

Founders of startup businesses need to decide whether to incorporate in Delaware, as often suggested or even demanded by VCs, or in the state in which they will be conducting their business operations. This article, written by a startup business lawyer, takes the contrary view to that most often espoused by lawyers in my field and argues that one should think twice before blindly going for Delaware.

During the high-tech bubble in the late 1990s and early 2000s, the idea of a quick path to an initial public offering became so entrenched that startups began skipping the step of incorporating in their own states and moved directly to a Delaware incorporation to speed up the process of going public. Although the bubble eventually burst, this practice has persisted.

Delaware law affords substantial advantages and is an ideal state of domicile for public companies and late-stage startups planning to go public. Delaware has a well-developed and reasonably consistent body of corporate law with which most business lawyers are familiar. It offers a variety of advantages that tend to shield an entrenched management—such as the ability to dispense with cumulative voting for directors and the ability to stagger the election of directors. For these reasons, it is favored by venture capital investors who typically control their portfolio companies (as well as by public companies whose managements wish to remain in office). It also gives preferred stock investors with voting control of a corporation the unilateral power to merge that entity into another without need for approval of the founders or other early-stage participants who own the common stock. Thus, there is good reason why preferred stock investors will tend to favor Delaware corporations. Before the high-tech bubble, the typical approach was for mature startups to reincorporate in Delaware when they reached the stage at which the advantages of Delaware law made a substantive difference to the company. The question for counsel is whether the early-stage startup phase is the right stage for Delaware incorporation.

Sometimes, founders want to incorporate in Delaware because they believe that the venture capitalists who will be funding the company later will insist on it. Some venture capitalists do, but many do not, and many startups will never seek venture capital funding.

For the typical California-based early-stage startup, Delaware typically does not offer any practical advantages over a California incorporation (I pick California simply because this is where I have practiced for 30 years). Perhaps the only near-term advantages are (1) that Delaware allows for a single-member board of directors, regardless of the number of shareholders in the company, where a state like California requires that the number of directors match the number of shareholders up to three, and (2) quicker and more reliable filing of documents in connection with funding events. The first of these can facilitate easier corporate governance in an early-stage startup. The second can avoid sometimes embarrassing delays when fundings are set to close. Apart from these areas, however, a Delaware domicile normally just adds administrative burdens for an early-stage startup based in California. These burdens include the difference in the way franchise taxes are handled and the need to qualify as a foreign corporation in California. There are also downstream risks to founders in connection with losing the value of their interests in

mergers without having a voice in the process (this being one of the reasons why some VCs favor Delaware even for early-stage, closely-held startups). In general, a Delaware domicile imposes more administrative hassle upon an early-stage company than would a local domicile and may create substantive risks down the road for the founding team. The burdens can be dealt with, but the question is whether the burdens are worth the relatively minor advantages, if any, afforded by a Delaware domicile in the early stage.

The major advantage to incorporating in your local state is simplicity. In an early-stage startup, keeping matters simple is important. It saves expenses, and does not divert company resources toward issues that could be avoided.

The point for counsel is not to avoid Delaware, but rather to consider the issues in light of the client's aims and not to choose Delaware reflexively.