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Selecting a State for Incorporation

A critical first step to forming any new business entity (corporation, LLC, etc.) is selecting the state in which to incorporate. While the default choice may be California for businesses planning to operate here, there are advantages and disadvantages to considering other states for incorporation.

❖ **Delaware.** If the business will not be closely held (i.e., will not have a limited number of owners that does not change much over time), then Delaware is often a good choice for incorporation since, in general, the Delaware General Corporations Law affords greater deference to the acts of directors, officers and majority owners than the California Corporations Code. In effect, this allows management to retain more control even though ownership may expand over time to include investors and employees. Some additional advantages to incorporating in Delaware:

➤ **No Cumulative Voting.** One of the more significant statutory protections for minority shareholders of a California corporation is the right to cumulative voting. Cumulative voting is not automatic but must be requested by a shareholder prior to voting. If requested, the number of votes available to each shareholder for an election of Directors is equal to the number of shares owned by each shareholder multiplied by the number of positions up for vote. A shareholder may then aggregate all of his or her votes for one candidate rather than dividing them among the slate of candidates. Doing so may allow a minority shareholder to elect a candidate that would not have been elected under traditional majority voting.

➤ **Number of Directors Required.** A Delaware corporation may have just one director regardless of the number of shareholders. Under California law, if a corporation has two shareholders, it must have at least two directors; and if the corporation has three or more shareholders, it must have at least three directors. For many start-ups, this means searching for additional Board members willing to serve, which may not be easy given the fiduciary duties and exposure to lawsuits that accompany board service.

➤ **Mature Laws and Knowledgeable Judiciary.** Delaware tends to have a well-established body of corporate laws and a knowledgeable judiciary that can efficiently address litigation.

➤ **Efficient Bureaucracy.** The Delaware Division of Corporations processes corporate filings very efficiently with adequate staffing and state-of-the-art systems and

equipment.

➤ **Franchise Taxes.** The Delaware annual franchise taxes can be as low as \$75; California charges a minimum of \$800.

➤ **Institutional Investor Preference.** For the reasons above, among others, Delaware is the state preferred for incorporation of corporations financed by venture capitalists and other institutional investors.

❖ **Nevada.** Many clients consider incorporating in Nevada because the incorporation fees and reporting requirements are less onerous than in California. However, if the business entity will be operating in California, under California law, the entity must also register in California and be subject to the same reporting requirements as a California entity. This results in the fees and reporting requirements actually being higher than if the entity were simply incorporated in California.

➤ **Asset Protection.** However, there is at least one considerable advantage to incorporating in Nevada; it has the toughest laws in the country with regard to creditors attempting to enforce judgments against an ownership interest in a Nevada business entity. A creditor of a California business entity may foreclose on the ownership interests or otherwise take control of such interests. A creditor of a Nevada business entity, by contrast, may only get a charging order so that any dividends or distributions are paid to the creditor.

❖ **Other States.** A business entity may be incorporated under the laws of a state other than those discussed above but there are significant disadvantages. First, if the entity will operate in California, it will be necessary to register as a foreign corporation in California and be subject to fees and reporting requirements of both states. In addition, corporate counsel may need to be retained in the state of incorporation. In addition, the body of corporate law of these other states is often not as developed as that of Delaware, New York and California and therefore there may be less guidance as to how a court is likely to resolve a corporate dispute.

❖ **Carefully Consider Your State of Incorporation before Forming!** Selecting the most appropriate state for incorporation of your business entity is a decision that should be made carefully after consulting with legal counsel.

❖ **Please feel free to contact Mario Kashou, Boris Lieberman or James Shafer at 415-255-2450 if you have questions about incorporating a new business entity.**

This Newsletter is intended as a general guide to law issues and developments. It does not contain a general legal analysis or constitute a legal opinion of Farallon Law Group LLP or any member of the firm on the legal issues described. It is recommended that readers not rely on this general guide in structuring individual transactions but that professional advice be sought in connection with individual transactions.