.A. No. 2020-0005 (Del. Ch. Aug. 13, 2020).

This article was published on Westlaw Today on April 7, 2021.

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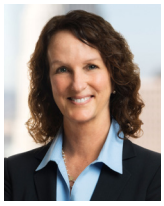

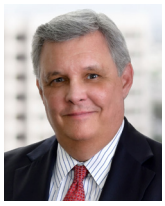

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