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**DELAWARE CORPORATIONS
NOT THE BEST FOR CALIFORNIA STARTUPS**

(Business Advisory No. 6)

For startups companies doing business in or from California, a California incorporation is best, rather than one in Delaware.¹ While Delaware law favors management rights², California corporate law has undercut these advantages through Corporations Code, Section 2115 which requires the application of California’s law. Delaware imposes franchise taxes based on the number of authorized shares, sometimes resulting in thousands of dollars of yearly taxes.³ Since “cash is king” for startup companies and since California’s corporate law is going to generally apply anyway, California incorporations are recommended for California startups. So take it slowly, and use your cash wisely; investors expect that. At a more appropriate time (prior to your IPO) your California corporation can be reincorporated through a merger into a Delaware corporation.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the mere distribution of this Advisory.

¹ The preference for startups is a corporation. A corporate entity structure is simple and easily understood by investors. A Subchapter “S” tax election is usually suggested, which election, in time, will convert to a “C” tax status as significant investors arrive (Series A). Limited liability companies (LLCs) are not usual as subsequent investors are generally concerned about the multiple classes, their various (and different) rights and entitlements, and the need to gain the consent of all members in all classes of the LLC for conversion to a corporation.

² Realistically, management may not include the startups founders; after rounds of investments, management rights are typically transferred to the controlling investors.

³ California’s franchise taxes are \$800 plus 1.5% of profit yearly for “S” corporations. Federal taxes are non-existent at the entity level, as “S” corporations are treated as partnerships with no federal entity tax and only individual taxes on profit.

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California Corporations Code, Section 2115. This statute provides that most of California Corporations Code applies to out-of-state corporations, such as a Delaware corporation. This occurs when (1) the average of the property, the payroll and sales factors⁴ are more than fifty percent (50%) in California in the last income year and (2) more than half of the corporation's voting stock is held by persons with addresses in California. Corporations Code, § 2115.

The breath of Section 2115 is wide and is interpreted broadly by the courts. Rather than being governed by Delaware statutes on key areas, as noted below, California corporate law governs out-of-state corporations (including Delaware corporations) operating in California.⁵ For example:

- Director elections and removals (Corp Code §§ 301-304)
- Agent indemnifications (Corp Code § 317)
- Profits Distributions (Corp Code §§ 500-506)
- Cumulative Voting (Corp Code § 708)
- Mergers and Acquisitions
- Sales of Corporate Assets; and
- Rights of Inspection for Directors and Shareholders (Corp Code §§ 1600-1602)

There is an uncertainty as to Corporation Code, § 2115's enforceability, as there are differing court decisions. The California courts have upheld Corporations Code, § 2115, *Wilson Louisiana-Pacific Resources*, 138 CA 3d 216 (1982) but a Delaware court has said that Section 2115 is unenforceable, *Vantage Point Venture Partners 1996 v. Examon*, 871 A 2d 1108 (2005). Delaware believes that the statute violates the Due Process Clause of the 14th Amendment of the U.S. Constitution. Thus, enforceability may depend on who files a lawsuit first and in what courthouse (California or Delaware).

⁴ These are computations defined by California's Revenue and Tax Codes, §§ 25129, 25132, and 25134

⁵ For example, the author of this Advisory was involved in a bitter buyout arbitration between the two shareholders of a Delaware Corporation based in California. The arbitrator found that Section 2115 applied but that California law did not require the application of the covenant of good faith and fair dealing between two shareholders, as it did not directly involve the internal affairs of the corporation and they had elected Delaware law in their "Russian Roulette" buy-sell agreement

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One of the basic differences between California and Delaware corporate law is the covenant of good faith and fair dealing. California law has this covenant as one of its basic tenets; Delaware generally does not recognize these principles.⁶

Delaware's Management Entitlements. Most corporate statutes of states other than Delaware provide a balance of the interests of management, shareholders and outside persons/entities, dealing with the corporation. Delaware's corporate statutes have a distinct management bias. Some of this management bias is shown in the following differences of Delaware and California law.

1. *Cumulative Shareholder Voting Rights.* California shareholders have a right to cumulate their votes for the election of directors. This means that a shareholder can vote all of their shares for one director, which accumulation protects/allows minority shareholder to gain seats on the Board of Directors. Shareholders of a Delaware corporation do not have this right; each shareholder has a vote for each Board seat. This results in a majority shareholder deciding on the person to fill each Board seat and thus, the majority shareholder controls the Board.
2. *Responsibility of Board of Directors.* Directors of corporations governed by California law are held liable for their negligence. Under Delaware law, a director is not liable for his/her negligence but is only liable when their actions amount to gross negligence. Delaware courts have generally limited the personal liability of directors, while California requires directors to act in good faith, for the best interests of the corporation and its shareholders, after reasonable inquiry into the relevant circumstances.
3. *Director Control.* A Delaware Corporation can operate under the control of a single director. 8 Del Code Ann. § 141(b). California requires one director if there is one shareholder, two directors with two shareholders, and three directors if there are three or more shareholders. Thus, California law requires more Director votes and thereby, more input from shareholders.
4. *Agent Indemnifications.* For indemnification by the corporation (coverage for director or agent liability, attorneys' fees and damages), a California director or officer must act "in the best interest of the corporation." Corporation Code § 317. Delaware states it in the opposite way, indemnification of offices and directors are authorized so long as the activity is "not opposed to the best interests of the

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- corporation.” 8 Delaware Code Ann § 145. Thus, a Delaware director or officer enjoys a much wider entitlement to indemnification for their actions, possibly to the detriment of the corporation’s shareholders.
5. *Shareholder Distribution.* Under California law, distributions (dividends and other payments) are only declared after a good faith determination by the Board of Directors that the corporation is financially sound both before and after the distribution. Delaware law is not so restrictive and management is given wide breath in making distributions to shareholders.
 6. *Inspection Rights.* California shareholders can inspect their corporation’s books and gain a list of shareholders; California directors have the broad entitlement to view everything – after all, they are leading the corporation. Delaware’s inspection rights are more circumspect as both shareholders and directors must establish a specific purpose for any inspection. Thus, under Delaware law, the majority of the Board may insulate directors and shareholders from inspecting the corporation’s books, assets, plants, activities, etc., and thereby control the corporation’s activities as they see fit.

California’s Delaware Franchise Taxes. A Delaware corporation operating in California must register to do business in California. This means that there are both Delaware and California franchise taxes.

For California, the tax burden for the corporation is reasonable - \$800 plus 1.5% of profit for an “S” Corporation.

Delaware franchise taxes, however, are based on the number of authorized shares (not issued shares) and their par value. In addition, the Delaware taxing authority has default calculations. So that many times, thousands of dollars of franchise taxes are levied requiring submissions through accountants and attorneys to come to a reasonable amount.

We have found that having a California corporation with reasonable franchise taxes is best until there can be a reincorporation in Delaware at a later time when the additional taxes as well as additional accounting and legal assistance (and costs) are appropriate.

Conclusion. California-based startups should incorporate in California since they will be subject to California corporate law and will be taxed by California’s Franchise Tax Board. Delaware incorporations are unnecessary, do not achieve any significant legal objectives, and are costly to maintain with yearly taxes by both California’s and Delaware’s taxing authorities. The

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company's financial resources and focus should be on its operations, knowing that when a Delaware corporation is appropriate for investors, or other liquidity events, it can be easily accomplished by a merger reincorporation.

On such a future occasion, the founders of the startup must realize that control of the company may pass to other individuals, who will have the benefit of management rights firmly supported by Delaware law. The tradeoff hopefully is that the company's founders are well compensated hundreds/thousands of times over for their efforts in starting the company and seeing it manifest their dream.

As always, you should be sure that additional legislation has not been enacted or court decisions rendered, that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. You should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

S. Timothy Buynak
Business and Tax Attorney

This Advisory is one of a series of business and tax advisories prepared by the attorneys at the Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.

Buynak, Fauver, Archbald & Spray, LLP provides business legal services to individuals, business entities and nonprofit organizations from entity formation and start up, through day-to-day operations and exit strategies.

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