



THE DELAWARE EFFECT:

How (and why) the nation's second-smallest state became a coveted business domicile

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THE *Delaware* EFFECT

Delaware notched a new state record in 2018, when more than 216,000 new business entities were formed under the First State's corporate and alternative entities laws. The 2018 figure handily beats the previous record of 198,000 entities in 2017¹. At last count, 67.2% of all Fortune 500[®] companies were incorporated in Delaware, and in 2018, 82% of all initial public offerings involved companies that were formed in Delaware². Those are impressive statistics, and reveal a few important things. First, they suggest that the nation's business climate continues to improve since the financial crisis of 2008, with new entity formations as part and parcel of that recovery. Second, they speak clearly of the continued appeal of the Diamond State as a corporate address.

On the surface, Delaware might seem like an unlikely candidate for a center of the business world. In geographical terms, it's the second-smallest U.S. state, and population-wise it hovers near the bottom, followed closely by North and South Dakota³, places known more for their windswept prairies than their crowded urban centers. Yet despite its diminutive stature, Delaware continues to be a domestic and international heavyweight, in terms of corporate formations. Which raises the question: Why? Truth is, no single factor is responsible for Delaware's near-dominance as a business jurisdiction. Instead, it's the combination of a number of elements—some accidents of history, others the result of deliberate, sustained action on the state's part.

For simplicity's sake, we'll call it the “*Delaware Effect*,” and we'll divide it into *four reasons*:

- ① *Depth of jurisprudence*
- ② *Division of courts into courts of law and courts of equity*
- ③ *A judicial culture of professionalism and competence*
- ④ *The importance of the corporate franchise to Delaware's fiscal future*



First, a little background.

Throughout much of early U.S. history, corporations existed strictly as entities for the public benefit. To form a corporation, an organization had to demonstrate some kind of public purpose (think universities, hospitals, or companies charged with improving infrastructure such as roads, bridges, and canals). To be granted the privilege of incorporation was to receive state sanction, a designation that allowed companies, through shareholder investments, to amass capital for their projects.

Then, in the late 19th century, a sea change took place. In the fevered economic conditions of the Gilded Age, a new idea gripped the business world: that corporations should serve as investment vehicles for the express purpose of generating profits for their shareholders. The corporation was an attractive legal structure because it limited shareholders' personal risk to just the money they'd invested in the company. It was an age of railroad, oil, and steel barons, and demand for new business entities was high. New Jersey was first to answer the call, in 1875, by liberalizing its business law to permit incorporation for "any lawful business or purpose whatever."

New Jersey's dominance was short-lived, though. Within the span of a few decades, variations on its corporate laws had been adopted by several other states. In 1899, Delaware not only adopted New Jersey's law in its entirety, but also began a shrewd campaign of self-promotion by undercutting its neighbors on the fees it charged for corporate formations. According to one account from the time⁴, in 1902, neighboring Pennsylvania was charging roughly \$3,000 for new entities—more than \$70,000 in today's dollars or, as your great-grandfather might say, "a lot of money in those days." Delaware, by contrast, was charging a mere \$150. Delaware's "early adopter" status led directly to our first reason for the state's preeminence as a business domicile.

① Depth of Delaware's Jurisprudence

As one of the first U.S. states to adopt a General Corporation Law, Delaware enjoyed a distinct "ground floor" advantage, legally speaking. Every business matter that was litigated under the Delaware statute built on a body of law that made it clear to all who followed what the outcomes of any business-related legal actions would likely be. Certainty is a big concern for business leaders. They want to know the risks; they want to know the potential outcomes. Delaware's depth of jurisprudence—the more than 100 years of legal precedents that now exist in our body of law—gives lawyers who advise those same business leaders a good understanding of how a Delaware judge might rule on a particular business issue.

As former Chief Justice William Rehnquist of the U.S. Supreme Court once stated: Corporate lawyers across the United States have praised the expertise of [the Delaware court], 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 claim⁵. Abundant case law isn't a compelling enough reason to send businesses flocking to Delaware, though. In fact, by simple legislative action, other states could co-opt Delaware's entire body of judicial precedent and make it their own.

② Division of Courts into courts of law and courts of equity

In many U.S. states, criminal and civil cases are tried by jury in a single court system. Whether the case in question is a violation of state law or a violation of contracts and agreements, it's litigated in a court of law.

Delaware is different. Here, the court system is divided into two distinct parts: a court of law and a court of equity. Under this system, which originated in medieval England, criminal and most civil statutory and contractual matters are heard in the court of law, which has a jury system and a presiding judge. Matters of fiduciary duty and corporate governance, on the other hand, are heard in the court of equity, which in Delaware is called the Court of Chancery. The Delaware Court of Chancery has no jury—only a judge. So what makes Delaware's divided court system so attractive to businesses? One word: speed. In order to honor defendants' constitutional rights, most U.S. states hear criminal cases before civil cases, pushing corporate matters to the back burner. For example, in many states, if you sue someone for breach of a business agreement, it could take as long as three years before you even see a jury. A growing number of states do have so-called "business" or "commercial" courts, but even these still tend to hear other civil, and in some cases criminal, matters.

By contrast, Delaware's Court of Chancery doesn't hear criminal cases, and for the most part it doesn't hear civil penalty cases. It exists solely to hear equitable and business matters, including issues related to the fiduciary duties of care, loyalty, and good faith. That means much faster outcomes for everyone involved. How much faster? A survey of 200 cases brought before the Court of Chancery between 2009 and 2016 found that in cases where the court ruled on a motion for temporary restraining order, the motion was decided a brisk seven days after filing, on average⁶. For cases where the court ruled on a motion for preliminary injunction, the motion was decided an average of 26 days after filing.

③ Delaware's judicial culture of professionalism and competence

Delaware's Court of Chancery judges typically are very experienced and specialized corporate lawyers who have spent many years in the practice of business law. They approach their job in a unique way. They hold hearings on weekends. They read briefs all night long and then hold hearings the next day. They allow for flexible scheduling and accommodation of parties' interests.

Delaware's legal culture is different in other significant ways. For one, Delaware judges aren't elected. They're vetted by well-respected members of the state bar who understand the singularity of corporate law's place in Delaware, and are then appointed by the governor based in large part on those attorneys' recommendations. The result is a very skillful, focused, and motivated judiciary. Simply put, if you want a business matter decided quickly, reasonably, and dispassionately, you won't find a better place than the Delaware Court of Chancery. Our judiciary is second to none.

④ Importance of the state's fiscal future

Franchise taxes are the second largest contributor to Delaware's revenue stream after personal income tax. Corporations buoy the Delaware economy in ancillary ways, too. In addition, our judicial system supports a vibrant legal community of well-compensated lawyers and paralegals who pay personal income tax to the state, as well as the necessary hotels, restaurants, and document preparation and management companies needed to bolster corporate litigation.

Clearly, it's in Delaware's best interest to remain an attractive business jurisdiction, and it does so by being responsive and innovative. It's often said that the Delaware Division of Corporations is run more like a business than a government agency, and attentive, nimble service is part of its winning formula for client satisfaction. The state legislature is also very quick to adjust the Delaware General Corporation Law when necessary⁷. Every year, the corporate bar, the business community, the legislature, and the governor's office collaborate to carefully review and amend the law so that it remains fair and competitive. In contrast, other states that are less dependent on corporate franchise revenue are slower to change and adapt their law.

A final word

When a business decides to incorporate in Delaware, it's investing in much more than a corporate address. It's investing in the Delaware "brand" and all the advantages that come with it. It's buying certainty. It's buying speed. It's buying judicial expertise, and it's buying professionalism. If recent formation activity is any gauge, Delaware remains a compelling and competitive brand. Along with steady interest from the U.S. business community, an increasing number of international corporations are looking to Delaware as a home for their new entities. All of this points to a strong future for Delaware as a business domicile, for the very reasons mentioned above.

About the Author

Ian McConnell is the chief compliance and risk officer and deputy general counsel for CSC®. He is responsible for managing and developing CSC's enterprise-wide risk and crisis management efforts, as well as providing legal guidance to the company's business units. Prior to this role, McConnell was the director of Government Affairs for CSC and associate general counsel.

McConnell began his legal career as an associate at the Wilmington, Delaware, law firm of Morris, Nichols, Arsht & Tunnel. He then served at the Delaware Department of Justice in a number of senior leadership roles, including as director of the Consumer Protection and Fraud Division, as state solicitor, and ultimately, as chief deputy attorney general.

McConnell is a graduate of Middlebury College where he received a B.A. in East Asian Studies with a concentration in Japanese. He holds a J.D. from Boston College Law School. He graduated with honors from both institutions. Upon graduating from Middlebury, McConnell was commissioned as an infantry officer in the U.S. Marine Corps and deployed overseas as the executive officer of troops aboard the USS Ashland. He was admitted to the Delaware State Bar Association in 2006.

McConnell lives in Greenville, Delaware with his wife, and has four children



Positive TERRITORY

In 2018, more than 216,000 new business entities were formed in Delaware, setting a new state record. Corporate formations have rebounded from a lull following the financial crisis of 2008, and in recent years, a growing number of international entities have chosen Delaware as a legal domicile.

In Delaware...



216,000+
new business
entities were
formed at
last count

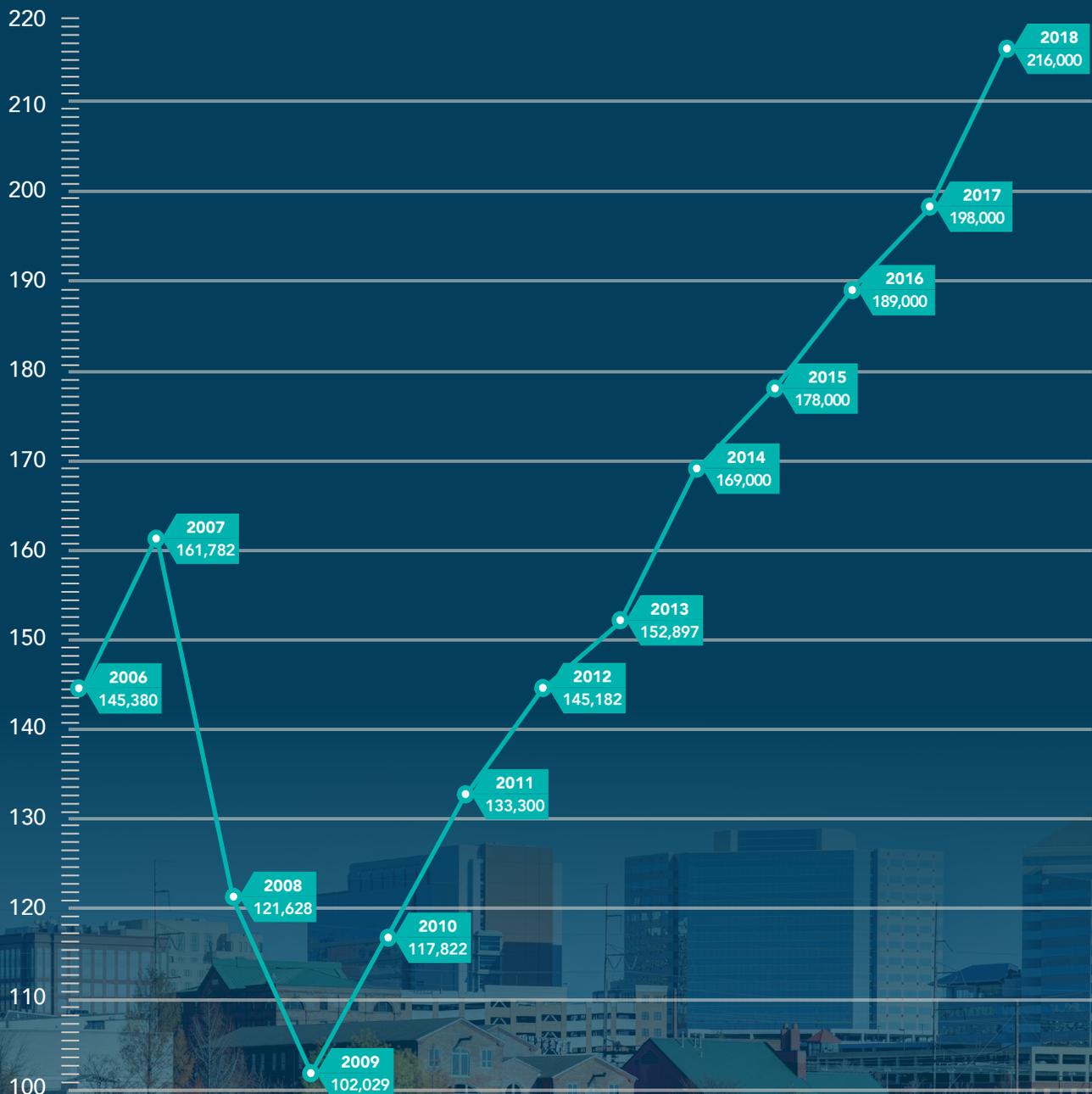


67.2%
of all Fortune
500® companies
were incorporated
here



82%
of U.S.-based initial
public offerings
chose the First
State as their corporate
home at last count

New Delaware Entities





We are the business behind business.

CSC is a business, legal, tax, and digital brand services company that provides knowledge-based solutions to clients worldwide.

CSC's technological edge and client base continue to grow each day. In fact, 90% of the Fortune 500[®] companies depend on CSC for their most business-critical services.

Citations:

¹ "Delaware Division of Corporations 2018 Annual Report," Delaware Division of Corporations, 2019.

² Ibid.

³ "Annual Estimates of the Resident Population: 2014 Population Estimates," U.S. Census Bureau.

⁴ "Address by Josiah Marvel, esq., before the students of the dept. of finance and economy of the University of Pennsylvania, May 14, 1902."

⁵ "Why Corporations Choose Delaware," by Lewis S. Black, Jr., Delaware Department of State Division of Corporations, 2007.

⁶ "The Delaware Court Of Chancery: Forum for Enforcement of Trade Secret Rights," by Adam W. Poff and Gregory J. Brodzik, BNA's Patent, Trademark & Copyright Journal, 87 PTCJ 478, Jan. 3, 2014.

⁷ One recent example is the 2017 amendment to the Delaware General Corporation Law permitting the use of blockchain technology to manage stock holder information.