



Why Corporations Choose Delaware

Written by
Lewis S. Black, Jr.

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WHY CORPORATIONS CHOOSE DELAWARE

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INTRODUCTION

I am frequently asked why so many corporations are formed in Delaware. Why indeed? It is apparent that Delaware continues to be the favored state of incorporation for U.S. businesses. Delaware has been preeminent as the place for businesses to incorporate since the early 1900s, and its incorporation business, supplemented by the growth in numbers of such “alternative entities” as limited liability companies, limited partnerships and statutory trusts, continues to grow smartly. Close to a million business entities have made Delaware their legal home. Furthermore, while the sheer number of corporations organized in Delaware is significant, more significant still is the fact that so many large and important corporations are incorporated in Delaware. Of the corporations that make up the Fortune 500, more than one-half are incorporated in Delaware. It is no wonder that Delaware has become almost a brand name for the “business” of serving as the official home for corporations.

So what is the source of Delaware’s prestige—even cachet? Why do corporations choose Delaware? I think the answer is not one thing but a number of things. It includes the Delaware General Corporation Law which is one of the most advanced and flexible corporation statutes in the nation. It includes the Delaware courts and, in particular, Delaware’s highly respected corporations court, the Court of Chancery. It includes the state legislature which takes seriously its role in keeping the corporation statute and other business laws current. It includes the Secretary of State’s Office which thinks and acts more like one of the corporations it administers than a government bureaucracy.

There are other, less tangible, factors that go into the mix that make Delaware appealing to corporations and other business forms. There is the fact that Delaware is a small state whose populace is generally pro-business. The people of Delaware are aware that the income received from corporation franchise taxes is an important part of the state budget and that Delaware law firms that specialize in business law matters employ significant numbers of people. As a result, the Delaware citizenry supports the legislature in keeping Delaware’s business laws state-of-the-art. There is the fact that lawyers all over the country feel comfortable with Delaware corporation law. Many lawyers have learned Delaware corporation law in law school. Delaware cases are studied in almost every corporations course; hence, American lawyers generally are knowledgeable about Delaware business law. It provides a *lingua franca* for lawyers and

an instant credibility that facilitates business transactions. Perhaps the most important element is also the most difficult to articulate. It is the history and tradition that surrounds the Delaware corporation law and, in particular, the Court of Chancery, that invests the law with a predictability and respect that cannot be matched. A law school professor friend of mine was once asked about the merits of creating a national corporation law. He replied: “We already have a national corporation law. It’s called the Delaware corporation law.” He meant, of course, not just the statute but the case by case development of a common law of corporations that is widely accepted as American corporation law.

Each of these elements contributes to Delaware’s special appeal as a legal home for business entities. What follows describes their individual attributes and how they interact with one another to form the package that makes Delaware so attractive.

THE STATUTE

The Delaware General Corporation Law is, in a sense, the least unique thing in the mix of things that recommends Delaware incorporation. That is because it is the most easily duplicated. Indeed, parts of the General Corporation Law—in some cases almost the entire statute—have been copied in other jurisdictions. But, while the statute can be copied, the process and philosophy that result in statutory law are a different matter. By design, the Delaware General Corporation Law is a dynamic thing. Although the modern Delaware corporation statute has its origins in the last decade of the nineteenth century, over the years it has been constantly revised and fine-tuned.

The statute itself is an enabling statute intended to permit corporations and their shareholders the maximum flexibility in ordering their affairs. As such, it does not purport to be a code of conduct. Indeed, it is written with a bias against regulation. When compared to some corporation laws where the drafters have attempted to regulate every nuance of corporate behavior or deal with every conceivable eventuality, the Delaware statute has a spare, almost open quality. Every effort is made to simplify drafting and to avoid complexity.

On the other hand, the statute has many provisions dealing with practical problems which might otherwise impair business planning. For example, the Delaware General Corporation Law led the way in

permitting stockholders to limit the liability of directors by appropriate language in the corporate charter. This provision was in direct response to problems related to the high cost of liability insurance for directors and officers that threatened to deprive businesses of able leaders. In the same vein, the statute also includes provisions authorizing corporations to indemnify directors, officers and employees that have been widely copied elsewhere.

On a more mundane level, the General Corporation Law includes a number of provisions designed to make the internal workings of corporations run smoothly. For example, committees of the board of directors may have alternate members so that the committees can still function even though one member is absent or disqualified. Certificates of correction can be filed with the Secretary of State to fix corporate documents where an obvious error has crept in. A simplified procedure is included for corporations and other business entities to change their form by switching to a limited liability company, a limited partnership or a statutory trust.

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The existence of provisions such as these is an interesting collateral benefit of Delaware's success as a corporate domicile. Because there are so many Delaware corporations, their managers and advisers are likely to identify business problems or potential business problems before they are seen elsewhere. The open lines of communication with Delaware lawyers and the Delaware legislature, described below, make it easy to address these problems quickly and in a sophisticated manner. In this way, the Delaware General Corporation Law is the beneficiary of the synergies which result from its own wide acceptance.

The provisions of Delaware law providing for the organization of a business not as a corporation but as one of the "alternative entities" described above have broadened Delaware's appeal as a formal legal situs for business organizations. Some managers and entrepreneurs have found that, notwithstanding the considerable flexibility in the corporate form, their needs are better met by conducting business in the form of a limited liability company, a statutory trust, a limited partnership, or a limited liability partnership. All of these more or less specialized formats for the conduct of business are available under Delaware law. The limited liability company format, in particular, has proved very attractive because of the absence of formalities that it offers and favorable tax treatment.

THE LEGISLATURE

The fact that the Delaware legislature gives a high priority to corporation law matters and can bring real expertise to those matters is also an important ingredient of the package which encourages corporations to incorporate in Delaware.

The Delaware General Corporation Law is the great beneficiary of an unwritten compact between the bar and the state legislature. In broad outline, its terms recognize that the legislature will call upon the expertise of the Corporation Law Section of the Delaware Bar Association to recommend, review and draft almost all amendments to the statute. It is understood that the bar is obligated to leave parochial client interests behind when proposing corporate legislation, to present issues fairly and in an even-handed fashion, and always to deal candidly with the legislature on matters involving the corporation law. This understanding is greatly helped by the fact that Delaware is such a small state. The old maxim that one's word is one's bond works better in an environment where the people involved interact regularly. Because of this arrangement, the Delaware legislature, in exercising its legislative function, is able to utilize the sophistication of people who deal with corporation law matters on a daily basis and, through them, to tap into the network of lawyers throughout the country who regularly pass along constructive ideas and suggestions to the Delaware bar.

As a result of its long experience with corporation law matters, and the importance of those matters to Delaware, the legislature has developed a philosophy that emphasizes the stability of Delaware corporation law. The guiding principle that underlies legislation affecting corporations in Delaware is to achieve a balanced law. Wisely, the legislature has understood that, in the long run, the best corporation law is the one that has the respect of all the constituencies which corporations serve, and that short-term appeals to one group or another inevitably lead to disrespect for the law and undermine its long-term viability. Further, the fact that so many corporations are incorporated in Delaware means that no single corporation or small group of corporations is able unduly to influence the development of the corporation law, adding further to its stability.

In this, to be sure, the Delaware legislature is serving the best interests of the state. The legislature, and the people of Delaware generally, take pride in the national reputation of Delaware corporation law. Like anything

else, people pay attention to what is important to them. The Delaware General Corporation Law is a high priority item to Delaware's elected representatives. Hence, the Delaware legislature is another important part of the mix that makes Delaware the most favored state of incorporation.

THE COURTS

Many experienced lawyers believe that the principal reason to recommend to their clients that they incorporate in Delaware is the Delaware courts and the body of case law those courts have developed. They point, in particular, to the national reputation and importance of the Court of Chancery.

5 Delaware's Court of Chancery dates to 1792. The roots of separate chancery courts to deal with matters of equity, as distinct from matters of law, go back much farther, to the ecclesiastic courts of Norman England. The reasons why a separate equity court was created in Delaware are obscure. The important fact is that cases involving corporation law issues came to be concentrated in a separate court in Delaware where there were no juries and where judges were called upon, on a regular basis, to explain the reasons for their decisions in written opinions. Over time, this body of decisional law, and the reputation for expertise in corporate matters which followed, caused more and more jurisdiction over business issues to be centered in the Court of Chancery. In effect, the same kind of symbiosis occurred—and continues—in the court system as in the development of statutory law. The Court of Chancery developed expertise in corporation law matters. Its reputation for expertise led, in turn, to more cases being brought to the Court and, over time, more expertise.

Its reputation and importance have also enhanced the Court of Chancery in more subtle ways. In particular, it has permitted the Court to attract some of the best lawyers in Delaware to serve as chancellors and vice chancellors. The rewards are measured in terms of respect of the corporate bar, not just in Delaware, but in the entire nation.

It is one of the great pleasures of Delaware lawyers to bask in the reflected admiration that others feel for the Court of Chancery. This is particularly true when one has the pleasure of accompanying out-of-town lawyers making their first appearance in Chancery. Surrounded by portraits of past chancellors, the lawyers present their arguments in a small courtroom where the atmosphere lends itself to reasoned debate. Whether

they win or lose, lawyers are impressed by how well-prepared the judges are, the familiarity with complex business transactions and insight into the inner workings of corporations their questions display, and the civility and respect with which both sides are treated.

If anyone doubts the special quality of the Court of Chancery, I wish he or she could have seen the celebration of the Court's 200th anniversary. After a day of speeches and other activities at the state capital in Dover, including the reenactment of early Court of Chancery cases in the original courthouse on the Green, a glittering formal dinner was held at the Gold Ballroom of Wilmington's Hotel du Pont. The room was filled to overflowing. Speakers recounted the proud history of the Court. Some spoke of early chancellors like William Killen (1793-1801), and Nicholas Ridgley (1801-1830), in warm terms as though they were old friends or venerated teachers, still living, who had just stepped out of the room.

Former Chief Justice William Rehnquist of the United States Supreme Court summed up the Court's unique status and the reasons for it. First, he called attention to the fact that, because the Court of Chancery, by design, has no jurisdiction over criminal and tort cases—"matters which create huge backlogs in other judicial systems"—it is able to process corporate litigation quickly and effectively. Then he went on to say:

"Corporate lawyers across the United States have praised the expertise of the Court of Chancery, noting that since the turn of the century, it has handed down thousands of opinions interpreting virtually every provision of Delaware's corporate law statute. No other state court can make such a claim. As one scholar has observed, "[t]he economies of scale, created by the high volume of corporate litigation in Delaware, contribute to an efficient and expert court system and bar."

"Perhaps most importantly, practitioners recognize that [o]utside the takeover process...most Delaware corporations do not find themselves in litigation. The process of decision in the litigated cases has so refined the law, that business planners may usually order their affairs to avoid law suits.' This recognition confers on the Court of Chancery one of the highest forms of praise the judiciary can receive. As one commentary concluded, [t]ime is the best test of an institution and, over time, Delaware's law has earned respect and emulation. Such success is not dramatic, but the result of careful, conservative, long-time attention."

As the Chief Justice observed, most Delaware corporations never find themselves involved in lawsuits in the Court of Chancery. On the other

hand, one experienced general counsel I know takes a practical approach. He told me that, if his corporation is going to be sued anyway, he would far prefer to litigate in the Court of Chancery where he is assured a level playing field and a knowledgeable judge. The history and tradition of the Court of Chancery and the human capital of its excellent judges, cannot be magically transplanted to some other jurisdiction. The Court of Chancery is an institution unique to Delaware. Its very existence offers a further reason for corporations to choose to incorporate in Delaware.

Furthermore, while most cases involving corporation law decided by the Court of Chancery are not appealed to the Delaware Supreme Court, some of the best known decisions on Delaware corporation law have been handed down in appeals to that court. The Delaware Supreme Court has become known, in particular, for the speed with which it can review significant decisions on appeal when time is of the essence. Indeed, it is not uncommon for the Supreme Court to announce its decision shortly after hearing arguments with a more detailed opinion to follow. Hence, the Delaware court system offers, at every level, long and sophisticated experience in corporation law matters and a ready willingness to deal with those matters on an expedited basis whenever necessary.

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THE CASE LAW

The case law, created over the years by the Court of Chancery and the Delaware Supreme Court, is the tangible evidence of Delaware's corporation law expertise. It is this highly developed body of case law, more than the statute, which is "the Delaware corporation law."

The existence of this body of law has great practical advantage for those deciding where to incorporate. First, Delaware law is the common currency of corporations. Lawyers and judges everywhere are familiar with the law and respect it. It is the means by which, as Chief Justice Rehnquist said, "the Delaware state court system has established its national preeminence in the field of corporation law..."

Because of the scope of Delaware corporation law and its wide acceptance as a standard, managers of Delaware corporations do not have to look elsewhere for guidance in assessing the legal consequences of their acts. I frequently get calls from lawyers asking, on a hypothetical basis, how the Delaware courts would decide a particular question. They explain that they are advising a corporation organized in another

state where there is no law on the subject or where the soundness of the existing precedents is in question. They want to know how the Delaware courts would likely come out because they believe the courts of the other jurisdiction would follow Delaware law. Delaware corporations have the benefit of having their actions governed by a law that is recognized and respected everywhere.

In addition, the wealth of Delaware corporation law is also a boon to corporate planning. Corporate executives can cope with known problems. What they cannot cope with is the unknown. The likelihood that a particular issue will have been addressed by the courts and that there is law on the subject is greater for Delaware corporations than for corporations incorporated elsewhere. Speaking of the choice of Delaware incorporation, Ray Garrett, Jr., former Chairman of the Securities and Exchange Commission and first Chief Reporter for the American Law Institute's Principles of Corporate Governance project said:

“Why do they go to Delaware? I don’t believe it is a mystery to any lawyer who has given a bit of thought to the appropriate state of incorporation. You’re concerned about flexibility, capital structure, and corporate purposes. The fact is that Delaware has more law and has answered more questions through its decisions. Whether you like them or not, it is easier to get an answer to a question under the Delaware Act than it is under say, the Illinois law, which has very few cases in the corporate area. There is also an absence of various specific restrictions that are more troublesome than beneficial to anyone.”

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The presence of courts that are expert in dealing with business problems is a benefit to those who form their corporations in Delaware. But the existence of a wealth of precedents written by those courts may be even more valuable since, as mentioned above, it makes it less likely that resort to those courts will ever be needed.

THE SECRETARY OF STATE’S OFFICE

The Division of Corporations of the Delaware Secretary of State’s Office handles all filings required by law to be made with the Secretary of State and maintains the official records of all Delaware corporations and alternative entities. It is also responsible for assessing and collecting corporate franchise taxes, registering foreign business entities to do business in Delaware and, in some cases, the Secretary of State is authorized to

accept service of process. In short, its duties are like the duties of most state offices where businesses are organized and their records are kept.

This description, of course, sounds like a recipe for a typical government bureaucracy. But the Delaware Secretary of State's Office is different. It manages to be a thoroughly modern state agency and one that is user-friendly at the same time. As a result, the Secretary of State's Office supplies a wholly independent reason why corporations choose to incorporate in Delaware.

The reasons that the Delaware Secretary of State's Office has achieved the reputation and admiration it enjoys boil down to two things—efficiency and attitude.

The Division of Corporations employs state-of-the-art computer technology. Documents filed with the Secretary of State are scanned onto an imaging system and stored electronically. The Division's website at <http://corp.delaware.gov> provides easy access to a variety of online services and information including forms and fee schedules, basic corporate information in the Secretary of State's database, and the Online Delaware Code. Registered agents who meet the qualifications to be online registered agents may not only view documents filed with the Secretary of State but also submit filings directly and actually print plain or even certified copies of documents, as well as good standing certificates.

Not only does the Secretary of State's Office have the machinery to deliver quality service, it also is organized to deliver quality service with separate administrative sections to expertly handle basic customer inquiries, franchise tax matters and business entity filings. A second shift of Division personnel works until midnight, largely to accommodate requests for expedited handling, but also with the capability to pre-clear documents for subsequent filing. The Secretary of State even offers one hour, two hour, same day and 24 hour service for urgent and time-sensitive filings for an added fee.

Because of these efficiencies, Division employees always know the exact status and location of a service request and are able to ensure timely and satisfactory service. Indeed, I have seen transactions structured so as to involve Delaware business entities simply to avoid potential ministerial bottlenecks in other jurisdictions that could delay an important closing.

These operational achievements are impressive; yet the quality which most recommends the Delaware Secretary of State's Office is the *esprit de*

corps of its people. In this, Delaware Secretaries of State, past and present, have built something truly unique. The personnel of the Division of Corporations think of their agency as a business. And, indeed, the Division is that rarest of state agencies—one that makes a profit. This entrepreneurial attitude is in marked contrast to the bureaucracy that bedevils the private sector in dealing with the Secretary of State’s counterparts in some other states. The personnel of the Delaware Secretary of State’s Office think of themselves as employees of a service business. Their attitude has won friends for Delaware among users of the Secretary of State’s Office and contributes to Delaware’s success in attracting new incorporations.

CONCLUSION

Why do corporations incorporate in Delaware? There is not one answer but many. They include a modern and nationally recognized corporation statute and a well-developed case law that facilitates business planning; the respected Court of Chancery to deal with corporation law issues should they arise; an efficient and user-friendly Secretary of State’s Office; and a legislature that puts a high priority on corporation law matters and is committed to keeping Delaware’s business laws current.

Certainly, some of the parts of the package that encourage companies to incorporate in Delaware can be imitated, even duplicated. But most of them cannot. In any case, the total package, and the synergies that its various parts lend to one another, make Delaware the premier home for corporations today.

It is also likely that Delaware will continue to enjoy its enviable position. Bayless Manning, the former Dean of Stanford Law School, stated it perfectly when he described the synergies that cause him to recommend Delaware to his clients. After saying some nice things about Delaware lawyers, he went on to say, in words that describe Delaware’s attraction almost as a force of nature: “Further, my Delaware counsel and I will have a wide ranging and sophisticated body of corporation law—a jurisprudence if you will—to bring to bear on almost any problem that will arise. No other jurisdiction can provide so much. And that is why Delaware is national and why its own gravitational pull tends to attract more companies each year and thereby, further reinforces its preeminence.”

ABOUT THE AUTHOR

Lewis S. Black is of counsel to the Wilmington firm of Morris, Nichols, Arsht & Tunnell. He has served on the Council of the Corporation Law Section of the Delaware State Bar Association, the Committee on Corporate Laws of the American Bar Association and as Chairman of the ABA's Committee on Federal Regulation of Securities. He has also served on the Legal Advisory Committee of the New York Stock Exchange and the editorial advisory boards of the *Securities Regulation and Law Report* and the *Journal of Corporation Law*. He is the author or co-author of numerous books and articles on corporation and securities law, including *Delaware Corporation Law and Practice* and *The Lawyer's Basic Corporate Practice Manual*. He was named one of the fifty leading securities lawyers in the United States by the *National Law Journal* and *Chambers Guide to America's Leading Lawyers* called him "the dean of the corporate bar" in Delaware.

EXPRESS MAIL ADDRESS

Division of Corporations
John G. Townsend Building
401 Federal Street, Suite 4
Dover, DE 19901

REGULAR MAIL ADDRESS

Division of Corporations
P.O. Box 898
Dover, DE 19901

TELEPHONE NUMBER

(302) 739-3073

WEB ADDRESS

<http://corp.delaware.gov>