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How Did Delaware Get So Popular?

Stephen W. Clinton
Romin P. Thomson

INTRODUCTION

On any given day, the authors meet with entrepreneurs on the verge of starting new ventures. They might be inventing a new product, starting a staffing company, or developing new technologies designed to "out-Google" Google. These entrepreneurs often propose that the authors help them form new corporations "in Delaware" rather than California. They may propose Delaware for any number of reasons. They may know that most publicly traded U.S. companies are Delaware corporations. They may believe (wrongly) that Delaware corporations operating in

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California are not required to pay California franchise taxes. They may believe that venture capitalists will only work with Delaware corporations, or they may have been urged by business associates and friends to incorporate their start-up company in Delaware. The reality is that, in most instances, it does not make sense for a California-based start-up to form a Delaware corporation.

As business lawyers practicing in the Silicon Valley since 1997, the authors have found the impulse to domicile in Delaware to be one of the most common issues that they confront—and it is becoming more common. This article will consider why there are so many Delaware corporations and when it makes sense for companies to "go East." It will consider Delaware's popularity and describe some of the subtle, but important, distinctions between Delaware and California corporate law. These factors must be evaluated against the backdrop of the uncertainty associated with competing doctrines of state law and the added administrative burden with which a Delaware corporation operating in California must contend.

In the authors' view, forming a California-based entity in Delaware adds costs and complication with marginal benefit, if any, in most cases. Entrepreneurs are already heavily burdened with that "out-Googling" Google thing. For a young company, time and money are usually scarce. To the extent possible, the legal infrastructure should be moved out of the way. Counsel's goal should be to keep life simple for entrepreneurs who are basically fighting for survival in a global marketplace.

Meetings with entrepreneurs wishing to form Delaware corporations present counsel with a delicate issue. Choosing where to incorporate is generally a conversation that takes place at the time of the initial interface with the clients. Often, counsel has no track record or history with the clients, yet the first thing counsel often must do is disabuse the clients of a notion they have come to accept as a sort of gospel.

This article is basically a longer version of the conversation that the authors have had numerous times with clients in that situation. In the authors' view, although there are times when a Delaware corporation is the optimal entity, forming a California corporation usually makes more sense for a California-based start-up company.

DELAWARE IS THE DOMINANT CORPORATE DOMICILE

Delaware is unquestionably the leading state of corporate domicile in the United States. Sixty-three percent of Fortune 500 companies are incorporated

there. More than 50 percent of all publicly traded companies in the U.S. are Delaware corporations. There are more than 945,000 active business entities in Delaware and thousands of corporations are formed there every year (31,472 in 2011). Eighty-six percent of all U.S. companies with initial public offerings in 2011 were incorporated in the state of Delaware. Those statistics are impressive. See *Delaware Division of Corporations 2011 Annual Report*, available at http://corp.delaware.gov/2011CorpAR.pdf.

Delaware's success in attracting businesses is widely attributed to several characteristics that make it appealing. First, the state has historically offered a corporate statute that tends to be more flexible and favorable to corporate management as compared with other states, including California. This remains true, although over time, many parts of the Delaware General Corporation Law (DGCL) have been copied by other states (including California), reducing the magnitude of the differences.

What really cannot be copied is the Delaware Court of Chancery. The Court of Chancery is a prominent and highly regarded court dedicated to corporate and fiduciary matters. It has been in existence for more than 200 years and is responsible for most of U.S. corporate case law. Ballantine, *Questions of Policy in Drafting a Modern Corporation Law,* 19 Cal L Rev 465, 466 (1931). Cases move relatively quickly and are heard by judges rather than juries, and the judges have a great deal of experience and sophistication in handling corporate matters. As a result, the Court of Chancery offers a scope and depth of common law that cannot be matched. The extensive common law creates more certainty and predictability for corporate management with respect to their business decisions.

Delaware's small size is also considered a benefit. It is argued that the state legislature and state bar association work closely together, helping the state enhance and improve its corporate laws. Black, *Why Corporations Choose Delaware* (Del Dept of State, 2007), available at http://corp.delaware.gov/whydelaware/whycorporations_web.pdf. Relative to California, its Secretary of State offers more alternatives for expedited filing services for corporate documents at lower fees. Delaware also touts other benefits. See generally http://corp.delaware.gov/.

There is no question that Delaware has a number of advantages that other states cannot hope to match within any reasonable amount of time. These advantages alone, however, should not drive the decision-making process for California entrepreneurs. Many of them will be irrelevant to the California-based corporation.

DELAWARE'S CORPORATE LAW TENDS TO FAVOR MANAGEMENT

State corporate statutes generally seek to balance the interests of shareholders, management, and the outside world, including creditors. Much is said about the Delaware's management-friendly bias. Although not absolute, the authors find this presumption to be true in many significant ways. What follows is not a complete deconstruction of Delaware corporate law. The discussion focuses on areas of law that most affect the authors' practices. The authors highlight some of the differences they find important and discuss the respective biases of Delaware and California corporate laws. Ultimately, these distinctions are either undercut or thrown into mass confusion by California's so-called long-arm statute, Corp C §2115, and the related common law.

Shareholder Voting Rights

In California, shareholders have the right to "cumulate" their votes in an election of directors. See Corp C §708. Any shareholder may demand that directors be elected by cumulative voting and, in that case, each shareholder will receive one vote per share for each board seat up for election. This provision has a major impact on director elections because, through cumulative voting, it is possible for minority shareholders to elect one or more members of the board of directors. In this way, California law protects minority shareholders, allowing them an avenue to participate in management. Shareholders of Delaware corporations do not have a right to cumulate votes, although a Delaware corporation may opt to allow for cumulative voting. See 8 Del Code Ann §214. As a result, a majority shareholder of a Delaware corporation can dictate the composition of the board of directors. (Note that this article uses the California term "shareholders" throughout, but the DGCL uses the term "stockholders.")

Another difference is the way the two states address voting agreements among shareholders. Voting agreements are used for a wide variety of reasons, but they are a tool often used by management to ensure that shareholders will approve transactions adopted by management. Their enforceability is often a top concern of management. One factor driving founders to Delaware is its relative clarity on the issue of voting agreements. Voting agreements have been upheld under Delaware common law and have been codified by statute since 1967. See 8 Del Code Ann §218(c). Historically, the California Corporations Code suggested that a voting agreement, outside the context of a statutory close corporation, might

constitute an impermissible, irrevocable proxy. See Corp C §§705(f), 706. As of January 1, 1998, this issue was resolved when §706 was amended to permit voting agreements outside the context of statutory close corporations. Still, Delaware's long-standing comfort with these agreements provides a measure of predictability and stability. Other issues under California law, such as the impact of cumulative voting rights, complicate matters for California corporations adopting voting agreements.

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Director Liability

The California Corporations Code specifies most of the duties expected of directors, requiring that directors act in good faith, in a manner they believe to be in the best interests of the corporation and its shareholders, with reasonable inquiry. See Corp C §309(a). California imposes a duty of inquiry with respect to virtually every significant decision made by directors. Delaware has largely allowed the rules regarding these duties to emerge from common law and, as a result, although similar, they are less specific and less rigid.

In California, directors are held to a basic negligence standard. Under Delaware law, to be liable, directors responsible for a breach of the duty of care must have acted with *gross* negligence. See *In Re Lear Corp. Shareholder Litig.* (Del Ch 2008) 967 A2d 640, 651.

Each state permits the inclusion in the articles (or certificate) of incorporation of provisions eliminating or limiting the personal liability of a director for monetary damages, and the statutes of both states generally allow limitations on the liability of a director for mere negligence in the breach of his or her duty of care to the corporation. Corp C §204(a)(10); 8 Del Code Ann §102(b)(7). Nonetheless, Delaware's more broadly composed standards and well-developed case law provide directors with significantly more protection and clarity regarding personal liability. For that reason, Delaware is considered a more favorable state with respect to the limitation of personal liability of management.

Agent Indemnification

The standards applied when evaluating an agent's right to indemnification again reveal Delaware's bias towards management and California's relative indifference. As one would expect, both states authorize the corporation to indemnify its directors and agents. Delaware's reach is wider in subtle, but important, ways. For a director to receive indemnity in California, he or she must act in a way "reasonably believed to be in the best interests of the corporation." Corp C §317. To this standard, Delaware adds a provision for indemnity when the action is "not opposed to the best interests of the corporation." 8 Del Code Ann §145(a)–(b). A director can receive indemnification even though his or her actions were not in the corporation's best interests, as long as they were not opposed to the best interests of the corporation.

Mandatory indemnification extends to California directors when the director has been "successful on the merits" in an underlying derivative action. See Corp C §317(d). To this standard, Delaware adds "or otherwise." See 8 Del Code Ann §145(c). A director need only be successful on technical grounds, *e.g.*, among other things, winning a case based on a plaintiff's lack of standing.

Anti-Takeover Measures

A primary factor driving corporations to Delaware is the relative flexibility of Delaware courts in evaluating anti-takeover measures. Publicly traded corporations often find themselves targets of a potential acquisition by shareholders perceived to be unfriendly to management. In that situation, management often reaches for various anti-takeover measures to protect their interests and what they perceive to be the interests of the shareholders at large.

One popular anti-takeover measure historically has been a shareholder rights plan, often referred to as a "poison pill." The plan consists of the issuance to existing shareholders of rights to acquire more shares at a substantially discounted price, while not offering the same rights to the "unfriendly" acquirer. This technique arguably violates California law, which generally prohibits distinctions between classes or series of shares or the holders thereof. See Corp C §203. Whether the technique does in fact violate California law remains an open issue undecided by California courts, but not so in Delaware, where the Delaware Supreme Court has upheld it. See *Moran v Household Int'l, Inc.* (1985) 500 A2d 1346, 1357. The board's decision will remain subject to scrutiny under

Delaware's business judgment rule. Delaware has also adopted a business combination law that operates as another anti-takeover measure available to management. See 8 Del Code Ann §§251–267. In the authors' view, California's intransigence on this issue is a major deterrent for publicly held entities that are nearly always vulnerable to attacks from outside groups seeking to take control of their assets.

Delaware is considered a more favorable state with respect to the limitation of personal liability of management.

Distributions

Shareholder distributions for California corporations are subject to a high level of scrutiny by statute. The applicable statutes are complex, but basically permit distributions only when the corporation can meet specified financial tests. First, distributions are prohibited if they would make the corporation insolvent. See Corp C §501. In addition, distributions are prohibited if the corporation cannot meet either a balance sheet test or a retained earnings test. See Corp C §500. These tests remain complex, even though they were simplified by amendments effective January 1, 2012. See generally Tishler & Astudillo, *Revised Section 500 of the California Corporations Code: Easing Restrictions on Distributions*, 27 CEB Cal Bus L Prac 112 (Fall 2012). The underlying concept is that shareholder distributions are only permitted after a good faith determination by the board of directors, based on the corporation's financial statements (or other reasonable method; see Corp C §500(c)), that the corporation, after the distribution, will satisfy the statutory tests. These statutes require management to undertake a detailed and complex analysis, thus limiting management's flexibility when making decisions with respect to distributions.

The term "distribution" is defined broadly (see Corp C §166), and the knowing receipt by a shareholder of an unlawful distribution is unlawful (see Corp C §506(a)). This can be an issue in the context of a shareholder buy-out when the entity's solvency prohibits both payments and the receipt of payments scheduled over time.

Delaware's rules with respect to distributions are largely arbitrary and based on traditional concepts of legal capital. See 8 Del Code Ann §§154, 244. Appraisals and concepts such as "capital surplus" are relevant, but ultimately these restrictions have been referred to as a "farce . . . congenial to the management of a corporation that wants to make a distribution." Finkle, Marsh, Jr., & Sonsini, Marsh's California Corporation Law §2.05[E] (Aspen 2012). Clearly, directors of Delaware corporations that choose to distribute funds due to creditors instead to shareholders would face liability under general concepts of corporate law. That said, the statute does not, in any meaningful sense, attempt to dictate the specific circumstances in which a board may make a distribution. In this way, management is given far more opportunity to explain the circumstances surrounding a given distribution and why it merited approval while its California counterpart would be essentially boxed-in by statute.

Number of Directors

A Delaware corporation may operate under the direction of a sole director, regardless of how many shareholders it has. 8 Del Code Ann §141(b). In California, corporations with two shareholders must have two directors, and those with three or more shareholders must have at least three directors. Corp C §212(a). This is an innocuous requirement until entrepreneurs start to reflect on whom they can trust in the role of director and who would be willing to undertake the risks associated with becoming a director. In addition, the distinction demonstrates California's bias toward the importance of director meetings and toward ensuring the participation of multiple voices in the decision-making process when multiple shareholders own an entity.

Reorganizations

The California Corporations Code classifies reorganization transactions in three different ways. Depending on the substantive nature of the underlying transaction, the statute classifies them as either "sale of assets reorganizations," "exchange reorganizations," or "merger reorganizations." See Corp C §181. The classification determines what board of director approval, shareholder approval, and dissenters' rights would be involved with the transaction.

While the California statute looks to the substance of an underlying transaction, the Delaware statute looks to the form of the transaction when assigning the requisite approvals and associated rights. For example, under Delaware law, a transaction consisting of a sale of assets for stock will not trigger dissenters' rights, while a merger would—even though the net effect of these two transactions may be identical. See 8 Del Code Ann §§262, 271–285. Accordingly, the Delaware statute is much more

liberal and flexible and provides the board of directors with a more formidable arsenal to abolish or eliminate certain rights, which is not possible under the California statute.

Rights of Inspection

The respective biases of the California and Delaware statutes shine through with particular clarity with respect to the rules concerning rights of inspection. As one would expect, California's inspection rights are significantly broader than Delaware's. In California, any shareholder may view the corporation's "books and records," any 5-percent shareholder is entitled to review the corporation's shareholder list, and directors are entitled to review nearly everything. Corp C §§1601, 1602. In Delaware, there are no absolute inspection rights. Instead, rights of inspection are tied to a showing of proper purpose. Both shareholders and directors must establish a purpose reasonably related to the interests of the requesting party in order to inspect the corporate records. 8 Del Code Ann §220.

Because shareholders of California corporations are afforded broad rights of inspection, they can, if they so choose, keep an eye on management and monitor many management decisions for virtually any reason. In contrast, the Delaware statute allows management significant discretion as gatekeeper to corporate information. From a practical point of view, the Delaware statute may work merely to delay an inspection while the parties argue over the inspector's alleged "proper purpose."

THE IMPACT OF CALIFORNIA CORPORATIONS CODE §2115

The factors discussed above make clear that Delaware's statutory bias leans more toward management at the expense of shareholders and outsiders, in comparison with the California Corporations Code. For counsel, it would seem that the obvious conclusion is to form the entity in the state that best suits the needs of the specific client. Unfortunately, the matter is not nearly that straightforward because California imposes much of its Corporations Code on out-of-state corporations located in California. Much of the California Corporations Code will apply to an out-of-state corporation when (1) the average of the property factor, the payroll factor, and the sales factor (as defined in Rev & T C §§25129, 25132, 25134) with respect to the corporation is more than 50 percent during its latest full income year, and (2) more than one-half of the corporation's outstanding voting securities are held of record by persons having addresses in this state. Corp C §2115(a).

The reach of this statute is broad and applies to nearly all of the matters discussed above. It imposes a variety of California statutes on out-of-state corporations operating in California, including:

1. Director election and removal (Corp C §§301, 303, 304);
2. Agent indemnification (Corp C §317);
3. Distributions (Corp C §§500–506);
4. Cumulative voting (Corp C §708);
5. Mergers, reorganizations, and sale-of-assets transactions (Corp C §§1001(d), 1101, 1151, 1152, 1200–1203, 1300–1313); and
6. Rights of inspection (Corp C §§1600–1602).

Uncertainty as to Application

The net effect of Corp C §2115 is to undermine the purported benefits of forming a Delaware corporation and to create complications when there would otherwise be none. A Delaware corporation operating in California must consider the statute constantly. For each matter that arises—for each inspection demand submitted, for each director election conducted, for each acquisition transaction proposed—an attorney needs to be retained to evaluate both California and Delaware law and reach a conclusion regarding which statutory scheme applies to the matter at hand. This uncertainty with respect to the statute's application adds, at times substantially, to the administrative costs associated with operating a Delaware corporation in California.

Uncertainty Regarding Enforcement

There is also uncertainty with respect to the statute's enforcement. California courts have generally upheld Corp C §2115. See, *e.g.*, *Wilson v Louisiana-Pacific Resources, Inc.* (1982) 138 CA3d 216. However, the Delaware Supreme Court has done just the opposite. See *VantagePoint Venture Partners 1996 v Examen*, (2005) 871 A2d 1108. In *VantagePoint*, the court ruled that the statute violated Delaware's internal affairs doctrine and the due process clause of the Fourteenth Amendment to the U.S. Constitution. At this time, it remains unknown how California courts will respond to the analysis presented in *VantagePoint*. Attorneys can expect a controversy between the states to ensue. Until the matter is resolved, parties can be expected to engage in a race to the courthouse, seeking to enforce their rights in California or Delaware, depending on whether they want the California statute applied or disregarded.

Founders of Delaware corporations may wish to use their certificate of incorporation to designate the Delaware Court of Chancery as the sole and exclusive forum for derivative actions, claims asserting breach of fiduciary duty, claims arising out of the enforcement of the DGCL, or actions asserting claims governed by the internal affairs doctrine. This designation may be void, of course, depending in part on the ultimate interpretation of Corp Code §2115.

The net effect of Corp C §2115 is to undermine the purported benefits of forming a Delaware corporation and to create complications when there would otherwise be none.

REDUCED UNCERTAINTY AND ADMINISTRATIVE COSTS GIVE CALIFORNIA AN EDGE

The uncertainty regarding the application and enforcement of Corp Code §2115 creates work for lawyers, but one has to ask whether it creates any reasonable added value for the corporation. Put another way, is Delaware's prohibition of cumulative voting so important as to warrant the added costs associated with this uncertainty? What about Delaware's more liberal standards for distributions? Are any of the foregoing differences substantial enough to warrant the added costs associated with resolving the dilemma imposed by §2115 and its associated case law?

Put still another way, are any of these issues nearly as important to the founders as that "out-Googling" Google thing? Remember, the primary purpose of formation is to allow clients to build successful businesses. The challenges facing entrepreneurs are as difficult and complex today as they have ever been. For most start-up companies in California, the benefits of Delaware law are marginal and easily outweighed by the uncertainty and costs associated with issues such as conflicts of law, which of necessity would arise often.

There are other benefits associated with staying in California. A Delaware corporation operating in California must qualify as a foreign corporation in California. Qualification results in the imposition of California's franchise taxes, including its minimum tax requirements, on the Delaware entity. See Rev & T C §23151. In addition to California taxes, the Delaware corporation also has to pay Delaware's franchise taxes. Although these taxes are generally lower than California taxes, they present a unique problem in that they are not easily computed. Delaware bases its franchise taxes on the number of authorized shares and their associated par value. Delaware uses a default and an alternative means of calculating franchise taxes. The default calculation often results in a tax invoice of thousands of dollars to the corporation. Throughout the years, the authors have received calls from several panicked executives faced with a massive Delaware franchise tax bill. The alternative "assumed par value" calculation often results in a much lower tax bill (often $350), but requires recalculation of the invoice. It is often vital in a Delaware certificate of incorporation to designate a low par value for the corporation's authorized shares to take advantage of the "assumed par value" calculation.

A Delaware corporation operating in California must employ an agent for service of process in both California and Delaware, and a Delaware corporation is subject to the jurisdiction of the Delaware courts.

The differences between California and Delaware securities law are beyond the scope of this article. At least arguably, however, an issuance of shares by a Delaware corporation to a California resident is an issuance of shares in two states, implicating the securities laws of both states as well as the federal securities laws and triggering compliance costs in each jurisdiction.

DELAWARE WILL REMAIN A POPULAR CHOICE FOR SOME

This article has explained the authors' preference to form California corporations for businesses starting up in California. As with most things, there are exceptions.

One exception may apply to corporations in search of venture capital. There is still a strong sentiment by professional investors for their portfolio companies to be Delaware corporations. To the extent that sentiment is accurate, companies intent on raising venture capital should consider Delaware carefully. Certainly, if a particular investor is ready and willing to invest meaningful capital and is pushing for the entity to be domiciled in Delaware, the added costs and confusion should not outweigh the benefits of attracting capital. Under those facts, the investor should essentially get what it wants.

As one would expect given the vast number of publicly traded Delaware corporations, it also makes sense for large publicly traded entities to be domiciled in Delaware, although this decision need not be made at the time of formation. Those entities will generally want to take advantage of Delaware's stronger

management-friendly provisions such as broader indemnity and liability limits. Public companies will also be very interested in Delaware's robust anti-takeover statutes. Further, Corp C §2115 is inapplicable to most publicly traded corporations. See Corp C §2115(c). Entrepreneurs are often motivated to form Delaware corporations because they want to be well-positioned as Delaware corporations at the time of their initial public offering. In practice, growing California corporations are often reincorporated by merger on the eve of their public offerings.

For most start-up companies in California, the benefits of Delaware law are marginal and easily outweighed by the uncertainty and costs associated with issues such as conflicts of law.

There might be significant tax savings available to corporations that operate across state lines. A multi-state corporation would theoretically benefit to the extent it can apportion its tax liability to states with lower tax rates than those applied by the California Franchise Tax Board. It is essential to engage qualified tax counsel to evaluate this possibility.

Finally, in situations where a California-based corporation has already been established in Delaware (perhaps without the advice of counsel), the authors do not see a significant justification for changing the status quo. Again, the goal is to make life easier for clients. The simplicity achieved by changing from a Delaware corporation to a California corporation would most likely be nullified by the annoyance associated with the process.

CONCLUSION

The choice of domicile ultimately requires an analysis of both the legal and practical ramifications of the decision. Consider an initial meeting with the founders of the next great Silicon Valley start-up company. Where the founders choose to form their corporation is a decision that must be thought through carefully. There are subtle, but important distinctions between California and Delaware law, and consideration of those distinctions will help drive the decision. Those legal distinctions do not exist in a vacuum, however. They must be evaluated in light of the uncertainty caused by competing doctrines of state law and the added costs associated with redundant administrative burdens. In the authors' view, although there will continue to be circumstances in which a corporation formed in Delaware will be the appropriate course, considerations of potential uncertainty and added costs should drive most California-based businesses to form California corporations.

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