Public Benefit Corporations (DE)

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This Practice Note provides an overview of public benefit corporations organized in Delaware. It highlights the special provisions that apply to this type of corporation, including how public benefit is defined, duties of directors, notice and reporting requirements, and the conversion process.

The Delaware General Corporation Law (DGCL) was amended on August 1, 2013 to create a new form of entity known as the public benefit corporation (PBC) by adding a new subchapter XV (the PBC statutes) (DGCL §§ 361 to 368). A PBC is similar to a traditional corporation but has more requirements, including obligations to:

- Pursue one or more public benefits.
- Operate in a manner that considers the interests of those materially affected by its conduct.

This Note provides an overview of Delaware PBCs, including:

- How public benefit is defined.
- Duties of PBC directors and how they are enforced.
- Notice and reporting requirements.
- Converting a traditional corporation to a PBC.

PUBLIC BENEFIT

A public benefit is defined as a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities, or interests other than the pecuniary interests of the stockholders (DGCL § 362(b)). A PBC may choose to promote any public benefit, so long as that benefit fits within the broad parameters of the PBC statutes, including those of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific, or technological nature. However, the public benefit does not have priority over the more general obligation to all stakeholders. The PBC statutes instead require the directors to balance the pecuniary interests of the stockholders with the specific public benefit or benefits identified in the certificate of incorporation and the best interests of those materially affected by the corporation's conduct (see Duties of Directors).

Although the PBC statutes do not state how specific the public benefit needs to be, a PBC should pick a public benefit that is more narrowly defined than a restatement of the general benefit that the statute requires. However, the PBC's purpose should be stated broadly enough to limit the need for future amendments to its certificate of incorporation. For example, if a company's specific public benefit involves ensuring school children receive nutritious meals, the PBC should refer to that generic but specific purpose, rather than articulating the specific means by which the company currently achieves that purpose. If the PBC changes its method of providing nutritious meals, it then does not need to amend its certificate of incorporation.

DUTIES OF DIRECTORS

INTEREST BALANCING

The board of directors is responsible for directing the business and affairs of a PBC. However, unlike directors of a traditional Delaware corporation, directors of a PBC have a statutory duty to consider interests other than those of its stockholders. They must balance:

- The pecuniary interests of stockholders.
- The best interests of those materially affected by its conduct (stakeholders such as employees, creditors, customers, and suppliers).
- The specific public benefits identified in its certificate of incorporation.

(DGCL § 365(a).)

This is an enormous advantage for a company wishing to promote publicly beneficial objectives while remaining a for-profit entity. Before the enactment of the PBC statutes, directors were provided some leeway about social responsibility under the business judgment rule, but they were ultimately required to act for the purpose of maximizing the value of the enterprise (see *eBay Domestic Holdings v. Newmark*, 16 A.3d 1 (Del. 2010) and Practice Note, Fiduciary Duties of the Board of Directors (6-382-1267)). In corporate sale situations, directors of traditional corporations must act for the sole purpose

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of maximizing stockholder value in the short term (see *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and Practice Note, Fiduciary Duties of the Board of Directors: Sale of Control (6-382-1267)). Under the PBC statutes, directors must balance the interests of stockholders with those of other stakeholders in both sale and non-sale situations (DGCL § 365(c)).

One way to conceptualize the three-part balancing test is to think of it as imposing a mandate that directors balance the goals of:

- Providing a competitive return to stockholders.
- Having a net positive impact on society and the environment.
- Creating a net positive impact regarding the benefits specified in the corporate charter.

While balancing the interests described in the first two bullets might theoretically address policy concerns behind the adoption of the PBC statutes, the interests in the second bullet may be too broad to effectively hold directors accountable. In contrast, it is much easier to determine if directors are addressing the benefits specified within the corporate charter. The interest in the third bullet therefore becomes an important component to ensuring PBCs are acting responsibly.

DIRECTOR ACCOUNTABILITY

The PBC statutes are carefully drafted to ensure that the obligation of balancing does not create new types of interests. The PBC statutes provide that directors of a PBC do not owe a statutory duty to any person because of that person's interest in a public benefit identified in the certificate of incorporation. (DGCL § 365(b).) However, to maintain accountability for PBCs, stockholders may bring claims that directors failed to balance stockholder and benefit interests correctly. (DGCL § 367.)

Stockholder Derivative Suits

To bring a derivative suit, plaintiff stockholders must own, individually or collectively, at least:

- Two percent of the corporation's outstanding shares.
- If the corporation's shares are publicly traded on a national securities exchange (such as the New York Stock Exchange or NASDAQ), shares equaling at least $2,000,000 in market value.

(DGCL § 367.)

A suit for failure to balance only needs to allege that the directors failed to pursue one of the three interests (or perhaps engaged in a level of pursuit so weak as to constitute conscious disregard of that interest). For example, a plaintiff stockholder could allege that the directors were no longer:

- Pursuing stockholder return.
- Trying to have a positive impact regarding the corporation's specified purposes.
- Attempting to act in the best interests of everyone affected by its conduct.

Alternatively, a plaintiff might allege that despite pursuit of all three goals, the board engaged in a trade-off that no rational person would engage in. The plaintiff would then, absent a traditional conflict of interest, have to seek injunctive relief rather than monetary damages.

Limitation of Liability

The risk of personal liability for PBC directors in lawsuits challenging board balancing decisions is mitigated by Section 365(c) of the DGCL, which allows PBCs to eliminate monetary liability for certain breaches of fiduciary duty. Section 365(c) allows PBCs to extend the exculpation permitted under Section 102(b)(7) of the DGCL, which permits any corporation to eliminate liability of directors for breaching their duty of care. However, Section 365(c) does not allow exculpation of a director's actions or omissions that:

- Breach the director's duty of loyalty to the corporation or its stockholders.
- Are not in good faith or involve intentional misconduct or a knowing violation of the law.
- Include the declaration of an unlawful dividend or stock repurchase or redemption.
- Result in a transaction from which the director receives an improper personal benefit.

Section 365(c) extends the authority for exculpation to include disinterested directors making balancing decisions under Section 365(b) of the DGCL. This extension can be accomplished through a charter provision that provides that balancing decisions are neither breaches of loyalty nor considered not in good faith.

Unless they are receiving a personal benefit, directors protected by these exculpation provisions are only liable for balancing decisions if they are interested. For traditional Delaware corporations, a director is considered interested if:

- There are factors affecting his exercise of judgment regarding a decision that conflict or are inconsistent with the interests of the corporation.
- The director has a personal financial stake in the outcome (self-dealing transactions).
- The director receives a special material benefit from a transaction that is unavailable to other stockholders.

While Section 365(b) provides that a director of a PBC satisfies her fiduciary duties if the director's judgment is, among other things, disinterested, Section 365(c)'s authorization of a protective provision in the corporation's certificate of incorporation provides further security to directors of PBCs in making balancing decisions. Based on the scope of Delaware's protective provisions, self-dealing remains the likely focus of derivative challenges, and the Delaware Court of Chancery will likely focus on whether directors' decisions were disinterested.

Although the scope of director obligations is expanded under Section 365 of the DGCL to include the effect of decisions on stakeholders, the statute remains stockholder-centered in many respects. For example, no new beneficiaries are created, and only stockholders may bring lawsuits. The definition of "interested" for PBCs should therefore be the same as for traditional corporations. The ownership of stock by a director should continue to be evidence of his or her alignment with the corporation, rather than creating a disabling interest (see *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 115 A.3d 535, 547 (Del. Ch. 2015) ("[D]irectors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders.")). This conclusion is reinforced by the

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requirement that plaintiff stockholders own a material amount of stock before being permitted to challenge a balancing decision.

SUBSIDIARY PBCs AND THE POTENTIAL FOR DOUBLE DERIVATIVE SUITS

While the PBC statutes provide additional or different requirements for PBCs, it also expressly states that PBCs are subject in all respects to the remaining provisions of the DGCL (DGCL § 361). This leaves open the possibility that various traditional corporate law concepts will also apply to PBCs, including the double derivative stockholder suit.

A standard derivative suit involves a shareholder bringing a lawsuit that asserts a claim belonging to a corporation in which the shareholder owns shares (see *Lambrecht v. O'Neal*, 3 A.3d 277, 281 (Del. 2010)). A double derivative suit is brought by a stockholder of a parent corporation seeking enforcement of a claim belonging to a wholly owned or majority-controlled subsidiary corporation of that parent. Like a standard derivative suit, the stockholders initiating a double derivative suit must either:

- First make a demand on the parent corporation to take action to address or rectify the problematic conduct or circumstances.
- Allege in the complaint for its double derivative action that demand would be futile because the parent's board could not properly exercise its independent and disinterested business judgment in responding to a demand.

For more information on double derivative suits, see Practice Note, Shareholder Derivative Litigation: Double Derivative Lawsuits (8-508-8277).

Under Delaware law, directors of a wholly owned traditional corporation are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its stockholders. However, directors of a wholly owned PBC would also have a statutory obligation to balance the interests of all stakeholders, including the corporation's specific public benefits. (DGCL § 365(a).) It is therefore possible that a stockholder of a traditional parent corporation could bring a double derivative suit to hold subsidiary PBC directors accountable to their public benefit purpose (provided that the stockholder satisfied the demand requirements described above). The PBC statutes only expressly allow for stockholders owning at least 2% of the outstanding shares of the PBC to bring a derivative action on behalf of the corporation. (DGCL § 367.) This requirement is a means of ensuring that only stockholders with an appreciable ownership can bring legal action against a corporation to enforce the public benefit purpose. The possibility of a double derivative suit could be seen as a circumvention of this statutory protection. However, the test set out by the Supreme Court in *Lambrecht* may make pursuit of this claim largely impracticable.

STATUTORY BUSINESS JUDGMENT RULE

The PBC statutes expressly provide that the business judgment rule applies to all disinterested balancing decisions made by directors. If a stockholder initiates a derivative suit against the directors for failing to balance the three categories of interests, the directors are presumed to have satisfied their fiduciary duties if:

- The directors are informed and disinterested.
- The balancing decision has a rational purpose.

(DGCL § 365(b).)

Rationality is a concept in Delaware corporate jurisprudence that marks the outer limit of the business judgment rule (see *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000)). An irrational decision tends to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule. Under the business judgment rule, a Delaware court does not second-guess a director's decision if it can be attributed to any rational business purpose (see *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). Even if a stockholder believes a director's decision is substantively wrong, stupid, egregious, or irrational, there is no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests (see *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)).

For further discussion of the business judgment rule, see Practice Note, Fiduciary Duties of the Board of Directors: Business Judgment Rule (6-382-1267).

NOTICE OF PBC STATUS

Notice must be provided to the public that a corporation is organized as a PBC. This notice is achieved by:

- Including a statement that the corporation is a PBC in the heading of its certificate of incorporation.
- Identifying within its statement of purpose the specific public benefits to be promoted by the corporation.

(DGCL § 362(a).)

A corporation may include a PBC identifier (such as the words "public benefit corporation" or the abbreviation "P.B.C.") within its corporate name. However, if the corporation chooses not to include a PBC identifier, the corporation must, before issuing shares of stock, provide notice to investors that the corporation is a PBC, unless the issuance is according to an offering registered under the Securities Act of 1933 or if, at the time of issuance, the corporation has a class of securities registered under the Securities Exchange Act of 1934. (DGCL § 362(a).)

A corporation must also indicate that it is a PBC on its stock certificates (DGCL § 364).

REPORTS

PBCs must provide stockholders a report assessing the corporation's promotion of benefits (DGCL § 366). The PBC statutes require that the corporation provide this report every other year. The report must describe the board's goals and standards regarding stakeholders. The report must specifically include:

- The objectives the board has established to promote the best interests of stakeholders and the public benefits outlined in the certificate of incorporation.
- The standards the board has adopted to measure the corporation's progress in promoting those interests and benefits.
- Objective factual information based on the standards the board has chosen regarding the corporation's success in meeting those objectives.
- An assessment of the corporation's success in meeting the objectives and in promoting those interests and the public benefits the corporation seeks to achieve.

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The PBC statutes only require the biennial report to be provided to the company's stockholders. The report does not need to be made public. If a PBC chooses, it may include in its governing documents a provision that mandates the corporation to:

- Provide a report more frequently than biennially.
- Make the report available to the public.
- Use a third-party standard regarding, or attain third-party certification of, the promotion of its stated public benefits and the best interests of those materially affected by the corporation's conduct.

(DGCL § 366(c).)

CONVERTING TO A PBC

SUPERMAJORITY VOTE REQUIRED TO OPT IN, OPT OUT, OR CHANGE PURPOSE

PBCs can either be:

- Formed as a PBC from the outset.
- Converted to a PBC from a traditional corporation.

To convert a traditional corporation to a PBC, the board must obtain approval from at least two-thirds of the outstanding stock of the corporation entitled to vote thereon to effectuate the conversion. (DGCL § 363(a).) This enhanced voting requirement provides more protection than the simple majority vote generally required to effect a merger or amendment to the certificate of incorporation of a traditional corporation. The same high vote applies for mergers of traditional corporations if their stockholders are to receive stock in a benefit corporation. (DGCL § 363(b).)

Once an entity is organized as a PBC, there is also a supermajority approval requirement for the corporation to opt out or to amend its certificate of incorporation to change its stated public benefit purpose (DGCL § 363(c)). Approval of two-thirds of the outstanding shares of stock entitled to vote is required to:

- Amend or delete the provision in the certificate of incorporation identifying specific public benefits or requiring more specific reporting requirements.
- Effectuate a merger resulting in the public benefit corporation losing its public benefit status and changing its stated public benefits.

MERGERS AND ACQUISITIONS

A change in status for stockholders generally triggers a supermajority vote under Section 363 of the DGCL. This means if stockholders of a traditional corporation are going to receive stock of a PBC in a merger, they will be entitled to a two-thirds vote. (DGCL § 363(a)(2).) This provision is applicable even if the shares received are in a non-Delaware entity that is a benefit corporation or similar entity.

A supermajority vote is also required if stockholders of a PBC will receive stock of a domestic or foreign corporation that is not a public benefit corporation or similar entity. (DGCL § 363(c)(2).) In other words, a stock-for-stock merger in which stockholders are taken out of the benefit corporation structure requires a two-thirds vote. With cash-out mergers, if the target PBC remains a benefit corporation, supermajority vote is unnecessary. However, if the target PBC loses its benefit status, it may be considered a merger in which the shares of that corporation become shares of a non-benefit corporation, and supermajority vote would be required.

APPRAISAL RIGHTS

If a corporation amends its charter to become a PBC (or to change its purpose if it is already a PBC), its stockholders are granted appraisal rights (DGCL § 363(b)). These rights are extended only to stockholders who do not vote in favor of the amendment. Appraisal rights are similarly granted to stockholders of traditional corporations who receive PBC stock in a merger.

However, the PBC statutes place limits on when stockholders may seek appraisal. Appraisal is generally unavailable if:

- The stock is listed on a national securities exchange or widely held.
- Held of record by more than 2,000 holders.

This is referred to as the "market-out exception." However, there is an exception to the market-out exception that reinstates appraisal rights if the corporation enters into a merger or consolidation that requires stockholders to accept for their stock anything other than publicly traded shares. This exception mirrors the market-out exception of Section 262 of the DGCL, which governs appraisal rights for mergers of traditional Delaware corporations.

If a stockholder pursues appraisal, Section 262 of the DGCL requires the Court of Chancery to make an independent determination of the fair value of the shares as a going concern. (DGCL § 362(b).) Appraisal rights have been granted, analyzed, and refined by the Court of Chancery in transactions by and between traditional Delaware corporations, and these transactions provide an indication of how this valuation might occur in the PBC context. For more information on appraisal rights, see Practice Note, Appraisal Rights (8-517-0205).

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