



## Bankruptcy Brief

by Steve A. Peirce

# Adding “Public Benefit” to the Bankruptcy Mix Raises Thorny Issues

### Most anyone familiar with basic corporate law knows

that it is the directors’ duty to maximize profits for the shareholders, to the exclusion of other interests.<sup>1</sup> Or, as more bluntly stated by one writer:

Did you know that corporations are legally prevented from being decent and humane? Say a corporate leader discovers that he can make a higher profit by moving a factory to China and throwing thousands of Americans out of their jobs. If he decides to make profits secondary to the well-being of his workers and neighbors, his stockholders can sue him.

—John H. Richardson<sup>2</sup>

But one form of for-profit corporation, a public benefit corporation, might avoid these types of results.<sup>3</sup> Several jurisdictions have some form of public benefit corporation laws (Arizona, Arkansas, California, the District of Columbia, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia). These types of corporations are formed not just to serve shareholder profits, but also to accomplish other goals for the benefit of the public.

Now Delaware, the home of more corporations than any other state, has gotten into the act. On July 17, 2013, Gov. Jack Markell (D) signed into law Senate Bill 47, creating the legal framework allowing for public benefit corporations to be formed under Delaware law, effective Aug. 1, 2013. Senate Bill 47 amends Title 8 of the Delaware Code, adding § § 361-368 as the new public benefit corporations law. Under the new law, existing or new corporations may elect to become public benefit corporations.<sup>4</sup> Public benefit corporations are not nonprofit corporations; they are for-profit corporations intended to “produce a public benefit or public benefits and to operate in a responsible and sustainable manner.”<sup>5</sup> A public benefit corporation “shall be managed in a manner that balances the stockholders’ pecuniary interests, the best interests of those materially affected by the corporation’s conduct, and the public benefit or public benefits identified in its certificate of incorporation.”<sup>6</sup> Note the word “shall”

here, making it mandatory for public benefit corporations to consider other constituencies beside the shareholders.

How is a Delaware public benefit corporation formed? A public benefit corporation shall contain the words “public benefit corporation,” or the abbreviation “P.B.C.,” or the designation “PBC” in its name.<sup>7</sup> A public benefit corporation must identify itself as such in its certificate of incorporation.<sup>8</sup> The certificate of incorporation must identify within its statement of business or purpose one or more specific public benefits to be promoted by the corporation.<sup>9</sup>

So all this begs the question of what is a public benefit? In this context, “public benefit” means a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities, or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific, or technological nature.<sup>10</sup>

Another feature of public benefit corporations is a requirement for biennial reports to the shareholders, providing a progress report on the public benefit goals and results. A public benefit corporation shall, no less than biennially, provide its stockholders with a statement as to the corporation’s promotion of the public benefit or public benefits identified in the certificate of incorporation and of the best interests of those materially affected by the corporation’s conduct.<sup>11</sup> Although not a requirement, the public benefit corporation may elect in its certificate of incorporation or bylaws to allow a third party to establish standards and obtain third-party certification addressing the promotion of the public benefit and the best interests of those materially affected.<sup>12</sup> The leaders among these third-party public benefit certifiers are B Lab, a nonprofit organization that certifies benefit corporations such as Plum Organics and Patagonia, and the Global Reporting Initiative, a nonprofit that provides companies with a comprehensive sustainability reporting framework.

The duties of directors of a public benefit corporation involve a balancing act. The board of directors shall manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation’s conduct,

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and the specific public benefit or benefits identified in its certificate of incorporation.<sup>13</sup>

Are the directors liable to the nonshareholder constituents for failure to carry out the public benefits or protect those materially affected? No. A director of a public benefit corporation does not have any duty to any person on account of any interest of such person in the public benefit or benefits identified in the certificate of incorporation or on account of any interest materially affected by the corporation's conduct.<sup>14</sup>

Under the public benefit law, shareholders may still file derivative suits.<sup>15</sup> However, complaining shareholders must collectively own at least 2 percent of the outstanding shares, or, if the corporation is public, the lesser of 2 percent or at least \$2 million worth of shares to maintain a derivative suit.<sup>16</sup>

A shareholder could file a derivative suit alleging that the public benefit corporation is not doing enough to maximize shareholder profits. Or, conceivably, a shareholder could file a derivative suit alleging that the corporation is not doing enough to achieve its public benefit goals.<sup>17</sup> Under either of these scenarios, directors of public benefit corporations have significant protections. With respect to a balancing decision under § 362(a), directors would be deemed to have complied with their fiduciary duties to stockholders and the corporation if their decision is both (1) informed and disinterested and (2) not such that no person of ordinary, sound judgment would approve.<sup>18</sup> In addition, the certificate of incorporation of a public benefit corporation may include a provision that any disinterested failure to satisfy § 365 shall not constitute an act or omission not in good faith or a breach of the duty of loyalty.<sup>19</sup>

Interesting issues could arise if a public benefit corporation becomes insolvent or files bankruptcy. Under Delaware law, in the case of ordinary corporations, directors owe their fiduciary obligations to the corporation and its shareholders when a corporation is solvent or even in the zone of insolvency, but the duty shifts to the corporate creditors when the company is insolvent.<sup>20</sup> Such a situation does not allow the creditor to seek direct damages, but only allows the creditor standing to file a derivative suit on behalf of the company.<sup>21</sup> In the case of an insolvent public benefit corporation, one might argue under *Gheewalla* that a creditor would have standing to file a derivative action. But what of § 367, limiting derivative action standing to shareholders with certain ownership levels? Would § 367 foreclose any creditor derivative action? Could an argument be made that creditors are among the public benefit constituents or that they are persons "materially affected"? Under that argument, would § 365(b), providing for no duty to those nonshareholder constituents, foreclose any action by creditors?

And what of the scenarios involving a bankrupt public benefit corporation? Consider competing sales under § 363 of the bankruptcy code, where Bid No. 1 would bring more money to creditors, but Bid No. 2 would better serve the corporation's public benefit goals? Or plan confirmation objections that the chapter 11 plan does not serve the public benefit goals?

On the one hand, one could argue that 28 U.S.C. § 959 (providing that trustees and debtors in possession shall manage the estate according to state law) and the Delaware public benefit corporation law requires that the public benefit be considered (remember the "shall" language in 8 Del. C. §§ 362(a) and 365(a)). And doesn't the bankruptcy court defer to the business judgment of the debtor with respect to 363 sales?<sup>22</sup> So doesn't that business judgment



entail the consideration of public benefits as required by 8 Del. C. § 365(a)? On the other hand, one could argue that the public benefit constituents, being on the same level as shareholders, are simply "out of the money" and the insolvency of the corporation causes the director duties to shift to creditors and no other constituents, or that the absolute priority rule (providing that shareholders cannot receive or retain property until creditors are paid in full) requires that creditor interests be maximized.

But public benefit is not always about distribution of money, as the public benefit constituents could be, for example, the environment or certain artistic or religious interests. And in a bankruptcy case of a public benefit corporation, who argues for the public benefit or materially affected constituencies? Would 8 Del. C. § 365(b) foreclose any standing by say, an employee group that might lose their jobs if certain action is taken in the bankruptcy case?

Section 1102 of the bankruptcy code allows for the formation of creditor committees and equity security holders' committees to act in bankruptcy cases, but it does not mention any other types of committees. It seems that the public benefit laws at least offer the chance for a conscientious board of directors or shareholder group to act for reasons other than monetary gain, but if they do not, there may be little chance of a remedy.

A couple of years ago, the author was involved in a competing-bid 363 sale of a business' assets in a Chapter 11 case. The winning bidder with the highest monetary bid was a local company that proposed to keep the debtor's business open and hire all the employees, even giving them substantial raises, so everyone was happy. But what if that local bid were second highest, with the highest bidder being a foreign competitor who just wants to buy the business to shut it down? Would a public benefit corporation status for that debtor with a designated benefit to provide local jobs have carried the day for the local bidder? Or could the local bidder have intentionally low-balled the offer, thinking it would get the deal because it would provide local jobs? Perhaps the practice point here is that a sale procedures order could be drafted to require that any approval of bids must take into account the designated public benefits in addition to the bid price.

With the advent of public benefit corporations, the priorities of

the question of whether compelled testimony under oath by a public employee should be protected First Amendment speech even if the testimony arises from or is actually part of the employee's official job duties. The Court also will likely address how broad a public employee's official duties should be construed when it evaluates whether the official duties of the director of a youth training program included testifying before a grand jury against someone who had been on the program's payroll. No doubt, the decision in *Lane* will provide further guidance to courts and litigants to help address these challenging issues and bring much needed uniformity on these issues. ☉

## Endnotes

<sup>1</sup>See *Garcetti v. Ceballos*, 547 U.S. 410, 417 (2006) (citing *Connick v. Myers*, 461 U.S. 138, 143 (1983)).

<sup>2</sup>391 U.S. 563 (1968).

<sup>3</sup>*Id.* at 568.

<sup>4</sup>547 U.S. 410 (2006).

<sup>5</sup>*Id.* at 421.

<sup>6</sup>See *Reilly v. City of Atlantic City*, 532 F.3d 216, 231 (3d Cir. 2008).

<sup>7</sup>*Id.* at 227.

<sup>8</sup>*Garcetti*, 547 U.S. at 426.

<sup>9</sup>*Id.*

<sup>10</sup>*Id.* at 429.

<sup>11</sup>*Id.* at 430.

<sup>12</sup>*Id.* at 444.

<sup>13</sup>*Reilly*, 532 F.3d at 231 or 232 (citing *Garcetti*, 547 U.S. at 423).

<sup>14</sup>725 F.3d 734 (7th Cir. 2013).

<sup>15</sup>*Id.* at 740.

<sup>16</sup>*Garcetti*, 547 U.S. at 444.

<sup>17</sup>See *Clairmont v. Sound Mental Health*, 632 F.3d 1091 (9th Cir. 2011).

<sup>18</sup>See *Kiehle v. County of Cortland*, 486 Fed. Appx. 222, 224 (2d Cir. 2012).

<sup>19</sup>See *Bearss v. Wilton*, 445 Fed. Appx. 400, 404 (2d Cir. 2011).

<sup>20</sup>*Id.*

<sup>21</sup>No. 13-483.

<sup>22</sup>See *Lane v. Central Alabama Community College*, 523 Fed. Appx. 709, 712 (11th Cir. 2013).

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the various corporate stakeholders get a little more complicated, and it will be interesting to see how the courts sort this out.

## Endnotes

<sup>1</sup>*Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."); *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders.")

<sup>2</sup>John H. Richardson, *Saving Capitalism from Itself: Inside the B Corp Revolution* (ESQUIRE MAGAZINE, Aug. 23, 2010).

<sup>3</sup>See generally William H. Clark, Jr. and Elizabeth K. Babson, *How Benefit Corporations Are Redefining The Purpose Of Business Corporations*, 38 WM. MITCHELL L. REV. 817 (2012); see also Gary Schildhorn and Brya Keilson, *The Unresolved Dilemma of Creditors' vs. Stakeholders' Rights*, 32-4 ABLJ 58 (May 2013).

<sup>4</sup>8 Del. C. § 361.

<sup>5</sup>8 Del. C. § 362(a).

<sup>6</sup>8 Del. C. § 362(a); see also 8 Del. C. § 365(a) for similar language).

<sup>7</sup>8 Del. C. § 362(c).

<sup>8</sup>8 Del. C. § 362(a).

<sup>9</sup>*Id.*

<sup>10</sup>8 Del. C. § 362(b).

<sup>11</sup>*Id.*

<sup>12</sup>8 Del. C. § 366(c).

<sup>13</sup>8 Del. C. § 365(a).

<sup>14</sup>8 Del. C. § 365(b).

<sup>15</sup>8 Del. C. § 367.

<sup>16</sup>*Id.*

<sup>17</sup>See Clark and Babson at 849 (discussing the concept of an injunctive "benefit enforcement proceeding").

<sup>18</sup>8 Del. C. § 365(b).

<sup>19</sup>8 Del. C. § 365(c).

<sup>20</sup>*N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

<sup>21</sup>*Id.*

<sup>22</sup>*In re Continental Air Lines, Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986).

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