

Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.



ABOUT THE AUTHOR

Alexander J. Davie is an attorney based in the Nashville, TN area. His practice focuses on corporate, finance, and real estate transactions. He works mainly with emerging companies, venture funds, entrepreneurs, and startups. His firm's website can be found at www.alexanderdavie.com.

In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

Should new business owners incorporate in Delaware?

One question I frequently receive from people seeking to start a new business is whether they should incorporate that new business in Delaware. They frequently hear vague notions of the benefits of incorporation in Delaware but haven't heard any definitive statement on why they should or shouldn't choose Delaware as their state of incorporation. My advice most times is to incorporate in the home state of their business (usually the company's headquarters).

The one major significant benefit to being incorporated in Delaware is that Delaware has a highly developed body of corporate law. The Delaware General Corporation Law is considered to be well-designed and flexible. In addition, Delaware has established its own court system (called the Court of Chancery), which only hears corporate cases and is considered to be highly sophisticated and efficient. As a result of the depth of Delaware's body of corporate law decisions, boards of directors are able to better predict and understand their fiduciary duties to shareholders. Delaware also has a reputation of being "management friendly" when it comes to disputes between owners and the company's management, though whether this is actually true is subject to some debate.

Often when I explain these factors to an aspiring entrepreneur, they respond "that's it?" Yes, that is it. There are little to no tangible or financial benefits for a small business to incorporate in Delaware. It certainly is not a tax haven; it has some of the highest corporate state income taxes in the nation. Even if it were a tax haven, this would be of little benefit to the company, because the company will still be required to pay the state income taxes of its home state and any other states it operates within. In addition, incorporating in Delaware is

often more expensive for the business. It will be required to pay annual fees and franchise taxes to Delaware (which get pretty high for corporations) and it will also need to pay annual incorporation fees to its home state in order to qualify to do business in that state. So in the end, if a business incorporates in Delaware, but operates in another state, it will be more expensive than if it had just incorporated in its home state. The "management friendly" nature of Delaware corporate law usually is not of significant interest to a small business owner since small businesses rarely have a large division between ownership and control.

Who should incorporate in Delaware? Certainly large corporations have a good reason to do so. Since they have a significant division of ownership and control, the predictability of Delaware corporate law is helpful to directors, giving them clear guidance on what their duties to shareholders are. In addition, hedge fund, private equity, and venture capital fund managers frequently use Delaware limited liability companies and limited partnerships. They have good reason to do so because of the clear well-developed fiduciary duties of Delaware law. Like large corporations, hedge funds have a significant separation of ownership and control.

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One category of small business that should consider incorporating in Delaware is those businesses that anticipate unusually fast upward trajectories in their growth. If a business expects to be receiving venture capital funding within the next couple of years, it may be a good idea to opt for a Delaware corporation, because chances are, when the company does receive funding, the VC fund will insist that it convert into a Delaware corporation. However, if such funding is far off, be aware that it is not that difficult to change a company's the state of incorporation (compared with the relative complexity of any corporate financing), so a business does not need to incorporate in Delaware because simply because it may at some point in the future seek outside financing.

As always, your final choice in entity selection should be based on your own specific situation. Therefore, before making any final decisions on your form of business, you should speak with your attorney.