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Delaware's Siren Song

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By Keith Paul Bishop

Delaware has done a remarkable job in convincing out-of-state companies to forsake their headquarters' states and incorporate in Delaware. According to the Delaware secretary of state, 50 percent of all U.S. publicly traded corporations and 63 percent of all Fortune 500 companies have their legal home in the Blue Hen State. The conventional wisdom about the superiority of a Delaware charter is so entrenched that many lawyers may have forgotten the reasons why Delaware is a good choice. For those lawyers who have forgotten, there are, in fact, many reasons to recommend Delaware.

Incorporating in Delaware lets your clients show the world that they have money and they are not afraid to spend it. Delaware charges an annual franchise tax for the privilege of being a Delaware corporation. This tax is not cheap. The maximum franchise tax is $180,000 per year. This means that in the course of a decade, some Delaware corporations will pay nearly $2 million to the state of Delaware for the privilege of having a Delaware charter. In contrast, the annual fee to maintain a California charter is only $25. Delaware's franchise tax should not be confused with California's "franchise tax," which is a tax on doing business in California. Given a choice between spending $180,000 and $25 per year, it is easy to see that Delaware is the state to choose for those corporations with money to burn.

Delaware is an outstanding choice for those who like to read. Delaware promotes its corporate law as both "modern and flexible." Yet, the Delaware Code is so open-ended that anyone who simply reads it would learn next to nothing about the most important principles of Delaware law. The reason for this is that the Delaware Chancery Court makes nearly all of the important law for Delaware corporations. Although the Chancery Court is a trial court, its decisions are published. The chancellors, moreover, like to write. For example, Chancellor William Chandler's post-trial opinion in the derivative lawsuit against the directors of The Walt Disney Company challenging Michael Ovitz' multimillion-dollar severance agreement filled 174 pages and included nearly 600 footnotes. *In re The Walt Disney Co. Derivative Litigation*, C.A. No. 15452 (Del. Ch. Aug. 9, 2009). The Delaware Supreme Court took a meager 89 pages to affirm Chandler's decision. *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006).

A Delaware charter also offers excellent opportunities for directors and officers to travel. Perhaps because Delaware doesn't have a Yosemite, Big Sur or Hollywood, it has had to find other ways to bring visitors to the state. Thus, the Delaware Legislature has conveniently provided in Section 3114 of Title 10 of the Delaware Code that every nonresident director or officer who accepts election or appointment as a director or officer of a Delaware corporation consents to the appointment of the corporation's registered agent as agent for service of process. The Delaware Supreme Court has held that Section 3114 authorizes the exercise of jurisdiction over a nonresident defendant. *Armstrong v. Pomerance*, 423 A.2d 174 (1980). Thus, when directors and officers get sued, they will have the opportunity to travel across the country to visit Delaware.

The Walt Disney Company, for example, is headquartered in Burbank. Yet, Michael Eisner was able to spend six days testifying in tiny Georgetown, Del., during the trial of the derivative lawsuit against him and the other Disney directors. Eisner was able, however, to enjoy some of his time in Delaware. According to one press report, he and his wife toured the shopping outlets lining Delaware Route 1. Had The Walt Disney Company been incorporated in California where it is headquartered, Eisner and his wife would have had to put up with a drive down the Pacific Coast Highway.

California lawyers who incorporate their clients in Delaware and give legal advice on Delaware corporate law will also have the opportunity to travel to Delaware to defend themselves. In Sample v. Morgan, C.A. No. 1214 (Del. Ch. Nov. 27, 2007), Vice Chancellor Leo Strine found that "Having directed their legal practice toward Delaware by regularly providing advice about Delaware law matters to the corporation, these defendants [an Ohio lawyer and his firm] should have reasonably expected that they might face suit here [i.e., Delaware] if the managers and directors they were advising were sued for a breach of fiduciary duty related to that advice." Many California lawyers are likely to be shocked to discover that making arrangements with a service company to file corporate documents with the Delaware secretary of state can subject them to suit in Delaware.

Those who seek self-improvement through constructive criticism should choose Delaware. Chancery Court opinions typically include long narrative descriptions of the parties' conduct that in other state courts might be omitted as unnecessary dicta. The tone of these descriptions is often highly judgmental, even when the court concludes that a director or officer did not fall short of the applicable legal standard for purposes of imposing liability. Professor Edward Rock has described Delaware court decisions as "corporate law sermons." In the Disney derivative case, for example, Chandler concluded that Disney's general counsel, Sanford Litvack, "gave the proper advice and came to the proper conclusions when it was necessary." Having found no basis for imposing liability, the court could have stopped there. Yet, Chandler went out of his way to comment that Litvack "should have exercised better judgment" in one matter. He also criticized Litvack for not speaking up at a committee meeting - calling Litvack's reason for not doing so "pathetic."

Rock and others have argued that this gratuitous criticism serves a useful purpose - it puts others on notice that the Chancery Court expects a higher standard. There is a problem, however, with these judicial defamations. Because the Delaware courts often criticize without imposing liability, there is no appeal from these judicial barbs. Simply put, there is no place in Delaware for directors and officers to recover their reputations.

Finally, Delaware will appeal to those California attorneys who like California's General Corporation Law. California has enacted numerous "outreach" statutes that impose provisions of its corporate law on corporations incorporated in other states.

The most notable of these is Section 2115 of the California Corporations Code, which applies to a foreign corporation if more than one-half of its outstanding voting securities are held of record by people with addresses in California and most of its business is attributable to California (based on the average of the corporation's property, payroll and sales factors as defined in Section 25129, 25132 and 25134 of Revenue and Taxation Code). Corporations meeting these tests, often referred to as "pseudo-foreign corporations," are subject to a lengthy and diverse list of California corporate statutes, including Section 309 (directors' standard of care), Sections 500 to 505 (limitations on distributions) and Chapter 16 (rights of inspection). Although corporations with outstanding securities listed on the New York Stock Exchange, American Stock Exchange (now known as NYSE Amex) and the Nasdaq National Market (now known as the NASDAQ Global Market) are exempt, there are thousands of privately and publicly held corporations that do not have securities listed on these markets.

Not unexpectedly, the Delaware Supreme Court, citing the internal affairs doctrine, has refused to apply California's Section 2115. *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005). The doctrine holds that the internal affairs of a corporation are to be governed by the law of the state of incorporation. The California Supreme Court, however, has not yet addressed the issue. Further, it is unknown whether the Delaware courts will conclude that every provision listed in Section 2115 offends the internal affairs doctrine. As it currently stands, therefore, the status of Section 2115 is uncertain. Thus, any Delaware corporation that meets the Section 2115 thresholds takes on a great deal of uncertainty about the applicable law.

Section 2115 is not the only California Corporations Code provision imposed on foreign corporations. Numerous other provisions, including Sections 1501 (requirement of an annual report), 1600 and 1602 (shareholder inspection rights) and 1602 (director inspection rights). Incorporating in Delaware will not avoid the application of these and many other provisions of California's corporate law.

It was once said that no one was ever fired for buying IBM. The same may be true for recommending incorporation in Delaware. Indeed, Delaware does offer the benefits of conspicuous consumption, travel

and constructive criticism. Moreover, California lawyers may never need to really give up the California Corporations Code when they incorporate their clients in Delaware.

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