

# Delaware: The Land of a Million Corporations

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# The Benefits and Drawbacks of Forming in Delaware

Sarah Hewitt

# Overview

- Delaware is the corporate home of over 1 million corporations, limited liability companies, limited partnerships, not-for-profit corporations and other corporate entities
- More than 60% of Fortune 500 companies, over half of publicly-traded companies, over 80% of new IPOs and most tech startups formed there
- Over a hundred thousand entities added each year
- Far more companies are formed in Delaware than the companies physically headquartered there
- The number of Delaware corporations is out of proportion for a state that has a relatively small population (952,065 citizens in 2016)

## Overview

- Delaware has been ranked the #1 state legal system by the U.S. Chamber Institute for Legal Reform as the best and most business friendly state for the past 10 years
- It's the Incorporation Capital of the World!
- The State's General Corporation Law was passed in 1899 modelled after a similar law passed earlier in New Jersey

## Questions

- So, Why choose Delaware over the business' home state? and
- Why choose Delaware if you are entering the US market from overseas?
- There are a number of benefits to forming in Delaware!

# Benefits

First, Delaware is committed to new business

- It has a business friendly state government; 1/3 of the state budget comes from incorporations including filing fees, annual fees and taxes, etc. which may be why
- Delaware law is the most advanced and flexible business formation statute in the US
- The Law clearly spells out what companies can and cannot do and leaves little to interpretation; Predictable and dependable
- The state legislature and the Delaware State Bar Association keep Delaware's corporation statute and other business laws current, clear and concise, often with bi-annual updates

# Benefits

## Second, The Delaware Court of Chancery – Has Corporate Law Expertise

- It's a highly respected Court that focuses solely on corporate issues; it uses judges instead of juries; it's the oldest business court in America established in 1792 and the second most important after the US Supreme Court in its impact on corporate law
- Due to this concentration on business issues, the members of the Chancery Court have expertise and familiarity with complex corporate disputes and corporate law
- It has very knowledgeable judges, that typically issue well rationalized opinions
- This differs from states where judges are elected or politically appointed and may have no business knowledge or experience

## Benefits

Third, there is Extensive Case Law – “Precedent” for any issue that might arise in a Delaware company’s lifetime

- Due to the high volume of cases – there’s lots of case law
  - There are very few questions of first impression
  - This is not so in other states like Nevada which have mimicked the DGCL
- Volume of case law leads to predictability and gives companies and their counsel the ability to assess risks in disputes
- The case law also provides guidance as to “novel” ideas or approaches that can be taken

Fourth, More attorneys are versed in Delaware corporate law than probably any other state law – taught in law schools & most corporate lawyers’ practice

# Benefits

Fifth, Investors (private equity, venture capital and serial angel investors) prefer Delaware Law over other states

- Delaware law is familiar and predictable for investors and flexible for governance and investment structures
- From the startup side, Delaware permits one person to be an officer, director and shareholder unlike other states that may require three, and does not require any of them to be Delaware residents
- Investment bankers also prefer and often insist that IPO candidates be incorporated in Delaware so if any IPO is in the company's future you may want to start there
- Can easily convert a Delaware LLC to a Delaware corporation if you want to start with a LLC

# Benefits

Sixth, the Delaware Secretary of State's Office and its filings System are a benefit

- The Delaware Secretary of State's office is more sophisticated than most states' offices; and is lauded for its efficiency and service with a state-of-the-art computer system. It actually makes a profit and is run like a business itself
- The Secretary of State has "expedited" service with filings in 24 hours, same day, 2 hours and 1/2 hour; and it's open until midnight
- Timing can be critical in mergers and other corporate actions so Delaware's service standards are important
- Also, the Costs to incorporate in Delaware are lower than some other states (e.g. CA, NY, TX) and foreign jurisdictions
- And, Delaware does not require officer or director names to be disclosed on formation documents so there is some level of privacy

# Benefits

Seventh, Delaware has favorable Business Tax Laws, especially for international entrepreneurs and investors

- There is no state corporate income tax for Delaware corporations that operate out of state (but there is a franchise tax)
- There is no state sales tax on intangible personal property (such as royalty payments)
- Shares of stock owned by non-resident aliens are not subject to Delaware taxes
- There is no state inheritance tax on stock held by non-residents of Delaware
- There is no personal income tax on non-residents of Delaware
- There are no value added taxes (VAT)
- And the Franchise taxes can be quite low for small businesses and Delaware provides 2 alternative methods of calculation – based on authorized shares or the “Assumed Par Value Method”. Franchise taxes can range from a low of \$175 to a high of \$180,000

# Benefits

Other benefits of forming in Delaware include that :

- Directors of Delaware corporations are sheltered from personal liability by the director shield law in connection with their actions as board members
- Shareholder liability is limited by the amount of investment if corporate formalities have been followed
- There is no minimum capital investment required to form an entity
- Bylaws can generally be formulated or altered any time by directors
- Corporation may own without limitations as to amount or value stocks, bonds or securities of other corporations located in or outside Delaware as well as real and personal property

# Benefits

- Corporation can be set up to be an all-purpose corporation to engage in any lawful act or activity permitted in Delaware and can morph from one business to another
- Shareholder and Board meetings may be held anywhere or online or via written consent
- You do not have to maintain a Delaware business office address aside from your registered agent although there are “virtual office” packages available
- Your corporation or LLC can be headquartered in any state or territory of the US or in any country in the world
- Your Delaware corporation stock can be privately owned or publicly traded on any stock exchange anywhere in the world when properly registered
- Non-citizen non-residents may form Delaware C corporations and LLCs (not S corporations)

## So What are the Drawbacks?

- You do not need to live or have a physical address in Delaware to form a company there, but Delaware corporations must have a registered agent for service of process – these commercial agents can be expensive but you can shop for cheaper ones @\$130-\$150 a year. As previously mentioned, Delaware requires a franchise tax (so you may pay twice, once in Delaware and then in the home state)
- You'll have to register to transact business in more than one state if you'll do business outside of Delaware
- Delaware requires you to file annual reports even if you already have in your home state

## Another popular vehicle is the Delaware LLC

- First Delaware limited liability company was formed on October 1, 1993 when the Delaware Limited Liability Company Act first made the LLC a legitimate business entity
- Currently, about 2/3rds of all companies formed in Delaware are LLCs – 121,592 formed in 2014 and growing
- It's the most flexible type of business entity offered by any state or country in the world
- Delaware LLCs have minimal startup requirements, low startup costs, simple maintenance, affordable franchise tax and provide an ability for members to establish their own company structures and rules which are continued in an LLC operating agreement

# Benefits of Delaware LLCs

- LLCs possess increased asset protection against creditors of the members
- Members are not personally liable for the debts of the LLC beyond the dollar amount that the members have invested
- Members can choose how they want the LLC to be taxed – as a partnership, S corporation, C corporation or sole proprietorship. Single members LLCs are not recognized by the IRS
- LLCs are not required to disclose any information about the owners of the LLC to the state of Delaware, or to have an office or business address in Delaware but must have a Delaware registered agent like a Delaware corporation

## So What are the Drawbacks of Delaware LLCs?

- You'll have to register to transact business in more than one state if you'll do business outside of Delaware
- You'll have to pay Franchise Taxes of approximately \$300 annually in addition to your annual registered agent fee in addition to your home state taxes and fees if you have one
- Single member LLCs that are not seeking venture capital or going public might stick with their home state

## Conclusion

- Delaware's business laws (including the DGCL and the DLLCA) are enabling statutes and not a code of conduct
- Delaware's business laws are intended to provide flexibility in an organization's affairs, and are not written as a "regulation"
- Delaware's business laws are designed to make governance and internal procedures simple
- **For these and the other reasons discussed, millions of companies choose Delaware. Thank you!**

# The Delaware Court System

Richard Barkasy

# Why Delaware?

- Jurisdiction
- Business Friendly
- Delaware corporate law is the *de facto* national law of corporations
- Highly-respected judiciary
- Reputation for collegiality

# Delaware Chancery Court

- Limited jurisdiction
- Five Judges with vast experience in addressing corporate law disputes
- No jury trials
- Individualized case management

# Delaware Superior Court

- Court of General Jurisdiction
  - Civil and criminal matters
  - Family law
- Complex Commercial Division

# Delaware Supreme Court



# Delaware Bankruptcy Court

- Forum for bankruptcies involving major corporations
  - Local rules conducive for the efficient management of complex Chapter 11 cases
  - Consistency in decision-making
  - Recent Senate Bill which would drastically modify bankruptcy venue provisions

# Delaware Federal Court

- Intellectual Property cases
- Use of Magistrate Judges
- Current judge shortage and use of visiting judges

## Chapter 15

- Involves a foreign business (debtor) that has filed for bankruptcy in a foreign jurisdiction
- Debtor has assets and/or creditors in the US
- Allows for recognition and enforcement of foreign bankruptcy proceedings by US courts
- Allows for certainty in dealing with debtor's US assets and/or creditors in US

# Mergers & Acquisitions in Delaware

Megan Harmon

## Overview

- Over 35 years of extensive judicial review of M&A transactions
- Evolution of judicial expressions have evolved systematically over the years
  - Management led buy-outs/single bidder transactions were scrutinized and the Courts encouraged board-led, multi-bidder processes

# Overview

- In earlier decisions, use of defensive measures in M&A such as no-shops were discouraged
- Favoritism for fiduciary obligation of board members over third-party acquirers
- Stockholders were not capable of protecting their interests through votes alone

## Overview

- More recently the Delaware Supreme Court has shown different attitudes – it does not treat with skepticism single bidder transactions and no-shop provisions are now quite routine and accepted
- In case of breach the Courts look to prioritize rights of third party bidders for predictability to the contracting process

## Preference for Delaware as Controlling Law

- For all the reasons previously given Delaware is usually the preferred “controlling law” for any type of M&A transaction
- Often Delaware is the “compromise” governing law and forum/venue

# The Business Judgment Rule

- Has its genesis in corporate common law – the courts defer to the business judgment of corporate executives
- To challenge a corporate action, a plaintiff assumes the burden to prove that the directors breached their fiduciary duty: the duties of good faith, loyalty and due care

# The Business Judgment Rule

- Under the business judgment rule, a disinterested and independent board is presumed to have acted on an informed basis, in good faith and in the honest belief that the decision was in the best interest of the corporation

## The Revlon Doctrine – Targets / Takeovers / Mergers

- When a “sale of a company” or “sale of control”, the Courts will deviate from business judgment rule and apply what is known as “Revlon” doctrine
- Judicial review – a court will require that the Board’s fiduciary duties be focused on the short term goals of the shareholders to maximize value (as opposed to long term goals of the corporation), and when the Board’s decisions are challenged, the decisions will be reviewed with enhanced scrutiny

## The Revlon Doctrine – Targets / Takeovers / Mergers

- Enhanced Scrutiny – requires independent, disinterested directors to prove that the decision-making process was undertaken with adequate care and the decision was reasonable under the circumstance
- Factual based analysis, given the facts

## Appraisal Risks / Value Challenges and Demise of “Disclosure Only” Settlements

- Cases/challenges in M&A often involve value issues or appraisals in transactions
- *DFC* and *Dell* – two cases where Delaware Supreme Court held that the merger price will generally be entitled to significant weight and an appraisal action involving the sale of a public company pursuant to an open, competitive, and arm’s length bidding process

## Appraisal Risks / Value Challenges and Demise of “Disclosure Only” Settlements

- *Dell* extended this doctrine to mergers involving relatively limited pre-signing bidding process, at least where the process is competitive
- These decisions raise the bar as to “value” issues when there is some type of an arms length and competitive process

## Appraisal Risks / Value Challenges and Demise of “Disclosure Only” Settlements

- Historically in a challenge to a transaction, Courts routinely approved so-called “disclosure only” settlements in stockholder class actions. Here the organization and directors get a broad release of claims in exchange for their agreement to include in a proxy statement additional disclosures in advance of a stockholder vote on a transaction

## Appraisal Risks / Value Challenges and Demise of “Disclosure Only” Settlements

- Litigation proliferated where fees were created and Board members received broad releases involving all aspects of the transaction, i.e., deal insurance with quick resolution to the litigation
- These settlements started being criticized in 2013. The tide changed in approving these types of settlements and in 2016 in *In re Trulia, Inc.* the Chancery Court announced it will no longer approve disclosure only settlements unless “Plainly Material” and narrow releases

# Material Adverse Effect

- A typical MAE clause might define a MAE as “any event, circumstance, fact, change, development, condition, or effect that, either individually or in the aggregate, has had or could reasonably be expected to have a material adverse effect on the business, financial condition, results of operations, or other aspects of the business of the target and its subsidiaries, taken as a whole.” Next come several carve-outs from this broad definition of a MAE. These carve-outs are usually the focus of MAE negotiations, since they serve to narrow the universe of what the buyer can argue constitutes a MAE

## Material Adverse Effect

- Absent clear language to the contrary the party seeking to invoke an MAE clause bears the burden of proving an MAE has occurred – a heavy burden
- Rule of thumb – Delaware courts are loath to find an MAE to have occurred in the context of a merger
- *In re IBP* “a short term hiccup in earnings shall not suffice to succeed on an MAE”

# QUESTIONS?

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