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A CORPORATE PARADIGM SHIFT: PUBLIC BENEFIT CORPORATIONS

To Our Clients and Friends:

Since 2010, 30 states and the District of Columbia have passed legislation authorizing for-profit "public benefit corporations" ("PBC"), known in many states just as "benefit corporations."[1] Although these laws vary slightly by state, each requires the board of directors of a PBC to consider the public benefit, in addition to shareholder return on investment, in their decision-making. Although state corporate law statutes and the tax code treat PBCs as for-profit enterprises, the legal focus of this new corporate model contrasts with that of traditional corporations, which focuses solely on maximizing shareholder wealth. The PBC laws are designed to empower the board of directors to consider additional stakeholders *alongside* shareholders, and leave it to the board to determine the relative weight to place on shareholders' and other stakeholders' interests.

The PBC form may serve as a legal tool for larger companies as well as newer ventures and social entrepreneurs. As of August 2016, over 4,000 companies have formed as or converted to PBCs,[2] including well-known consumer companies like Patagonia, Kickstarter, and Method Products. In August 2013, just after Delaware's PBC statute became effective, Campbell Soup Company caused its newly acquired subsidiary, Plum Organics, to reincorporate as a PBC. Other public companies are similarly considering acquiring PBCs or converting subsidiaries to PBCs. At the time of this publication, there are no publicly traded PBCs, but Etsy, Inc., which is certified as a "B Corp" by the non-profit entity B Lab, has gone public. According to B Lab rules, Etsy must convert to a Delaware PBC by August 2017 to maintain its certification. Additionally, Laureate Education, a Delaware corporation operating more than 80 educational institutions worldwide, converted to a PBC before filing an S-1 with the SEC in October 2015 to prepare for an initial public offering.[3]

This alert examines some advantages and disadvantages of the PBC form to consider when deciding whether to incorporate a new business as a PBC, convert an existing entity to a PBC, create a PBC subsidiary, or move assets to a newly formed subsidiary PBC.

What Are the Legal Requirements for a PBC?

In general, much of the traditional corporate law and structure, including the decision-making body, governance and review standards, apply equally to PBCs. The most significant legal requirement of PBC laws is that a PBC's directors must consider constituencies in addition to the company's shareholders. For example, Delaware's PBC statute[4] requires a PBC to simultaneously consider its shareholders' return on investment, its impact upon those materially affected by its operations, and the specific public benefit or benefits set forth in its certificate of incorporation. The business judgment rule will apply to a board's decision-making when balancing these interests, but heightened judicial scrutiny will apply to

PBCs in conflict-of-interest scenarios, takeover situations, and other situations where courts more closely scrutinize board decisions, just as with traditional corporations.

Note that PBC statutes differ in this way from constituency statutes that have been adopted in many states other than Delaware. While constituency statutes *permit* a board to consider other constituencies, PBC statutes *mandate* those considerations. Therefore, PBC statutes can potentially allow a corporation to serve its chosen purpose or purposes more effectively and consistently.

An existing Delaware corporation seeking to become a PBC must secure approval from two-thirds of its outstanding shares entitled to vote in order to make the conversion. Conversion may therefore be difficult for companies that have numerous shareholders with interests that might not parallel those of the constituencies that boards would have to consider under the PBC form.

Under the Delaware statute, once a corporation has become a PBC, its board must:

- "Balance" the interests of the shareholders, other constituencies affected by the company's conduct, and the specific public benefits identified in the corporation's certificate of incorporation;

- Provide to shareholders biennial reports regarding the PBC's promotion of the public benefit; and

- Before issuing or selling shares, notify any person acquiring the shares that the corporation is a PBC.[5]

Other states have stricter requirements. Many states require that reports by PBCs measure the corporation's impact against an independent third-party standard and that the reports be produced annually and made available publicly on the corporation's website.

What Are the Benefits of the PBC Corporate Form?

Adopting the PBC corporate form could benefit a company in several ways. Below is a summary of significant benefits of PBCs.

Flexibility

By allowing a profit-seeking company to also serve identified public benefits, the PBC form protects the board by giving it more freedom to consider other stakeholders affected by its decision-making without exposure to claims that it breached its fiduciary duty to shareholders. As a PBC, but not as a regular corporation, the board can balance multiple interests by, for example, deciding against an action that would maximize profits but harm the public benefit described in its certificate of incorporation. Put differently, the PBC form can be viewed as expanding the scope of the board's discretion under the business judgment rule.

This flexibility could be particularly important if a PBC board decides to sell the company. Under the *Revlon* standard, the board of a standard Delaware corporation cannot consider social impact when choosing a buyer, but instead must focus solely on maximizing shareholder value. In contrast, the board of a PBC should be able to consider not only price but also other factors consistent with its purpose when deciding to sell.

Expanding Investment Possibilities

Becoming a PBC could increase the company's attractiveness to prospective shareholders who choose to invest in socially responsible companies. This segment of the investment community, which includes "impact investors," has grown dramatically in recent years.[6] Companies that demonstrate their commitment to social responsibility by using the PBC form could strongly position themselves to compete for investments from this growing pool of socially conscious investors.

In addition, many public investors and high-profile venture capital firms believe that sustainability and public-impact awareness can increase an organization's long-term value, in contrast to the more short-term gains created by a singular focus on maximizing shareholder wealth. Therefore, conversion to the PBC form could open the door to an expanded pool of potential investors.

Branding

Becoming a PBC also signals that a company is genuinely committed to providing a public benefit, rather than solely to maximizing profit. This is a powerful message that could aid PBCs' recruiting by attracting prospective employees who identify with their public mission and by motivating existing employees, thereby increasing productivity and retention. It may also be an important indication of meaningful commitment to a customer base that shares the same values as those endorsed by the PBC. Becoming a PBC also might improve relations with suppliers and regulators and more broadly secure intangible benefits from positive publicity.

Takeover Protection

A potential benefit for PBCs that have many shareholders or may become publicly traded is that many of the PBC statutes themselves provide a takeover defense. For example, Delaware's statute mandates that a PBC cannot merge or consolidate with another entity if, as a result of that transaction, the surviving corporation's certificate of incorporation "does not contain the identical provisions identifying the public benefit or public benefits," unless the transaction receives approval from two-thirds of the target PBC's outstanding voting shares. The difficulty of achieving this hurdle might deter a bid from a non-socially responsible or mission-incompatible acquirer.[7]

PBCs may also not be attractive targets for activists or hedge fund investors who seek to obtain board seats and thereby influence the board's decision-making. Even if they were to successfully obtain influence, the new directors would still have to consider and give appropriate weight to the public benefit along with shareholder value, and shareholders committed to the public benefit can enforce this through derivative suits, as described below. Activists and hedge funds might not be interested in companies where striking such a balance, rather than making decisions solely focused on short-term yield, is legally required.

Finally, by providing that a board consider additional constituencies, the PBC statutes could potentially make it easier to reject a hostile bid. Because the board can consider more than just monetary value when deciding whether to stay the course or sell the company, it should be able to reject a takeover that would result in the company's public-benefit mission being harmed, even where the takeover would provide the greatest short-term financial yield. For all of these reasons, the PBC statutes grant a degree of takeover protection not found in conventional corporation law.

What Are Some Risks of the PBC Corporate Form?

The PBC form also presents some potential uncertainties that each corporation should consider before deciding to organize as a PBC or converting a new or existing subsidiary to a PBC.

Investor Hesitancy

It is difficult to predict how forming or converting to a PBC will impact potential investors' decision-making. For publicly traded companies in particular, trading performance may be uncertain given that some investors might hesitate to invest in a company institutionally committed to more than just shareholder return on investment. Given these possible investor concerns, risk of a valuation haircut is a potential disadvantage to forming a PBC.

On the other hand, many financial entities and other investors, such as the "impact investors" discussed above, do not prioritize maximizing measurable financial value or short-term gains. Where some traditional investors might not invest in PBCs, others believing that aligned values are consistent with long-term value creation could make up at least some of the difference. Nevertheless, the relative newness of the PBC form and the inevitable uncertainty accompanying such novelty could be a barrier to securing capital.

Legal Uncertainty

The PBC corporate form's relative novelty also brings risks arising from the lack of legal precedent clarifying how PBCs should be managed. No shareholder has yet sued over the management of a PBC. Therefore, difficult fiduciary duty questions remain unresolved. For example, there is no guidance as to how boards with dual responsibilities to shareholders and other constituencies should balance those sometimes-competing interests in practice. The good news is that the business judgment rule still applies, so courts should give deference to board decision-making in balancing these interests. However, more difficult questions arise in conflict-of-interest scenarios, takeover situations, and other situations where courts more closely scrutinize board decisions. Therefore, if a shareholder were to sue, the lack of PBC-specific case law means that the outcome of such litigation may be less predictable than that of shareholder litigation against traditional corporations.

In addition to being protected by the business judgment rule, PBC boards are also protected from liability through express provisions contained in most PBC statutes. The statutes provide that only shareholders have standing to file a suit claiming a breach of fiduciary duties, which means that other constituencies cannot sue if the board fails to consider their interests. In addition, some states have minimum ownership thresholds for those seeking to file a derivative suit alleging that a PBC failed to balance the public interest. For example, Delaware requires shareholders to individually or collectively own the lesser of (i) 2% of the corporation's outstanding shares or (ii) shares of at least $2,000,000 in market value. California's statute[8] takes a different approach and, while it does not have an ownership threshold for a direct shareholder of a benefit corporation to bring a "benefit enforcement proceeding," it explicitly says that the corporation shall not be liable for monetary damages in such a proceeding besides the plaintiff's attorney costs and expenses.[9]

Even if the PBC is a wholly owned subsidiary of a traditional corporation, the PBC's board could still face a lawsuit for failing to consider the interests of other constituencies. Although the parent corporation is unlikely to sue, shareholders of the parent corporation could potentially bring a double derivative suit and sue the subsidiary PBC's board on behalf of the parent. However, California's statute limits the ability of shareholders of a parent entity to bring a benefit enforcement proceeding against a subsidiary to a group of persons that beneficially own 5% or more of the equity interest in the parent.

Additional Reporting and Disclosure Requirements

PBC statutes also require additional reporting and disclosure beyond that required of traditional corporations. PBCs must provide periodic reports to shareholders evaluating their efforts to promote the public benefits codified in their certificates of incorporation. For example, Delaware requires such reports at least every other year. Specifically, these reports must include the objectives the board has established to achieve its public-benefit mission and the standards chosen to measure its progress. Each report must also include actual performance results using those chosen standards and an overall assessment of the company's success in achieving its stated public-benefit mission to date.[10] Other states require sustainability reports and impact disclosures that assess the public impact against an independent, third-party standard. In summary, while the different states' PBC statutes impose different sustainability and impact disclosure requirements, all establish additional requirements not applicable to traditional corporations.

Another consideration for PBCs that want to go public is the degree of disclosure required in SEC filings. SEC registration statements, annual reports to shareholders, and certain other filings made by a PBC would need to describe in detail the practical consequences of the entity's PBC status, with particular attention paid to the impact on its directors' fiduciary duties.

Special Difficulties Associated with Subsidiaries

Traditional parent corporations face special challenges unique to forming new PBC subsidiaries or converting existing subsidiaries into PBCs. The first is the prospect of suits by parent corporation shareholders arguing that converting a subsidiary into a PBC was not in the best interests of the parent's shareholders. If the parent company's board were to be sued for converting a subsidiary into a PBC, it could likely defend its decision successfully under the business judgment rule if it reasonably believed that, although the conversion would allow the subsidiary's board to balance the interests of multiple constituencies, such a conversion would still ultimately be in the best interests of the parent corporation and its shareholders. The parent board could take the position that creation of a PBC subsidiary provides the parent corporation many legitimate benefits, such as good publicity, enhanced reputation, increased employee morale, improved customer relationships, and increased attractiveness to socially responsible job candidates and investors.

The divergence between a parent company's obligations and those of its subsidiary presents another potential challenge. Where a PBC subsidiary is owned by a traditional corporation, the parent corporation's board must still make decisions solely on behalf, and in the best interests, of its shareholders. For example, when deciding whether to provide additional funding to its PBC subsidiary, the parent corporation's board would be required to consider only whether providing the funding would benefit the parent's shareholders. Yet the subsidiary's directors would have a fiduciary duty to operate the subsidiary's business in a manner that balances the pecuniary interests of the parent company shareholder, the best interests of the constituencies materially affected by the subsidiary's conduct, and the public benefits named in the subsidiary's certificate of incorporation. The PBC subsidiary board would be legally required to consider each of those constituencies when determining how to use the funds received from the parent. Presumably, the parent would take this divergence into account in deciding whether to invest funds in the first place and might attach specific requirements to the investment to alleviate concerns that the subsidiary would not use the funds in a manner that was in the best interests of the parent's shareholders.

<u>What About B Corporations?</u>

Many companies also seek "B Corporation" (or "B Corp") certification in addition to, or in lieu of, becoming a PBC. B Lab, a nonprofit entity, will certify as B Corps companies that commit to meeting certain standards of overall social and environmental performance on an ongoing basis.[11] While the B Corp is a private certification, and not a legally recognized corporate form, it does provide many of the same publicity benefits as a PBC. However, because B Corp certification does not legally alter the fiduciary duties of a company's directors, securing B Corp certification without establishment of or conversion to the PBC form cannot alone offer all of the legal protections and strategic benefits that PBC status offers. Additionally, there are multiple circumstances in which PBC conversion would ultimately be required to maintain B Corp certification.

<u>Conclusion</u>

In summary, while several legal uncertainties associated with public benefit corporations have yet to be resolved, the model's popularity and growth is expected to continue into the foreseeable future. As demand for socially conscious companies grows, and as more investors, customers, and employees become aware of the PBC model, an increasing number of businesses will give serious consideration to the PBC form. It is quite possible that more public companies will convert subsidiaries to PBCs and that there will be a number of publically traded PBCs in the foreseeable future. This activity may make more organizations feel comfortable incorporating as or converting to a PBC, causing the momentum to build further. Accordingly, the PBC model, despite some currently unresolved legal uncertainties, is an attractive option for many organizations to consider.

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[1] *State by State Status of Legislation*, B Lab, http://benefitcorp.net/policymakers/state-by-state-status (last visited August 4, 2016).

[2] *Find a Benefit Corp*, B Lab, http://benefitcorp.net/businesses/find-a-benefit-corp (last visited August 4, 2016).

[3] LAUREATE EDUCATION, AMENDMENT NO. 3 TO FORM S-1 REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933 (May 20, 2016), https://www.sec.gov/Archives/edgar/data/912766/000104746916013340/a2227130zs-1a.htm.

[4] Delaware General Corporation Law §§ 361–368.

[5] This requirement does not apply if the corporation includes "PBC" or "Public Benefit Corporation" in its corporate name, the issuance is made pursuant to an offering under the 1933 Securities Act, or the corporation has at the time of issuance a class of stock registered under the 1934 Securities Exchange Act.

[6] Jeff Benjamin, *Socially Responsible Investing is Coming of Age*, INVESTMENT NEWS (Mar. 6, 2016), http://www.investmentnews.com/article/20160306/FREE/160309960/socially-responsible-investing-is-coming-of-age.

[7] However, if the acquirer attempted to purchase the PBC with cash, as opposed to equity in the post-merger company, it could likely circumvent the two-thirds vote requirement.

[8] CAL. CORP. CODE §§ 14600–14631.

[9] Although Delaware's PBC statute does not explicitly prohibit monetary damages, injunctive relief is still the most likely remedy as it is unlikely that a plaintiff would be able to show that shareholders suffered monetary losses from the board's failure to consider the public benefit.

[10] Delaware's PBC statute only requires PBCs to disclose these reports to shareholders. Therefore, where a PBC is a wholly owned subsidiary, neither the general public nor the parent corporation's shareholders would be legally entitled to see the report, although the parent corporation may elect to share certain information to its shareholders and other stakeholders.

[11] *How to Become a B Corp*, B Lab, https://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp (last visited August 4, 2016).

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