State Law & State Taxation Corner

By Thomas E. Rutledge

Going to Delaware (?)

In *Wayne's World*, while Wayne and Garth were able to work up significant enthusiasm for Guess girl Claudia Schiffer, they were rather at a loss to be similarly enthused with respect to Delaware. Obviously, neither of them were attorneys. Today Delaware dominates[1] the "marketplace" for the organization of business organizations, whether they be publicly or privately held.[2] Now I put "marketplace" in quotations intentionally; whether there is an actual efficient market in business organization law is open to significant debate. In fact, most business entities are organized under the laws of their home jurisdiction. To the extent that there is an analysis of the merits (or not) of organizing a particular venture in another jurisdiction, that other jurisdiction is almost always Delaware. That consideration of only Delaware all too often deprives the venture of the benefits of other well-written organizational laws, an example being those of Colorado. Furthermore, all too many attorneys are of the belief that Delaware law is necessarily *better* without appreciating that Delaware is *different*; even when those differences are, to a greater or lesser degree, appreciated, *different* is all too often equated with *better*.

Now I do not mean to suggest that the Delaware business entity statutes and their supporting structures are not highly valuable and vitally important resources. They are; I regularly organize various businesses in Delaware. That is not to say, however, that Delaware's statutes are necessarily better. Rather, they are different, and sometimes that difference is beneficial. At other times those differences may be detrimental.

Thomas E. Rutledge is a Member in the law firm of Stoll Keenon Ogden PLLC in Louisville, Kentucky

Statutes

Undoubtedly the various Delaware business entity statutes are the most intensively scrutinized statutes of this nature in the country. Drafting committees focused upon the General Corporation Act, the various unincorporated acts and the Statutory Trust Act meet regularly to consider developments in practice and judicial developments and from those fashion proposed amendments for presentation to the Delaware legislature for enactment. It is practically guaranteed that, on an annual basis, there will be a statutory update to most if not each of these acts. This regularity of action engenders jealousy in many other jurisdictions. For example, I am familiar with a situation in my home jurisdiction of Kentucky where a particularly flawed decision interpreting a stock restriction agreement was rendered in 1996;[3] it was not until 2002 that a corrective amendment to our business corporation act could be put in place.[4] But even as it is appreciated that the laws are continuously reviewed, and from that review updates are suggested (and ultimately enacted), the question must be asked whether, in a particular factual situation, the proposed revision to the statute is beneficial. Recall that outside the law of corporations, business organization statutes are essentially default form agreements for structuring a relationship. Modifications in the statute, as contrasted with the *status quo ante*, are typically zero sum; when the authority to act is allocated to a particular actor, the other participants in the venture lose the ability (absent contractual modification) to object to that exercise of authority. Where you stand depends on where you sit, and if you sit with the minority/noncontrolling participants in a particular venture, a statutory modification which "updates" the statute to afford greater discretion or authority to those in control of the venture is not a worthy change in the law, and you would likely wish, in that instance, that the statute had not been amended. At the same time, from the perspective of those in control, additional protections afforded the minority (*e.g.*, increasing the circumstances in which dissenter rights may be exercised) may be viewed as unjust.

Again, it is important to differentiate *different* from *better*. For example, under the majority of the business corporation laws in the United States, while a typical transaction may be approved by a majority of the shareholders at the annual or a special meeting of the shareholders, outside of a meeting, the shareholders may act only by a unanimous written consent.[5] As such, either all shareholders approve of an action or, in the alternative, it may be approved by a simple majority, but the detractors are given the opportunity at a meeting to voice their objections and attempt to sway votes to their side. Delaware follows a different model, pursuant to which a proposed corporate action may be approved by written consent from a majority of the shareholders.[6] Consequently, the opposing position is not afforded the opportunity to meet with the other shareholders in their attempt to sway votes. While these two models of corporate governance are *different*, your view as to which is *better* is dependent as to whether you are (i) the majority and desire to act with the reduced transaction cost of no shareholder meeting and a minimum of input from the minority, or (ii) the minority participant desiring at least an opportunity to make known your viewpoint and argue in favor of it.

Undoubtedly the various Delaware business entity statutes are the most intensively scrutinized statutes of this nature in the country.

These differences extend beyond what might be characterized as "logistics." For example, under Delaware law, in the case of a conflict transaction between the corporation and an affiliate of a director, it is the burden of the director to demonstrate the entire fairness of the transaction.[7] In contrast, under the law of Kentucky (as well as the law of many other states that use some form of the Model Business Corporation Act), it is the plaintiff's burden to prove by clear and convincing evidence at a threshold of wanton or reckless misconduct that the transaction violated the directors' fiduciary obligations, *i.e.*, that the transaction was not in the best interests of the corporation.[8]

Other provisions of Delaware law are, well, let's just say curious. By way of example, in 2010 the Delaware legislature exempted partnership and operating agreements from the statute of frauds.[9] Essentially, a person who it is asserted agreed orally to contribute real property to a partnership may be required to perform on that obligation, while one who it is asserted orally agreed to contribute to a venture that is not a partnership[10] will not have that commitment enforced against him or her.[11] In most states that is not the rule.[12]

It was only in 2011 that the Delaware LLC Act expressly addressed the default threshold for amendment of the operating agreement,[13] with this provision effective for only those LLCs formed on or after January 1, 2012. In those LLCs, the default rule is that the amendment of the LLC agreement requires the approval of all of the members. Left unresolved is the default rule for amendment for LLCs formed prior to January 1, 2012.[14]

Another curious provision is that under Delaware law it is possible for a partnership organized under its adoption of RUPA to elect not to be an entity.[15] Of course, RUPA states that a partnership is an entity.[16] What then is the consequence when a RUPA partnership is not an entity? In effect, Delaware, by statute, permits you to do something but says nothing about the effect of utilizing that capacity.

Last in this series is the fact that the Delaware LLC Act, until the effective date of a 2013 amendment is silent as to what are the default fiduciary duties in an LLC. While the statute is express that the LLC agreement may modify or even eliminate those duties,[17] it does not tell you what you are modifying and what you may eliminate. A now infamous "debate" arose between the Delaware Chancery and Supreme Courts over whether these duties exist, and if so, what they are.[18] Most LLC acts avoid these issues by defining the default fiduciary obligations and providing guidance as to their modification.[19] To date in Delaware we have had only Chancery Court decisions holding that the "traditional fiduciary duties" exist in LLCs.[20] Now, under amendments proposed to the Delaware LLC Act, § 18-1104 would be amended (new text italicized) to provide as follows:

> In any case not provided for in this chapter, the rules of law and equity, including *the rules and laws of equity relating to fiduciary duties and* the law merchant, shall govern.[21]

And that (assuming enactment of this amendment) is all you get; a confirmation that the duties exist but without any explanation of what are those duties.

By organizing a venture in Delaware, you buy into this debate and the existing uncertainty, creating the need in the operating agreement to address the range of issues that arise in crafting fiduciary duty provisions.[22]

The Common Law in Parallel with Statutes

Another set of issues that also require consideration when organizing a venture in Delaware is the utilization in business organization law of the common law. To give but one example, while most business corporation acts define a standard of care applicable to corporate directors,[23] the fiduciary duty of care of a Delaware director is defined by common law. Practitioners who are typically accustomed to referring to a governing act for these matters will sometimes fail to address the common law aspects. Further, practitioners considering those common law implications in a state such as Delaware that issues a voluminous number of exacting opinions, opinions generated by both the Court of Chancery and the Supreme Court might find the task rather daunting.

> This degree of focus permits greater time to study and consider the statute at issue and as well the time and opportunity to focus upon the many decisions rendered by the Delaware courts.

In addition, counsel always needs to be aware that many of the organizational acts themselves incorporate the general common law.[24] This fact necessitates at least working knowledge of Delaware nonentity law. Further, in the unincorporated realm, where Delaware has strongly fixed its position as a "freedom of contract" jurisdiction,[25] it is necessary to know Delaware contract law when either crafting or interpreting a partnership/limited partnership/LLC agreement. Most attorneys would have some reluctance to draft a contract and in it, *ab initio*, provide that it is governed by the law of some state in which they are not resident and indeed are likely not even a member of the bar. Conversely, it is quite common for attorneys to draft contracts governed by Delaware law; those contracts are called partnership agreements, limited partnership agreements, LLC agreements and shareholder agreements. But honestly, if you have written those agreements, did you first research Delaware law on the minimum requirements for sufficient consideration, on what penalty clauses will constitute an illegal forfeiture provision and the myriad other points of law that will impact on the enforcement of the agreement?

Infrastructure

Attorneys

While we can debate the pros and cons of the various Delaware business entity acts and the philosophies that drive them, few if any can challenge the quality of the Delaware bar. Being focused upon Delaware's primary industry, namely the rendering of legal services, typically to sophisticated clients, many members of the bar are able to devote themselves exclusively to what would be, in any other jurisdiction, an overly narrow focus. This degree of focus permits greater time to study and consider the statute at issue and as well the time and opportunity to focus upon the many decisions rendered by the Delaware courts.

The Court of Chancery and the Supreme Court

In any carefully undertaken calculus with respect to choosing the jurisdiction of business organization, the Court of Chancery and the Supreme Court of Delaware hold a preeminent place in recommending Delaware as the jurisdiction of organization.[26] The Delaware Chancery and Supreme Courts are more educated with respect to, and on an ongoing basis have a more nuanced understanding and appreciation of, business law than any other courts in the country. While states such as Nevada have sought to duplicate Delaware by adopting, *in toto*, its statutes and case law, they cannot provide, on an ongoing basis in a particular case, a similar assurance that the sitting judge will be an expert in these areas of law.[27] The Delaware judiciary provides an element vital to the depth and vibrancy of Delaware business organization law and one not restricted, as it is typically in other states, to what may be characterized as marginal issues.[28] Be aware, however, that irrespective of their mastery of business law, the Delaware judiciary is subject to the laws passed by the Delaware General Assembly. As such, when one fails to fully appreciate the Delaware substantive law under which a business organization is organized, that surprise is going to only be magnified when the issue is brought before the Delaware courts. Further, as Delaware is a strong contractarian jurisdiction, it is vitally important that the organizational documents be carefully crafted. The caution and direction of then Vice Chancellor Strine in *Willie Gary LLC v. James & Jackson LLC* that:

> With the contractual freedom granted by the [Delaware] LLC Act comes the duty to scrivin with precision.[29]

must be kept in mind.[30]

Nework Externalities

A network externality exists if a good or service is more valuable to a purchaser as more purchasers buy that same good or service. Network externalities will continue to drive business formations to Delaware where the courts will review and render decisions on the widest possible range of sophisticated questions. Unique among the states, network externalities drive business to Delaware because, well, everyone else does it, and it is therefore more valuable. Understand, however, that "it" is only more valuable because of network externalities if "it" had initial value. A poorly reasoned adoption of Delaware law for a particular venture does not benefit from network externalities, and therein lies the caution against a knee-jerk reliance on Delaware's dominance in the field.

Endnotes

1 *See, e.g.*, Lucian Ayre Bebchuk and Assaf Andani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 Yale L. J. 553, Table 5 (2002-3) (Delaware is the jurisdiction of in excess of 85 percent of publicly traded nonfinancial companies.).

2 For a discussion of Delaware's rise to prominence, *see, e.g.*, Curvis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 Del. J. Corp. L. 885 (1990).

3 The decision in question was *Man O' War Restaurants, Inc. v. Martin*, 932 SW2d 366 (Ky. 1996).

4 *See* Ky. Rev. Stat. Ann. § 271B.6-270 as amended by 2002 Acts, ch. 102, § 13.

5 *See, e.g.*, MBCA § 7.04; Ky. Rev. Stat. Ann. § 271B.7-040. Indiana has an interesting approach to this issue. The general rule is that the shareholders may act by unanimous written consent. Ind. Code § 23-1-29-4(a). Where, however, the corporation has a class of voting shares registered under Section 12 of the Securities Exchange Act of 1934, the shareholders may act by consent at the same voting threshold as would be required at a meeting. Ind. Code § 23-1-29-4(b).

6 Del. Code Ann. tit. 8, § 228(a).

7 *See, e.g., Emerald Partners v. Berlin*, 787 A2d 85 (Del. 2001).

8 *See, e.g.*, Ky. Rev. Stat. Ann. §§ 271B.8-300(5), (6).

9 *See* Del. Code Ann. tit. 6, § 15-101(12); id. § 17-101(12); and id. § 18-101(7).

10 *See, e.g.*, Del. Code Ann. tit. 6, § 15-202(c)(1) (joint tenancy is not a partnership).

11 *See* Del. Code Ann. tit. 6, § 2714.

12 *See, e.g.*, Ky. Rev. Stat. Ann. § 371.010(6) (statute of frauds against enforcement of oral agreements for conveyance of real estate); id. § 275.200(1) (agreement to contribute to LLC not enforceable unless set forth in writing); Ind. Code § 23-18-5-1(a) (same).

13 Del. Code Ann. tit. 6, § 18-302(f).

14 Based on discussions with certain Delaware attorneys, the rule prior to this amendment may have been that all parties, and not simply all members, needed to consent to an

Endnotes

amendment to the operating agreement. As such, non-member managers (*see* Del. Code Ann. tit. 6, § 18-101(7)) (managers are bound by the operating agreement) and third parties afforded rights under the operating agreement could have vetoed an amendment. This point was not expressly addressed in the Delaware LLC Act or in a published decision.

[15] *See* Del. Code Ann. tit. 6, § 15-103(c).

[16] *See* Rev. Unif. Part. Act § 201(a); *accord* Del. Code Ann. tit. 6, § 15-201(a).

[17] *See* Del. Code Ann. tit. 6, § 18-1101(c).

[18] *Contrast* Myron T. Steele, *Freedom of Contract and Default Contractual Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 Am. Bus. L.J. 221 (Summer 2009) (positing that there are no default fiduciary duties in limited partnership or LLCs organized under Delaware law) *with Auriga Capital Corp. v. Gatz Properties*, LLC, 40 A3d 389, 2012 WL 361677 (Del. Ch. 2012) (holding that here exist default fiduciary duties in Delaware LLCs) and *Auriga Capital Corp. v. Gatz Properties, LLC*, 40 A3d 839 (Del. 2012) (holding LLC manager had violated contractually defined standards and chastising Chancellor Steele for reviewing hypothetical of what are the standards absent a contractually agreed standard and declaring those portions of his opinion dicta.). Then, in *Feeley v. NHAOCG, LLC*, 62 A3d 649; 2012 Del. Ch. LEXIS 274 (Del. Ch. Nov. 28, 2012), Vice Chancellor Laster adopted the reasoning and path of analysis employed by Chancellor Strine in Auriga Capital, writing "Until the Delaware Supreme Court speaks, the long line of Court of Chancery precedents and the Chancellor's dictum provide persuasive reasons to apply fiduciary duties by default to the manager of a Delaware LLC."

[19] *See, e.g.*, Ky. Rev. Stat. Ann. §§ 275.170(1), (2) (defining standards of care and loyalty and requiring that departure therefrom be in a written operating agreement); Ind. Code §§ 23-18-4-2(a), (b) (setting forth default duties of care and loyalty, both being subject to modification in a written operating agreement) .

[20] *See, e.g., Phillips v. Hove*,2011 Del. Ch. LEXIS 137 (Del. Ch. Sept. 22, 2011) ("Unless limited or eliminated in the entity's operating agreement, the member-managers of a Delaware limited liability companies owe traditional fiduciary duties to the LLC and its member"); *Kelly v. Blum*, No. 5616-VCP, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010) ("[U]nless the LLC agreement in a manager-managed LLC explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to minority members."); *Bay Ctr. v. Emery Bay PKI*, No. 3658-VCS,2009 Del. Ch. LEXIS 54 (Del. Ch. Apr. 20, 2009) (holding that "in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC"); *In re Atlas Energy Res. LLC*, No. 4589-VCN, 2010 WL 4273122, at *6 (Del. Ch. Oct. 28, 2010) ("[I]n the absence of explicit provision in a limited liability company agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the limited liability company context."). This string cite has been adopted from Mohsen Manesh, *Damning Dictum: The Default Duty Debate in Delaware*, available on SSRN.

[21] At the time of this writing, the proposed amendment has passed the legislature, but has not been signed by the governor.

[22] At minimum the agreement will need to address what are the duties, by whom are they owed, to whom are they owed, by what mechanism may they be enforced, when do they arise, when do they terminate and is the standard of culpability different from the aspirational standard.

[23] *See, e.g.*, MBCA § 8.30; Ky. Rev. Stat. Ann. §§ 271B.8-300(1)(a)-(c).

[24] *See, e.g.*, Del. Code Ann. tit. 6, § 15-104(a) ("In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern."); id. § 18-1104 ("In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern.")

[25] *See, e.g.*, Del. Code Ann. tit. 6, § 18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); Del. Code Ann. tit. 12, § 3825 ("It is the policy of this subchapter to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments.")

[26] With respect to the quality of the Delaware Chancery Court, *see, e.g.*, William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, speech at the bicentennial of the Delaware Court of Chancery, 48 Bus. Law. 351, 354-55 (1992).

[27] It should be noted that other states, Ohio and North Carolina being examples, are moving to specialized business courts, an effort that should be reproduced nationwide.

[28] As observed in Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679, 707 (2002-03):

> An important element of a state's corporate legal structure is its judge-made law. It is judge-made law, rather than statutory law, that governs such fundamental issues as the fiduciary duties of directors, officers and controlling shareholders in self-dealing transactions, scope of corporate opportunities, the obligations of directors in dealing with control challenges, the prerequisites for a derivative suit, directors' disclosure obligations, and the scope of impermissible corporate waste.

[29] *Willie Gary LLC v. James & Jackson LLC*, 2006 Del. Ch. LEXIS 3 (Del. Ch.).

[30] Also, it needs to be recognized that the opinions of the Delaware courts are typically interpreting Delaware law. It does not always follow that those decisions can be applied in foreign jurisdictions. Rather, foreign (to Delaware) case law or statues will often dictate a different result when assessing business organizations organized in other jurisdictions. For example, Delaware law on the characteristics of a derivative claim and the requirements for bringing those claims as a derivative, and not a direct, action have little application in those states that have adopted § 7.01 of the ALI Principles of Corporate Governance and in so doing permit what are otherwise derivative claims as direct if the venture is closely held.