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PUBLIC BENEFIT CORPORATIONS: THERE'S NO PUBLIC BENEFIT TO BREACHING FIDUCIARY DUTIES

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INTRODUCTION

During the spring and summer of 2020, in the midst of the COVID-19 pandemic, the United States witnessed large, public protests and activism reminiscent of the 1950s and 60s. Following the death of George Floyd, a Black man, at the hands of Minneapolis police, the American public once again mobilized to fight the ills and inequities of racism and discrimination. A significant number of nonprofit organizations and government departments have been created to resolve the social and political issues that plague Americans. Even Corporate America has been called to act, given that seventy percent of consumers are interested in the social justice efforts taken by the corporations they patronize.[1] By the third quarter of 2020, plenty of companies answered the call. For example, Bank of America and PNC Bank each have committed $1 billion to address economic and racial inequality. Google's parent Alphabet pledged $12 million to further racial equality. Target Corp. has committed $10 million to civil rights organizations and 10,000 hours of consulting services to small businesses owned by people of color. Comcast Corp. also announced that it will allocate $75 million to organizations including the National Urban League, the Equal Justice Initiative, and the NAACP, along with $25 million in media over the next three years.

Recognizing that corporate activism could be inconsistent with the duty of directors and officers to secure and retain value for the company, some commentators have suggested that corporations committed to activism should create or convert to a Public Benefit Corporation ("PBC"). While the core trait of a PBC is that it must pursue public benefit, that charge is not superior to directors' and officers' responsibility to generate and preserve value for the company's stockholders. Thus, while PBCs provide legal cover for corporate activism, corporate management must weigh that interest against the obligation

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[1] *Consumers Expect the Brands They Support to be Socially Responsible*, Business Wire (Oct. 2, 2019, 12:09 PM), https://www.businesswire.com/news/home/20191002005697/en/Consumers-Expect-Brands-Support-Socially-Responsible.

to satisfy traditional fiduciary duties of due care and loyalty, as well as the obligation to avoid waste. This balance is not difficult to strike; it simply requires that directors and officers carefully evaluate the anticipated conduct to ensure the action considered appears likely to provide corporate benefit, reasonable for the resources expended. As part of that due diligence process, directors and officers also must make certain any transaction that benefits a director or officer is entirely fair to the corporation. Furthermore, directors and officers must ensure that the resources committed to a social cause are reasonable given the company's size and value, as well as the benefits of the philanthropy.

WHAT IS A PUBLIC BENEFIT CORPORATION?

On August 1, 2013, the Delaware legislature amended the Delaware General Corporation Law ("DGCL") to add subchapter XV (DGCL §§ 361 to 368, the "PBC Statutes"), which allows corporations to be formed as or converted to a PBC. In order to convert to a PBC, however, an established Delaware corporation must first receive the approval of at least 90% of the outstanding shares of each class of stock of such corporation.

While corporate management traditionally has a fiduciary duty to maximize stockholder value in making decisions, directors and officers of a PBC must balance those duties with obligations to (1) pursue one or more Public Benefits identified in its certificate of incorporation; and (2) operate in a manner that considers the interests of those materially affected by the company's conduct. According to DGCL § 362(b), a "Public Benefit" is the positive effect or reduction of negative effects on one or more groups (other than stockholders in their capacities as stockholders). The PBC Statutes contemplate a company's Public Benefit may be related to artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific, or technological endeavors. PBCs also must provide stockholders with a report every other year that describes the PBC's progress towards its Public Benefit goals.[2]

In managing and controlling a company's business and affairs, directors and officers of a Delaware corporation owe, to their corporation and its stockholders, the obligations to act with due care and loyalty.[3] Although emphasized, the obligation to pursue Public Benefit does not have priority over other duties

[2] DEL. CODE ANN. tit. 8, § 366(b) (2019).

[3] *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006); *see also* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) (explicitly holding that corporate officers owe the fiduciary duties of due care and loyalty).

owed. And, the PBC statutes were drafted to avoid the creation of other statutory benefits based on a person's interest in a PBC.[4] Stockholders could thus file an action asserting that directors and officers failed to exercise due care or loyalty while seeking to accomplish some Public Benefit.[5] Hence, directors and officers must balance stockholders' pecuniary interests with the Public Benefit(s) described in the certificate of incorporation and the best interests of those materially affected by the corporation's conduct.

Even PBCs Must Take Care Not to Cause Harm

At its core, due care mandates that directors act on an informed basis and consider all material information reasonably available.[6] A company's board and officers are expected to have reasonable knowledge of the company's business, obtain credible information with respect to corporate actions, and anticipate and understand the consequences of each decision or transaction.[7] But, they will not be penalized for a simple error in judgment "if the decision appeared reasonable at the time the decision was made."[8] A breach of the duty of care exists only if the directors and officers acted with gross negligence, meaning that their conduct "constitutes reckless indifference or actions that are without the bounds of reason."[9]

In *Smith v. Van Gorkom*, the Delaware Supreme Court found that the defendant directors breached their duty of care by approving a transaction during a two-hour board meeting, after only relying on the board chairman's twenty-minute presentation.[10] Among the board's failings were that it did nothing to understand the value of the company it decided to sell, it did not conduct a market analysis, and it refused to meaningfully review the contracts governing the transaction.[11] Similarly, in *Cede v. Technicolor*, the board was found to have breached the duty of care by failing to conduct a pre or post-transaction market test without having a rational business basis for not doing so.[12] Given the holdings in *Van Gorkom* and *Cede*, corporate management must make sure to

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4 DEL. CODE ANN. tit. 8, § 365(b) (2019).

5 *Id.* § 367.

6 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993); Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000).

7 *See* Moran v. Household Int'l Inc., 500 A.2d 1346, 1356 (Del. 1985).

8 Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964).

9 Zucker v. Hassell, 2016 WL 7011351, at *7 (Del. Ch. Nov. 30, 2016), *aff'd*, 165 A.3d 288 (Del. 2017).

10 Smith v. Van Gorkom, 488 A.2d 858, 880 (Del. 1985).

11 *See id.*

12 *Cede*, 634 A.2d at 369.

adequately deliberate and investigate corporate action related to the purpose of Public Benefit, to ensure that it would not result in harm to the company.

As mentioned above, Section 367 of the DGCL allows a stockholder to bring an action where the PBC's management has failed to balance Public Benefit with traditional obligations. Among those obligations is to generate and preserve value for the PBC and its stockholders. Thus, directors or officers of a PBC expose themselves to liability by approving conduct for the Public Benefit that caused the PBC to suffer unreasonable losses. As required by the duty of care, corporate management must have reasonable knowledge of the company's business such that they avoid action that interferes with the PBC's ability to generate revenue.

Loyalty to Public Benefit and to the Stockholder

Corporate management also must adhere to the duty of loyalty, which assumes that they affirmatively protect the interests of the corporation and refrain taking any self-interested actions that cause injury to the company they serve. The duty of loyalty further mandates that the best interest of a corporation and its stockholders takes precedence over any interest possessed by a director or officer and not shared by the stockholders generally.[13] For example, in *Boyer v. Wilmington Materials*, the Court of Chancery held that a company's five-person board breached the duty of loyalty when it agreed to sell substantially all of the corporation's assets at an unfair price reached through an unfair process to a company owned by three of the board members, and in which the other two directors would own shares after the transaction.[14] Similarly, in a post-trial decision in *Valeant Pharm. Int'l v. Jerney*, the court held that a director/officer breached the duty of loyalty by approving an initial public offering and a failed corporate restructuring that would result in large cash bonuses for himself.[15] Not only did the officer/director defendant fail to prove that his $3 million bonus was fair to the corporation, but he also could not demonstrate that the process through which it was awarded was entirely fair to the company.[16]

Given the boundaries set by the duty of loyalty, directors and officers must be careful to understand the corporation's Public Benefit activities, including whether any directors or officers stand to gain materially. If any director or officer will benefit from the Public Benefit conduct, the company's decision-

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13 *See id.* at 361; *see also* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1175–76 (Del. 1995).

14 Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 885 (Del. Ch. 1999).

15 Valeant Pharm. Int'l v. Jerney, 2007 WL 2813789, at 1 (Del. Ch. Mar. 1, 2007).

16 *Id.* at 16.

makers must confirm that the action or transaction being contemplated is fair to the corporation and its stockholders. Although evaluating fairness involves a fact-intensive analysis, activism that personally benefits directors and officers likely will not be considered fair unless it confers some significant, tangible benefit to the corporation other than the public's general approval of the corporate conduct.

Corporate Activism Is Possible Without Waste

Finally, directors and officers of PBCs must be mindful of corporate waste, which exists where the company engaged in an exchange or transaction that was "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[17] A waste claim exists "where directors irrationally squander or give away corporate assets."[18]

The case *Theodora Holding Corp. v. Henderson* is instructive. There, a company's stockholders filed a derivative lawsuit asserting that the corporation's losses were the result of corporate waste in the form of a significant charitable donation.[19] The Court of Chancery held that since the corporation's charitable donation was less than the federal tax deduction limit of five percent of the company's income, it did not constitute waste because it could be written off.[20] Similarly, in *Kahn v. Sullivan*, the Delaware Supreme Court refused to find that a board's decision to fund the construction and establishment of an art museum constituted a waste of corporate assets, because the corporate resources committed were reasonable considering the corporation's value, annual revenue and profits, and tax benefits.[21] Furthermore, the corporation received economic benefit from being able to use the museum to promote its business.[22]

The lesson for PBCs is clear. They should be careful that their budgets and resources are allocated in a manner that does not unreasonably prioritize Public Benefit efforts to the detriment of the PBC. Stated differently, resources earmarked for Public Benefit must be reasonable given the PBC's size, assets, revenue, and value.

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17 Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).
18 *Id.*; *see also In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006).
19 Theodora Holding Corp. v. Henderson, 257 A.2d 398, 399–400 (Del. Ch. 1969).
20 *Id.* at 405-406.
21 *See* Kahn v. Sullivan, 594 A.2d 48, 61 (Del. 1991).
22 *See id.* at 62.

Thankfully, It Is Harder to be Sued for Doing "Good"

As noted above, the PBC Statutes require corporate management to balance Public Benefit, the company's impact on the community, *and* traditional fiduciary obligations. To establish a claim against directors or officers of a PBC, an eligible stockholder must assert facts indicating that corporate management failed to or did not adequately pursue one of these three interests. The stockholder might also allege, despite business practices that typically prioritize all three interests, that the company or its management failed to consider one or more of the interests with respect to a *specific* transaction or series of transactions. However, given the relative newness of this requirement to balance interests and the associated judgment calls that must be made, the drafters of the PBC Statutes wisely made it difficult for a stockholder to bring individual or derivative claims. The stockholder must either own (1) two percent of the corporation's outstanding shares, or, if the corporation is publicly traded, (2) the lesser of two percent of its outstanding shares or shares equaling at least $2,000,000 in market value.[23]

[23] *See* DEL. CODE ANN. tit. 8, § 367 (2019).