California's Mandate to Diversify Corporate Boards

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On September 30, 2020, California governor Gavin Newsom signed into law Assembly Bill 979, which requires publicly held corporations headquartered in California to include at least one person from an underrepresented community—defined to include individuals who self-identify as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or as gay, lesbian, bisexual, or transgender—by the end of 2021. The new measure is the first of its kind in the nation and follows on California's pioneering 2018 law mandating gender diversity on corporate boards.

As more states consider such measures, the positive effects of these laws are certain to increase as more and more diverse directors take seats in corporate boardrooms.

The Problem of a Lack of Diversity on Corporate Boards and California's Attempt at a Remedy

The California legislature explained the urgency of the diversity problem in corporate America in the proposed bill itself. According to Deloitte and the Alliance for Board Diversity, the percentages of Fortune 500 company board seats held by African American/Black, Hispanic/Latinx, and Asian/Pacific Islander people were 8.6 percent, 3.8 percent, and 3.7 percent, respectively. These paltry numbers are grossly disproportionate to these groups' overall share of the U.S. population. And of the 662 publicly traded companies headquartered in California, 233 had all White boards of directors. Although not reported in the bill itself, a survey conducted by Out Leadership identified fewer than 20 openly LGBT+ directors serving on Fortune 500 company boards—less than .3 percent

To address these dire numbers, and to help publicly traded California corporations realize the benefits of diversity, Assembly Bill 979 amended California Corporations Code Section 301.3 to require that a publicly-held domestic or foreign corporation whose principal offices are located in California must have at least one director from an underrepresented community on its board by the

end of 2021. By 2022, those same corporations must increase their diversity depending on the size of their board, with boards of nine or more seats requiring three directors from underrepresented communities; boards of five to nine seats having two such directors; and boards of four or fewer having one such director. A corporation may increase its board size to comply with the law.

The amended Section 301.3 empowers the California Secretary of State to implement reporting regulations and can enforce those requirements using fines. The Secretary of State may impose a $100,000 fine for each director seat required to be held by a member of an underrepresented minority that is not. Second and subsequent violations may result in $300,000 fines. Additionally, a corporation that fails to timely file board member information is subject to a $100,000 fine.

The Secretary of State has not yet implemented any regulations, nor has it indicated when it will.

Taking a Cue from California's Gender Diversity Statute

Assembly Bill 979 comes on the heels of California's earlier-enacted law mandating increased gender diversity on corporate boards. As of September 2018, California has required publicly traded companies headquartered in the state to have at least one woman on their boards by the end of 2019, with a further increase required by the end of 2021.

The law has been a resounding success according to a recent report from the California Partners Project. When the law was passed, 26 percent of public companies in California had all-male boards, and women held only 15.5 percent of board seats for companies with boards that had at least one woman. This was bad for business: companies with three or more women on their boards reported earnings per share that were 45 percent higher than companies without them.

Today, as a result of California's mandate, the boards of only 2.3 percent of California public companies remain exclusively male.

Other states have followed California's lead. In May 2020, Washington mandated that 25 percent of individuals on the boards of companies headquartered in its state must self-identify as women by the end of 2021. Illinois and Maryland have enacted board diversity reporting requirements, and Hawaii, Massachusetts, Michigan, and New Jersey each have considered similar legislation to California's.

Given the current climate and the benefits that increased diversity brings to companies, it is likely that other states will consider racial and LGBTQ diversity mandates. Indeed, after George Floyd's death, companies themselves have responded to public pressure by focusing on diversity initiatives themselves, reporting their diversity numbers, committing to provide more training to underrepresented communities for leadership roles, and by changing the compositions of their boards to make them more diverse.

California's Diversity Law Is Poised To Have A Positive Impact For California Companies And The Economy

Diversity on corporate boards is good for business. As the McKinsey study cited in Assembly Bill No. 979 showed, for every 10 percent increase in racial diversity on the senior-executive team, earnings before interest and taxes rise .8 percent. In addition, a Harvard Business Review study showed that boards with greater racial diversity benefit from the introduction of a broader range of perspectives that can help shape board decisions.

With over 50 percent female equity ownership, 30.4 percent of associates identifying as people of color, and 21 percent identifying as LGBTQ, Selendy & Gay has seen firsthand the benefits of diversity and a diverse leadership. Solving complex problems requires a diversity of perspectives, and Selendy & Gay has engaged in a meticulous process to cultivate that. Our diversity is key to our ability to deliver creative solutions for all our clients, no matter the size of the team or difficulty of the problem.

Selendy & Gay is excited to see diversity in California's boards of directors grow and witness the gains that those companies realize as a result.

Challenges

Judicial Watch has sought to enjoin the California Secretary of State from expending any taxpayer funds toward the law's enforcement because they claim the law violates the California constitution's equal protection clause and its restriction on discriminating against or granting preferential treatment to any individual group on the basis of sex in public employment and public contracts. Their challenge to the racial diversity bill is nearly identical, seeking the same relief and asserting violations. They liken the laws to affirmative action in schools, asserting that they are unconstitutional quotas.

We do not view these challenges as likely to succeed. For example, Judicial Watch's invocation of the restriction on discrimination and preferential treatment in public employment and contracts is without merit, as no government contracts are predicated on board diversity and the directors are private, not public, employees.

The equal protection clause challenges may have more teeth, especially given that race and sex are suspect classes under the California constitution requiring strict scrutiny. However, the drafters of the bill were well-prepared for these challenges. The legislative record strongly supports the argument that the law is narrowly tailored to a compelling government interest.

California has a compelling interest in the success and regulation of its economy and has demonstrated in its legislative findings that its mandate will serve that interest. In terms of narrow tailoring, it is difficult to think of an alternative. One could argue that there are other ways to improve the economy, but California can respond that there is no way to obtain the particular and discrete advantages of having a diverse board of directors without invoking race.

Further, although it is understandable why Judicial Watch would call these laws quotas, including because of the affirmative action cases, it is not so clear that a quota will be fatal under the circumstances. In affirmative action cases, it is difficult, if not impossible, to quantify the benefits that affirmative action brings to schools, whereas California provided specific tangible benefits associated with such practices.

We will continue to follow developments related to this mandate. Should you have any questions, or wish to speak with us directly, please contact any of the attorneys listed above.

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Practices

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