So You Think Washington Is A Delaware State? Debunking the Myth that Washington Follows Delaware on Issues of Corporate Law

BY BRIAN BUCKLEY

Fenwick
FENWICK & WEST LLP

As many corporate lawyers and business leaders know, in order to entice companies to incorporate there, Delaware actively positions and markets its state courts as the preeminent experts on matters of corporate law. As a result, rather than develop their own body of corporate law, some other states have chosen to adopt Delaware's. Contrary to a common misperception, Washington is *not* one of the states swimming in Delaware's wake. With very few exceptions, Washington courts have rejected or simply ignored Delaware's lead in favor of forging our state's own body of corporate law. That trend has implications both for corporations considering whether to incorporate in Washington (rather than Delaware), and for lawyers advising their Washington clients on corporate matters.

As discussed in detail below, the widespread myth that Washington is a "Delaware state" is not innocuous. Delaware's corporate law is unique and differs in many significant ways from Washington's corporate law. For a Washington corporation, relying on Delaware law is likely to yield erroneous legal advice. And Delaware law is a poor predictor of how Washington state courts will resolve disputes involving Washington businesses.

For several decades, Delaware has worked hard to advance its status as the "venue of choice" for companies looking to incorporate. A significant component of that strategy is Delaware's relatively well-developed body of law regarding the myriad issues that affect corporations and other business entities. Delaware's Court of Chancery — a trial-level state court from which appeal is taken directly to the Delaware Supreme Court — is specifically tasked with handling corporate disputes and matters of corporate law. Delaware bills the Chancery Court as "the nation's preeminent forum for the determination of disputes involving the internal affairs of the thousands upon thousands of Delaware corporations and other business entities through which a vast amount of the world's commercial affairs is conducted." According to the Chancery Court's website, "Its unique competence in and exposure to issues of business law are unmatched." See http://courts.delaware.gov/chancery/.

Delaware's strategy has worked: over half of Fortune 500 companies are incorporated in Delaware and thousands of new companies incorporate there each year. In addition, a (perhaps unintended) consequence of Delaware's efforts to lure corporations to its state is that courts in other states have increasingly looked to Delaware for guidance on corporate law issues. As one New Jersey court put it: "When considering issues of first impression in New Jersey regarding corporate law, we frequently look to Delaware for guidance or assistance." A few other states have followed suit, and have adopted blanket policies of turning to Delaware law to fill in gaps in those states' own corporate law. And there is truth to the generalized notion, as the Third Circuit Court of Appeals articulated it, that "Delaware is recognized as a pacesetter in the area of corporate law."

Many Washington lawyers and their clients believe that Washington too is a "Delaware state," i.e., that the Washington courts routinely adopt Delaware corporate law in areas where Washington's law is silent or unresolved. Corporate bloggers and commentators have stated that "[i] n the absence of Washington case law or clear statutory guidance on a particular point of Washington corporate law, Washington's Supreme Court and lower courts have exhibited a pattern of regularly referring to Delaware case law as relevant legal authority" (*The Venture Alley*, November 24, 2010), and have concluded that "if the Washington statutory scheme is similar to that of Delaware in another area – given the reasoning that Delaware courts are well versed in corporate law – it seems reasonable to rely on Delaware case law in cases involving Washington corporations" (*Outside Inhouse Lawyer Blog*, May 21, 2009). When it is to their clients' advantage, litigators often make the same basic claims in trying to convince Washington courts to follow Delaware authority on unsettled points of corporate law. As explored below, however, it is not in fact the case that Washington courts routinely look to Delaware law for guidance on corporate issues.

There are, of course, many Washington cases involving Delaware corporations (or other Delaware business entities) where our state courts are required to apply Delaware law, because a corporation's basic corporate affairs are governed

by the law of the state in which the entity is incorporated. But the critical question, and the one explored here, is whether Washington courts are likely to apply Delaware law to *Washington* corporations on corporate issues where our own state law is silent or unsettled.

The Washington Business Corporation Act (the "WBCA") was enacted in 1989 and governs the affairs of Washington corporations. The statute is based upon the national 1984 Revised Model Business Corporation Act (the "MBCA"), which was promulgated by the American Bar Association. The Washington Legislature did not formally adopt the official comments to the MBCA, but those comments are published in full as part of the legislative history of the WBCA and are persuasive authority for interpreting the WBCA. The legislative history of the WBCA expressly directs Washington courts to look for guidance from other states that have adopted the MBCA. Conversely, the legislative history directs Washington courts to disregard the law in states that have not adopted the MBCA, because such states operate under a different statutory framework.

Delaware has not adopted the MBCA. In its quest to be the "venue of choice" for newly formed corporations, Delaware has instead crafted its own unique corporate statute and accompanying body of case law. As a result, Delaware's corporate code differs substantially from the WBCA in many important respects. The disparities include, among many others, provisions governing critical issues such as amendments to a company's articles of incorporation; anti-takeover provisions; mergers and corporate dissolution; shareholder action without a meeting; authorization of classes of shares, and accompanying voting rights; corporate transactions with interested directors or officers; dissenting shareholders' rights; dividend distributions; and special shareholder meetings. Thus, pursuant to the Washington Legislature's directives, the default assumption should be that Washington courts will disregard Delaware corporate law, at least on issues grounded in the WBCA.

Yet the myth persists that Washington courts have evinced a "pattern" of looking to Delaware for guidance. Not so. Washington courts routinely decide novel or unsettled issues of corporate law without any reference to Delaware law. On other corporate issues, Washington courts occasionally reference Delaware law, but with no more frequency or deference than authority from other states. And on some issues, Washington has expressly rejected Delaware corporate law in favor of Washington's own standards.

Prior to 2009, there were only three corporate issues on which Washington courts had chosen to adopt or follow Delaware law. The first issue involved the "corporate opportunity doctrine"; the Washington Supreme Court found "persuasive" two Delaware cases addressing the scope of that doctrine. The second issue involved the standards for valuing dissenters' shares in dissenters' rights proceedings; the Court of appeals adopted the standards set forth in a particular Delaware case. But that result was due, in no small part, to the fact that the legislative history for the key statutory provision, Revised Code of Washington (RCW) 23B.13.020, specifically referenced the same Delaware case. The third issue involved the power of a corporation to repurchase its own stock; the Washington Supreme Court relied on Delaware law to interpret Washington's statute. But that case, decided in 1957, long pre-dated the adoption of the MBCA or the WBCA, and the Supreme Court noted that the Washington statute at issue "copied the Delaware statute almost verbatim," therefore Delaware law was obviously instructive.

In May 2009, the Washington Supreme Court issued its opinion in *In re F5 Networks, Inc.*, and established only the fourth corporate issue on which Washington follows Delaware law. The underlying *F5 Networks* lawsuit was pending in the United States District Court for the Western District of Washington. A group of F5 shareholders sought to proceed derivatively on behalf of the company to pursue claims against certain F5 directors and officers for alleged "back-dating" of stock options. A shareholder may only act derivatively on behalf of a corporation if the shareholder can establish that it would be "futile" to make demand on the corporation's board of directors to take the same action. A majority of states have abandoned the "demand futility" notion, and have instead adopted a policy that shareholders must always make demand on the corporation's board of directors to act before attempting to proceed derivatively (a concept referred to as "universal demand"). Delaware still hews to the "demand futility" concept (which has been widely criticized), and Delaware has developed a large body of case law interpreting and implementing that concept.

In *F5 Networks*, the federal court certified to the Washington Supreme Court the question of whether Washington follows Delaware's "demand futility" doctrine or is instead a "universal demand" state. F5 advocated for Washington to join the majority of states and embrace a "universal demand" standard. The Association of Washington Business (the "AWB") submitted an *amicus curiae* brief also urging the Court to reject "demand futility" and to adopt "universal

demand." In support of its brief, the AWB included a letter from Professor Richard Kummert of the University of Washington School of Law. Professor Kummert, who unfortunately passed away in April 2012, taught corporate law at the UW Law School for over 40 years. Professor Kummert was also a founding member of the Washington State Bar Association Corporate Act Revision Committee, which drafted and recommended adoption of the WBCA. Professor Kummert is often referred to as the father of Washington corporate law, and was clearly the foremost authority on the history, intent, and policies behind the WBCA.

In his letter in support of the AWB's amicus brief, Professor Kummert not only advocated for the Supreme Court to recognize "universal demand" and reject Delaware's "demand futility" doctrine, he also made the following observations regarding Delaware law generally:

> Washington courts have never routinely applied Delaware's corporate case law. Indeed, at no point have our courts evinced a pattern or practice of following, or even looking to, only Delaware corporate case law when deciding corporate law issues in Washington. In fact, the opposite is true. When Washington courts seek guidance in deciding corporate law issues not resolved by our common law, they survey decisions in other states and national commentary and try to emulate authorities considered best.

Thus, the individual most singularly responsible for and familiar with the WBCA believed strongly that Washington is not, and has never been, a "Delaware state," as the prevailing myth would have it.

Despite Professor Kummert's guidance, in an unprecedented move, the *F5 Networks Court* chose to adopt wholesale Delaware's "demand futility" doctrine. One obvious policy (or political) reason for that decision might be that "demand futility" is more favorable to shareholders than to corporations. The Court also noted that the states adopting a "universal demand" standard have, by and large, done so by statute (which the Washington Legislature has, to date, not done). Once the Court resolved to accept the "demand futility" notion, there was no other rational choice but to incorporate Delaware's jurisprudence interpreting and implementing that doctrine. After all, "demand futility" (at least in its modern iteration) is wholly a creation of the Delaware courts and cannot be understood in isolation from Delaware's corporate law.

For our purposes, however, what is most notable about the *F5 Networks* opinion is what the Supreme Court did *not* say. The Court acknowledged Delaware's own self-serving proclamation that its law has achieved "some modest importance in the American scheme of corporate governance." And the Supreme Court noted that, with regard to "demand futility" specifically, "Delaware's court are well versed in this area." But the Court did *not* state that Washington generally looks to Delaware for guidance on corporate law issues, or even that Delaware law is generally persuasive or influential in Washington. In short, in *F5 Networks* the question of whether Washington is in fact a "Delaware state" was front-and-center, yet the Supreme Court conspicuously failed to accept that notion.

One year later, in July 2010, the Supreme Court considered the issue again in *Sound Infiniti v. Snyder*. In that case, a minority shareholder in a closely held corporation sued after being forced out of the corporation by the majority shareholders via a reverse stock split. The minority shareholder sought not only to exercise dissenters' rights under the WBCA (RCW 23B.13.020), but also to assert separate claims for breaches of fiduciary duty against the majority. The legal issue before the *Sound Infiniti* Court was whether an appraisal of, and payment for, a dissenting shareholder's stock is the exclusive remedy for such a shareholder, absent a showing of fraud. Relying on Delaware law, the minority shareholder argued that appraisal is not an exclusive remedy and that his separate fiduciary breach claims could proceed. He had the wind at his back for that argument, because the official comments to the relevant WBCA section expressly reference Delaware law and the specific Delaware case on which the minority shareholder relied. The *Sound Infiniti* Court did refer to Delaware law as "influential" in finding that the fraud exception under the dissenters' rights statute was broader than just common law fraud. But the Supreme Court rejected Delaware's notion that the minority shareholder could pursue separate breach of fiduciary duty claims. Relying instead on New York law (which was also referenced in the WBCA commentary), the Court held that, absent fraud, appraisal is the dissenting shareholder's exclusive remedy.

As it relates to this article, however, the *Sound Infiniti* decision went further yet. Despite no longer being a shareholder, the former minority shareholder also sought to assert derivative claims on behalf of the corporation. In support of his argument, the minority shareholder invoked an exception from a well-known Delaware case addressing derivative actions. The Washington Supreme Court did not

bite. The Court declined to import the Delaware exception because it was contrary to prior Washington law. Thus, despite express references to Delaware in the relevant WBCA commentary, and a generalized nod to Delaware's "influence," the *Sound Infiniti* Court took no material guidance from Delaware law.

What does all of this mean for Washington corporations, and for the directors and officers who run those businesses? It means that Delaware should not be your guide. Delaware corporate law is unique and specialized, and cannot be effectively superimposed on Washington's WBCA or our body of corporate case law. Nor, contrary to popular belief, do Washington courts routinely or reliably look to Delaware for guidance.

Erroneously relying on Delaware law can have significant real-world consequences. Take an example: Your company is considering a sale of a substantial group of assets, and your Board of Directors must determine whether the transaction requires shareholder approval. Delaware's standards are more shareholder-friendly and less strict regarding which asset sales trigger shareholder approval requirements. Consequently, if your Board is advised to rely on Delaware law, it may conclude that a shareholder vote is necessary. But under Washington law, and the law of other MBCA states, shareholder approval is required only where an asset transaction is tantamount to a sale and wind-down of the entire business. If the Board relies, as it should, on Washington law, it may conclude that the sale transaction can be consummated without a shareholder vote.

In summary, Washington is not a "Delaware state" and the Washington courts have never in fact demonstrated a tendency to refer to or rely on Delaware corporate law. The myth that such a "pattern" exists is dangerous. Delaware law is unique and specialized, and cannot be readily or effectively superimposed on the divergent case law or statutory schemes of other states. That is certainly true in Washington, where our WBCA is based on the national MBCA and owes almost nothing to Delaware's corporate statute or case law. Consequently, looking to Delaware law for guidance in counseling Washington corporations may lead lawyers to provide the wrong advice. And, with very limited exceptions, lawyers should certainly not rely upon Delaware law to predict the results in corporate litigation involving Washington corporations.

For more information on these or related matters, please contact your Fenwick securities team or the author.

Brian Buckley (206.389.4521 bbuckley@fenwick.com)