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VIRGINIA OR DELAWARE: NO REASON TO LEAVE THE OLD DOMINION

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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 formation or redomestication in Delaware of the entity to be used in the deal. 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] One popular reason for this preference is the 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. In fact, the Delaware Division of Corporations recently produced a mass mailing to attorneys in their database 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]

Despite the reasons that Virginia attorneys might once have had to form Delaware entities, those reasons have dissipated. Existing case law and the annual efforts made to continuously improve Virginia's business entity statutes, including the enactment of the Virginia Business Trust Act that became 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 in which 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

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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 "Unocal"[6] test) or when the decision concerns the breakup of the company and/or a change of control (the "Revlon"[7] test). Delaware courts have 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 the Virginia Code section governing standards of director conduct[12] is a "radical departure from the former common law and statutory business judgment standards" similar to those that govern directors' decisions in Delaware.[13] Unlike under Delaware law, a challenger to a Virginia board's decision cannot "inquire about the substance of the advice received by a director . . . Rather, "good faith" under the statute presents the question of whether a *process* was engaged that would produce a defensible business decision."[14] The Virginia statute prevents a challenger from "testing the veracity" of the board, which arguably makes the protection it affords unique in the country.[15]

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.

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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 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 corporations 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.

	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

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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 that available in Delaware. Some of the principal points that a practitioner should be aware of include the following:

Virginia Offers a Full Range of Business Entities. With the addition of the business trust in 2003, a full range of business entities will 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 presently 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 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 document,[16] 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.[17] Trustees' decisions are governed by the same pro-management terms of the business judgment rule statute that protects directors of Virginia corporations.[18]

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.[19] 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.[20] The trust agreement alone will determine the removal process for trustees.

Virginia Provides for Inter-Entity Mergers and Conversions. Like Delaware, Virginia is extremely flexible in permitting inter-entity mergers and conversions, which can 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.[21] Similarly, it is possible to conduct inter-entity conversions between corporations and limited liability companies, [22] and to merge corporations, limited liabilities companies, partnerships and business trusts among each other.[23]

Virginia Permits Shelf LLCs. In 2002, the Virginia LLC Act was amended to permit the formation of an LLC without any members.[24] 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 for a transaction. 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 the only state at this point 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

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LLC's interest owners to have access to records of the LLC.[25] 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.[26] By comparison, Delaware permits restrictions and limitations on authority to be included in the Delaware equivalent of an LLC's operating agreement.[27] 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 certainty 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 specialized 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 following chart highlights S&P's primary requirements for the use of LLCs in rated transactions, and demonstrates the flexibility of Virginia LLCs.

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Standard & Poor's Multi-Member LLC Criteria[28]	Virginia LLC Act Provisions
LLC should have perpetual existence	Virginia LLCs have perpetual existence unless otherwise provided by the operating agreement or articles of organization. Va. Code § 13.1-1046
Insolvency of one or more members should not, in and of itself, cause the dissolution or termination of the LLC.	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 all of the members go bankrupt and dissociate from the LLC, the LLC will continue to exist.
Dissolution or termination under any means should be limited.	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
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.	The articles of organization may limit the purpose of the LLC. Va. Code § 13.1-1008
LLC should be treated as a separate legal entity from its members.	Virginia LLCs are legal entities separate and distinct from their members. Va. Code § 13.1-1002
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.	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 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 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

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Standard & Poor's Multi-Member LLC Criteria	Virginia LLC Act Provisions
The operating agreement should provide liability protection to the members and managers who rely on the provisions of the operating agreement.	In any proceeding brought by or in the right of a 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.

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. ◆

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(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 Va. Code § 13.1-690.

13 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)..

14 Id. at 145-46.

15 Id. at 146 (citing 20 Univ. Rich. L. Rev. 67, 106 (1985)).

16 Va. Code § 13.1-1202.

17 Id § 13.1-1219, 13.1-1225.

18 Id § 13.1-1229.

19 Id § 13.1-1216.

20 Id.

21 Id. § 13.1-1010.1.

22 Id. §§ 13.1-722.8 to 13.1-722.13; Id. § 13.1-1010.4.

23 Id. §§ 13.1-722, 13.1-1070, 13.1-1257, 50-73.48:1, 50-73.128.

24 Id. § 13.1-1038.1A(3).

25 Id. § 13.1-1028.

26 Id. § 13.1-1021.1

27 Del. Code tit. 6, § 18-407.

28 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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VIRGINIA BUSINESS TRUST ACT CREATES NEW VEHICLE FOR REALIZING BUSINESS GOALS

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Seeking to create a "good business-climate," the Virginia legislature has given businesspersons another tool with which to pursue their business goals. The recently enacted Virginia Business Trust Act (the "Act"; Va. Code Ann. § 13.1-1200 et seq.) combines the limited liability and codified fiduciary duties of a Virginia corporation with an extreme degree of contractual freedom, allowing parties to tailor the structure and governance of their business entity. Essentially, businesspersons can have key statutory protections of a corporate entity along with an almost blank slate on which to sketch the governance structure of their business. The Act became effective October 1, 2003.

The "basics" of a Virginia business trust

A Virginia business trust (VBT) is an unincorporated, limited liability business entity that may conduct any lawful business. A VBT is of perpetual duration, unless otherwise stipulated in the organizational documents. One forms a VBT by filing signed "articles of trust" with the State Corporation Commission of Virginia. Minimal information is required in the articles of trust: the VBT's name, information about the registered office and agent, and the address of the VBT's principal business office. A VBT's principal business office need not be located in Virginia. A pre-existing corporation or other business entity may become a VBT via a "plan of conversion" that complies with the relevant provisions of the Act.

The controlling document of a VBT is the "governing instrument." A governing instrument may contain any provision not inconsistent with law or the articles of trust. The Act contains few mandatory provisions and, therefore, the governing instrument is largely a matter of contractual agreement, rather than statutory fiat.

Corporation-like protections with fewer statutory constraints than the Virginia Stock Corporation Act

The Act incorporates many of the attractive features of the Virginia Stock Corporation Act, such as limited liability and a deferential standard of conduct for managers, while containing far fewer mandatory provisions.

Codified and clear standard of conduct for trustees

To encourage high-caliber businesspersons to serve as trustees of VBTs, the Act provides a codified and clear standard of conduct for trustees. The Act states that a trustee will be held to the same standard of conduct as is a director of a Virginia corporation. As such, a trustee must discharge his duties as trustee "in accordance with his good faith business judgment of the best interests" of the VBT. The standard's focus on *good faith*, rather than *business acumen*, will allow trustees to make good faith decisions without fear that, if a decision turns out poorly, the wisdom of the decision will be dissected after the fact.

The Act makes other protective aspects of the Virginia Stock Corporation Act applicable to VBTs, as well. For instance, the Act specifies that a trustee or officer of a VBT may have no greater liability to a VBT or a beneficial owner than a director or officer of a Virginia corporation may have to a corporation. Similarly, a VBT may indemnify any trustee, officer, or employee to the same extent that a Virginia corporation may indemnify a director, officer, or employee. A trustee of a VBT also enjoys the same entitlement to mandatory indemnification as does a director or officer of a Virginia corporation. Unless otherwise provided in the articles of trust or in the governing instrument, a trustee will not be

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liable to third parties for actions taken in her capacity as trustee.

Limited liability for beneficial owners and the VBT

The Act provides that beneficial owners of a VBT are entitled to the same limitation of liability as shareholders in a Virginia corporation, unless otherwise specified in the governing instrument. Like corporate shareholders, beneficial owners risk their investments and nothing more. The Act further protects beneficial owners by specifying that neither the power to direct a trustee, nor the following of a direction from a trustee, will cause a beneficial owner to be a trustee, to incur liability related to the VBT, or to have fiduciary duties.

Just as beneficial owners are insulated from liabilities of the VBT, the VBT itself is insulated from liabilities of its beneficial owners. The Act provides that a creditor of a beneficial owner has no right to exercise any legal or equitable remedies with respect to VBT property in relation to an obligation of a beneficial owner.

Contractual freedom to tailor governance provisions

The contractual freedom provided by the Act allows businesspersons to tailor the capital and governance structure of a VBT more finely than is possible with other business forms, making the VBT a unique option for furthering business goals. Indeed, the Act itself states that it is "to be construed in furtherance of the policies of giving maximum effect to the principle of freedom of contract and of enforcing governing instruments." The paucity of mandatory provisions in the Act will allow for the creation of VBTs designed to meet a variety of different business needs. Below are some of the ways that the terms of a governing instrument may be varied to address specific situations.

- Trustees: selection, removal, duties and powers: Parties may stipulate the procedures for both the selection and the removal of trustees in the governing instrument. Although trustees are the "default" managers of a VBT, the Act allows for modification of the trustees supervisory duties within the governing instrument. The authority of trustees may be made more nuanced by the use of "series" of trustees, with each series of trustees having differing rights and duties.

- Capital contributions: A governing instrument may require beneficial owners to make contributions, but it may also allow for the grant of beneficial interests without contribution. A contribution may consist of cash, property, services rendered or a binding obligation to provide such consideration. The governing instrument can also delineate specific penalties and consequences for a person's failure to honor a written promise to contribute to the VBT.

- Voting rights and procedures: The governing instrument may grant or withhold the right to vote. Governance structures may also be more finely tuned by selectively granting the right to vote on specific matters to specified trustees or beneficial owners on a per capita, numerical, financial, or other basis. Furthermore, series of trustees or beneficial owners may be created which have differing voting rights. If voting rights are granted, parties are able to provide for voting procedures in the governing instrument. Parties can tailor to their specific situation requirements for notice, action by consent, quorum, proxies, and other matters related to voting.

The flexibility in voting allows governance of VBTs to be either highly participatory or highly centralized, or any balance in between. Broadly granted voting rights and high quorum requirements could be employed to require virtual unanimity of trustees and beneficial owners. Alternatively,

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a VBT may be structured so that trustees may take action, including the altering of rights of existing classes of beneficial owners and mergers, without the approval of the beneficial owners.

- Use of series to insulate assets: As with a Delaware business trust, a governing instrument may use series to insulate assets and compartmentalize liabilities within the larger VBT. The debts and liabilities of a particular series within a VBT will be enforceable only against the assets of that series, and not against assets of other series or the VBT as a whole, provided that such limitation is stated in the articles of trust and distinct series records are kept. Conversely, the assets of a particular series will be insulated against the debts and liabilities of other series within the VBT and the VBT as a whole. As such, the Act provides the flexibility to compartmentalize risk while maintaining organizational efficiencies of scale. ◆

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