

Virginia or Delaware?



No Reason to Leave the Old Dominion

by James J. Wheaton and Joel R. Nied

Delaware is renowned as a location to form corporations and trusts and, in recent years, has been treated as a preferred jurisdiction for new LLCs as well. Many lawyers who advise businesses with their principal place of business in other states, including Virginia, recommend that their clients form their new entities in Delaware. Similarly, when existing clients based in Virginia contemplate an offering, recapitalization, the formation of a joint venture or subsidiary or another major transaction, third parties—such as underwriters or the other side’s counsel—often recommend or even insist on the entity’s formation or redomestication in Delaware. It’s time to break this habit.

The predilection to incorporate in Delaware is understandable. As of 2001, 51% of all corporations—and 58% of all

Fortune 500 corporations—were incorporated in Delaware.¹ There is a perception that Delaware law is more favorable to management, supplies more comfort to underwriters and securities rating agencies and offers less risk of the unknown when disputes arise between shareholders and management. The Delaware Division of Corporations recently produced a mass mailing to attorneys touting Delaware as the home of the most business-friendly courts in the United States. That survey, commissioned by the U.S. Chamber of Commerce, ranked Virginia second.²

Virginia attorneys might once have had reason to form Delaware entities—but no longer. Case law and improvements in Virginia’s business entity statutes, including the enactment of the Virginia Business Trust Act that becomes effective

in October 2003, make Virginia a preferred state for the formation of new business entities.

Virginia’s Business Judgment Rule Improves on the Delaware Standard

Most business entities are formed by parties that expect to exert management control over the entity, and, for this reason, it makes sense for a new business entity to be formed in a jurisdiction where management receives protection from the second-guessing of management decisions and potential litigation. Attorneys often point to the well-established “business judgment rule” in Delaware as a strong incentive for management to choose a Delaware entity. Generally, Delaware courts presume that “in making a business

decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”³ The business judgment rule protects directors and their decisions unless the presumptions of the rule are rebutted.⁴

The business judgment rule insulates directors from liability for “negligent” board decisions, so long as the board’s information gathering and decision-making process was rational or employed in a good faith effort to advance corporate interests.⁵ However, notwithstanding the substantial protection of the rule, Delaware law leaves the board vulnerable and restricts its decision-making power in certain circumstances. Board decisions are subject to enhanced scrutiny when a board adopts a defensive measure in reaction to a perceived threat to corporate control (the *Unoca*⁶ test), or when the decision concerns the breakup of the company and/or a change of control (the *Revlon*⁷ test). Delaware courts concluded that these situations create the opportunity for management to entrench itself, despite the best interests of the shareholders. As a result, the courts apply, among other requirements, an objective “reasonable person” analysis to measure whether the actions of the board can be sustained.

The nuances of the business judgment rule that have been explained in numerous Delaware court decisions have “caused a general atmosphere of confusion and uncertainty for courts, academics and, most importantly, directors of corporations”⁸ The objective nature of the tests applied by Delaware courts in many situations means that directors of Delaware corporations can be found liable, even when they have acted in good faith and followed reasonable procedures, because they fail to satisfy a court’s perception of what a hypothetical “reasonable” director

would have done. For this reason, Virginia’s version of the business judgment rule may be superior.

The Virginia Stock Corporation Act states that:

“A director shall discharge his duties as a director . . . in accordance with his good faith business judgment of the best interests of the corporation.”⁹

The word “reasonable” is absent from the statute, and the omission from Virginia’s version of a similar Model Business Corporation Act provision was deliberate. The commentary to this Virginia provision notes that Virginia’s rule avoids the creation of an “elaborate idealized framework against which the conduct or judgment” of a director will be measured.¹⁰ In Virginia, a director’s discharge of duties is not measured by what a reasonable person would do in similar circumstances or by the rationality of the ultimate decision. Instead, a director must act in accordance with his or her subjective good faith business judgment.¹¹ As a result, the *Revlon* test, among other Delaware-based director judgment rules, does not apply in Virginia.

In *WLR Foods, Inc. v. Tyson Foods, Inc.*, the court stated that Section 13.1-690 is a “radical departure from the former common

Virginia board’s decision cannot “inquire about the substance of the advice received by a director Rather, “good faith” under the statute raises the issue of whether a *process* was engaged that would produce a defensible business decision.”¹³ The Virginia statute prevents a challenger from “testing the veracity” of the board, which arguably makes the protection it affords unique in the country.¹⁴

Virginia’s corporate business judgment rule is simpler and more direct than Delaware’s standards and provides greater protection to management. From that perspective, Virginia law improves on Delaware law. This business judgment standard is repeated in the Virginia Limited Liability Company Act and the Virginia Business Trust Act. As a result, the members and managers of LLCs and trustees of business trusts are afforded the same protection as corporate directors.

Virginia Entities are Often Cheaper to Form and Maintain

Delaware relies on fees paid to its Division of Corporations for a substantial portion of its state budget, and fees charged to Delaware business entities reflect that choice. Legislation is pending before the Delaware legislature to increase those fees

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law and statutory business judgment standards,” similar to those that govern directors’ decisions in Delaware.¹² Unlike under Delaware law, a challenger to a

even more, and this legislation has apparently received the concurrence of the various groups in Delaware needed to secure its passage in the 2003 session. For corpo-

rations and LLCs, a comparison chart showing some of the fees, which gives effect to the proposed 2003 increases, is included below. For corporations with relatively few shares, the differences between the states are insignificant (and Delaware's fees can in some cases be lower). However, for corporations with a large number of shares, the initial filing fees and the maximum annual franchise tax payable in Delaware is substantially higher than that in Virginia. The annual maintenance fees for LLCs will likewise be twice those in Virginia.

be available in Virginia. Business trusts are typically limited liability entities that are perpetual and unincorporated. Because of their flexible character, business trusts are often used as the entity structure for real estate investment trusts, mutual funds and entities used to securitize assets, among other unique business uses. Delaware is considered the preferred state for the formation of mutual fund business trusts. Until 2003, those wishing to form a trust in Virginia simply had no choice—there was no way to form such an entity in Virginia.

the same pro-management terms of the business judgment rule statute that protects directors of Virginia corporations.¹⁷

Absent a provision to the contrary in the trust agreement, the trustees can alter the capital structure of the trust without filing with the State Corporation Commission or consent of the trust members.¹⁸ Because of the flexibility available to a business trust, the trust can even eliminate the members' rights to vote on all issues and is not required to hold member meetings.¹⁹ The trust agreement alone will determine the removal process for trustees.

• Virginia Provides for Inter-Entity Mergers and Conversions.

Like Delaware, Virginia is flexible in permitting inter-entity mergers and conversions, which facilitate transactions between different types of entities. In Virginia, for example, it is possible to convert partnerships to limited liability companies by a simple filing with the State Corporation Commission.²⁰ Similarly, it is possible to conduct inter-entity conversions between corporations and limited liability companies,²¹ and to merge corporations, limited liabilities companies, partnerships and business trusts.²²

• Virginia Permits Shelf LLCs.

In 2002, the Virginia LLC Act was amended to permit the formation of an LLC without any members.²³ This created the possibility of forming a "shelf LLC," similar to the previously existing ability to form a shelf corporation. It is possible for a company or law firm to create a shell entity—before determining whether or how the entity will be used, or whether it will have any members—so that the entity will be immediately available when needed. Although other states allow an LLC to continue its existence once it has no members (which is particularly useful in structured transactions described below), Virginia is

	Delaware	Virginia
Corporations		
Certificate/Articles of Incorporation	Minimum of \$50, no maximum	Minimum of \$75, maximum of \$2,500
Annual Franchise Tax/Report	Minimum of \$35, maximum of \$165,000	Minimum of \$100, maximum of \$1,700
Good Standing Certificate	\$125 (short form)	\$6
LLCs		
Certificate of Formation/Organization	\$90	\$100
Annual Fee	\$200	\$100

Virginia Entities Provide Drafting and Management Flexibility

Because Virginia's business entity statutes are generally subject to annual revision based on recommendations of various bar-affiliated committees, these statutes offer drafting flexibility at least equal to Delaware. A practitioner should be aware that:

• Virginia Offers a Full Range of Business Entities.

With the addition of the business trust in 2003, a full range of business entities will

The Virginia Business Trust Act affords many of the same advantages available with Delaware business trusts. The act provides for creation by the filing of a single, brief document¹⁵ and allows the parties to the trust to determine by contract the relationship among one another, as opposed to having the parameters of the relationship dictated by statute.

The trust agreement, not the statute, determines the delegation of management control. The ability of the parties to determine the governance of the trust and degree of the trustee's liability is virtually unlimited.¹⁶ Trustees' decisions are governed by

the only state that allows an LLC to be formed without any members.

• **Virginia Provides Management Options.**

Delaware LLCs are perceived to provide a significant amount of drafting flexibility, but the Virginia LLC statute contains equivalent provisions, the same amount of flexibility and greater certainty in defining management relationships to the outside world. For example, the Virginia LLC Act was amended in 2002 to make clear that an LLC's operating agreement may impose restrictions, which are not subject to a reasonableness test, on the ability of an LLC's interest owners to have access to records of the LLC.²⁴ This provision parallels similar language in Delaware.

The statutory provision of the Virginia LLC Act that describes the allocation of management authority in member-managed and manager-managed LLCs makes clear that members are divested of management authority in manager-managed LLCs and that third parties are not subject to constructive notice of management restrictions that are contained in the LLC's operating documents, except to the extent that a restriction on the ability to convey real estate is included in the publicly-filed articles of organization.²⁵ By comparison, Delaware permits restrictions and limitations on authority to be included in the Delaware equivalent of an LLC's operating agreement.²⁶ For this reason, Delaware leaves open the possibility that an LLC might assert a restriction on authority against a third party without actual knowledge of the restriction, and that lack of cer-

tainty can be problematic in lending and other business transactions.

Virginia Entities are Available in Sophisticated Transactions

Delaware lawyers have done land office business in the last several years, providing general legal assistance and special-

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ized legal opinions in connection with securitizations and other structured finance transactions. In essence, the structured finance community appears to have defaulted to Delaware LLCs as an entity of choice, based in part upon the assumption that Delaware's preeminence in the corporate area would automatically translate to other types of business entities as well.

Many of the transactions in which Delaware LLCs are routinely used involve structures in which the parties desire to create a special purpose entity that will be "bankruptcy remote." An SPE will often include a member (often a lender affiliate) that does not own an economic interest in the entity, but because of its member status, has the ability to prevent the entity from going into bankruptcy because the LLC's documents require unanimous member approval for such an action.

The ability to use an LLC organized in a particular state will depend entirely on the ability of the entity to satisfy the ratings criteria imposed by Standard & Poor's (S&P) and other ratings agencies. The Delaware LLC act satisfies all the legal criteria necessary to permit a Delaware LLC to be used in a rated transaction, and Virginia is one of the few other states that also satisfies each aspect of the ratings criteria. The

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James J. Wheaton is a partner in the Virginia Beach office of Troutman Sanders LLP. He is the 2003–2004 chair of the Business Law Section of the Virginia State Bar and chair of the Subcommittee on Limited Liability Companies of the Partnerships Committee of the American Bar Association Section on Business Law. He has taught a seminar in business entities at the University of Virginia School of Law.



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Joel R. Nied is an associate in the Virginia Beach office of Troutman Sanders LLP, where he is a member of the firm's corporate and securities practice group. He is a graduate of the University of Pennsylvania and the Emory University Law School.

Standard & Poor's Multi-Member LLC Criteria²⁷

LLC should have perpetual existence.

Insolvency of one or more members should not, in and of itself, cause the dissolution or termination of the LLC.

Dissolution or termination under any means should be limited.

LLC should be able to limit itself to a “particular activity,” i.e., to provide cash flow to pay timely interest and principal on the rated obligations.

LLC should be treated as a separate legal entity from its members.

LLC should have an “independent manager” that is (i) a member that is an SPE, (ii) an SPE that is not a member or (iii) a natural person.

The LLC's operating agreement should contain provisions so that (i) the LLC cannot declare bankruptcy without consent of all the members and an independent manager; (ii) when acting on matters subject to the vote of the members, notwithstanding that the LLC may not be insolvent, the members and the independent manager take into account the interest of the LLC's creditors; (iii) the LLC cannot engage in dissolution, liquidation, consolidation, merger or asset sale (other than as provided in the relevant transaction document) or amendment to its organizational documents so long as the rated securities are outstanding, without prior written notice to Standard & Poor's; (iv) the LLC cannot assume additional debt or incur other actual or contingent liability unless (a) the additional debt is rated by Standard & Poor's the same as the issue credit rating requested for the rated securities in a given transaction, or (b) the additional debt is fully subordinated to the rated securities, and, in either case, is nonrecourse to the LLC or any assets of the LLC other than cash flow in excess of amounts necessary to pay holders of the rated securities, and does not constitute a claim against the LLC to the extent that funds are insufficient to pay such additional debt; (v) upon dissolution of the LLC, or other events of default of the rated obligations, the holders of the obligations should have the independent ability to retain the collateral and continue to pay scheduled debt service, or to liquidate the collateral in the event the proceeds would be insufficient to repay all amounts due.

The operating agreement should provide liability protection to the members and managers who rely on the provisions of the operating agreement.

Virginia LLC Act Provisions

Virginia LLCs have perpetual existence unless otherwise provided by the operating agreement or articles of organization. *Va. Code* § 13.1-1046.

Unless otherwise stated in the operating agreement or articles of organization, the bankruptcy of a member does not cause the LLC to be dissolved or its affairs to be wound up. Rather, the LLC may be continued without dissolution. *Va. Code* §§ 13.1-1040.1, 13.1-1040.2. In fact, even if all of the members go bankrupt and dissociate from the LLC, the LLC will continue to exist.

Aside from judicial or administrative dissolution, the LLC may be structured so that it is only dissolved pursuant to the terms of the operating agreement or upon unanimous written consent of the members. *Va. Code* § 13.1-1046.

The articles of organization may limit the purpose of the LLC. *Va. Code* § 13.1-1008.

Virginia LLCs are legal entities separate and distinct from their members. *Va. Code* § 13.1-1002.

Managers of Virginia LLCs do not need to be members of the LLC. *Va. Code* § 13.1-1024. In addition, Virginia law allows an entity to be a member even if it does not possess a membership interest. *Va. Code* § 13.1-1038.1C.

The duties (including the fiduciary duties) and liabilities of a member or manager of an LLC may be expanded or restricted by the LLC's operating agreement so as to provide for all of Standard & Poor's requirements for the operating agreements of special purpose entities. *Va. Code* § 13.1-1023.

In any proceeding brought by or in the right of an LLC or brought by or on behalf of members of the LLC, the damage assessed against a manager or member arising out of a transaction, occurrence or course of conduct can be as low as zero if so specified in the articles of organization. *Va. Code* § 13.1-1025. In addition, managers and members will not be held to a “reasonableness” standard.

chart on the preceding page highlights S&P's primary requirements for the use of LLCs in rated transactions and demonstrates the flexibility of Virginia LLCs.

Conclusion

Although Virginia does not immediately come to the minds of lawyers outside Virginia as a preferred jurisdiction for business entities in sophisticated transactions, there are many circumstances in which a Virginia entity will be preferable to an entity formed under the laws of Delaware or other jurisdictions. Virginia practitioners should be aware of the opportunities made available in Virginia's various business entities statutes, and use the flexibility provided by Virginia laws to give their clients and companies a full range of drafting and management options. ☺

Endnotes:

- 1 Lucian Arye Bebchuk, "Imperfect Competition and Agency Problems in the Market for Corporate Law" (2001) www.law.uchicago.edu/lawecon/workshop-papers/bebchuk3.pdf.
- 2 U.S. Chamber of Commerce, State Liability Systems Ranking Study, Final Report (Jan. 11, 2002).
- 3 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
- 4 *See In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. 1996).
- 5 *Id.*
- 6 *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 2d 946 (Del. 1985).
- 7 *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173 (Del. 1986).
- 8 Engledow, Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties, 63 Alb. L. Rev. 505 (1999).
- 9 Code § 13.1-690.
- 10 Joint Bar Committee Commentary to § 13.1-690 (revised 1999).
- 11 *Williard v. Moneta Bldg. Supply, Inc.*, 258 Va. 140, 151, 515 S.E.2d 277, 284 (1999).
- 12 *WLR Foods, Inc. v. Tyson Foods, Inc.*, 155 F.R.D. 142, 146 (W.D. Va. 1994), *aff'd*, 65 F. 3d 1172 (4th Cir. 1995), *cert. denied*, 516 U.S. 1117 (1996).
- 13 *Id.* at 145-46.
- 14 *Id.* at 146 (citing 20 Univ. Rich. L. Rev. 67, 106 (1985)).
- 15 *Va. Code* § 13.1-1202.
- 16 *Id.* § 13.1-1219, 13.1-1225.
- 17 *Id.* § 13.1-1229.
- 18 *Id.* § 13.1-1216.
- 19 *Id.*
- 20 *Id.* § 13.1-1010.1.
- 21 *Id.* §§ 13.1-722.8 to 13.1-722.13; *Id.* § 13.1-1010.4.
- 22 *Id.* §§ 13.1-722, 13.1-1070, 13.1-1257, 50-73.48:1, 50-73.128.
- 23 *Id.* § 13.1-1038.1A(3).
- 24 *Id.* § 13.1-1028.
- 25 *Id.* § 13.1-1021.1.
- 26 Del. Code tit. 6, § 18-407.
- 27 Standard & Poor's, Legal Criteria for Structured Finance Transactions, April 2002, Appendix 4 www.standardandpoors.com/spf/pdf/fixedincome/Legal2002.pdf.



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