

## IS DELAWARE THE RIGHT PLACE TO INCORPORATE YOUR BUSINESS?

A disproportionate number of businesses historically have been and continue to be incorporated in Delaware, even when few, if any, of their operations occur there. Why is this the case? And might it make sense for you to consider incorporating your business there instead of California?

### **The Switzerland of the United States?**

Delaware is a tiny state, but it is disproportionately popular as a locale for incorporation for many reasons discussed below, when contrasted with California, some of which may favor management over shareholders and the company and its officers and directors over outsiders. Almost one million businesses are currently incorporated in Delaware, including more than 63% of the Fortune 500 and more than half of the publicly traded companies listed on American stock exchanges.

### **Fees and Services**

Annual corporate fees are generally cheaper in Delaware, but this will depend on how each individual company is structured. Delaware's Secretary of State's Office, through which corporate filings must be made, has a well-deserved reputation for being responsive and user friendly, both on an absolute and a relative basis.

### **Flexible Corporation Statutes**

Delaware's General Corporation Law has a reputation for being among the most flexible in structuring the relationship between shareholders and management. Corporations with multiple shareholders may choose, unlike California corporations, to have only one director, which may streamline corporate governance, are not required to elect directors annually and are not required to have cumulative voting.

### **Legal Predictability**

Delaware has the most highly-developed, thorough body of corporate law of any state in the country. Cases relating to corporate governance are tried in Delaware in the Delaware Court of Chancery in front of a judge well-trained and experienced in corporate matters rather than in front of a jury. The quantity and quality of precedents and the background of the jurists usually lead to more reliable results.

## **Prestige and Familiarity**

Venture capitalists and investment bankers generally show a preference for companies incorporated in Delaware (and while companies can always reincorporate there after they have been in existence for a while, it may be easier to do the incorporation there initially if it is contemplated that this might be desired in the future), both for some of the company and management friendly considerations listed here, and also just because it is what they are used to seeing.

## **Privacy**

Unlike California, Delaware does not require officers and directors names to be listed in public documents. (Comment: in California, a shareholder's review of **accounting** books and records must be reasonably related to his interests as a shareholder under California Corporations Code Section 1601. The 5% shareholder rule covers only the names and addresses and of shares owned [California Corporations Code Section 1600].). With databases of all sorts subject to attack, this may provide persons serving in those capacities a level of comfort and anonymity.

## **Lack of Unequivocal Shareholder Protections**

In California, any 5%+ shareholder has an automatic right to inspect the company's books and records; in Delaware, such right is premised on the shareholder being required to show a "proper purpose". In California, any shareholder owning 33.3%+ of a company's equity may petition the superior court for involuntary dissolution of that company; Delaware does not have an analogous provision.

## **Distributions**

In California, a corporation's ability to distribute cash to its shareholders is determined by a balance sheet test, which can be based on financial statements, a fair valuation, or another reasonable method. In Delaware, this is determined by a capital surplus test, which provides a corporation may issue dividends as long as such distribution does not impair capital. Delaware's test is generally considered to be a bit more lenient.

## **Other Advantageous Corporate Law Provisions**

Delaware generally offers incumbent management more protection than California both in the context of hostile takeovers and stockholder derivative actions. However, unless and until your company is very large, and in the former case, publicly traded, these provisions are of little benefit. (Comment: a small company can be the subject of a derivative action.)

## **Protection of Directors from Individual Liability**

In the past, Delaware offered directors of corporations substantially more protection than California, both statutorily and in the corporation's ability to indemnify them, but these differences have largely disappeared due to changes in California's laws. Although Delaware's business judgment rule is considered to be incrementally broader than California's, in the vast majority of instances, the outcome will be the same. Likewise, while Delaware's indemnification standard is slightly more liberal than California's, California generally permits a company to indemnify its directors if it is authorized to do so

in its formation documents.

## **Alternative considerations – quasi-California corporations**

All of the foregoing would seem to be positive (or at worst, not germane) in considering whether to incorporate in Delaware. However, Section 2115 of the California Corporations Code provides that key provisions of the California Corporations Code (including those relating to election of directors, distributions, and inspection rights, among many others) apply to foreign corporations if the average of the property factor, payroll factor and sales factor with respect to the corporation is more than 50% during its latest full income year and more than half of the corporation's voting securities are held by persons having addresses in California. Foreign companies with substantial operations in California, such as having employees or renting or owning property and having material sales in California are required to qualify to do business here and to have a second agent for service of process. This may result in additional costs and record-keeping burdens for little to no substantive benefit.

## **Conclusion**

The advantages – or not - of incorporating in Delaware will vary widely depending on each company's individual circumstances, but in general, the larger the company, the more likely it is to have professional and/or public investors, and the less California-based its operations, the more likely it is to benefit from a Delaware incorporation. These factors should be discussed and considered carefully by you and your experienced advisors when making this choice.

## **Related Attorneys**

- Karl D. Chandler