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The Delaware Bar Foundation was founded in 1981 as a 501(c)(3) tax-exempt organization. Among its contributions to the legal profession, the Foundation publishes Delaware Lawyer and administers the IOLTA program. The Foundation has also created an Endowment Fund (maintained by the Delaware Community Foundation) designed to grow and generate income that the Foundation can use to further its mission, including aiding programs that provide legal services to the poor and public education about the law.

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If you have any questions, please contact the Foundation’s executive director, Jacqueline Paradee Mette, at (302) 658-0773.
EDITOR’S NOTE
Chuck Durante

Last year at this time, we decided to focus this issue on the “Delaware Advantage,” the distinctive combination of law, lawmaking and judging that is the envy of neighboring governors.

It permitted the state’s taxpayers to pay just 70 cents for every dollar of state services. It attracted to Delaware an uncommon quality of legal and financial talent. It enabled Wilmington’s downtown to thrive long after its peers became hollowed out. It provided a robust boom in middle-class white-collar employment that overshadowed the shrinkage in comparable blue-collar work. It showered endowment and energy on non-profit institutions.

Laws were made by a legislature in partisan equipoise, administered by governors reelected by acclamation. Administrations changed seamlessly with policies tacking slightly from one to the next. The state’s tax base was exported so effectively that tax rates decreased regularly over 30 years. One Nation under a Groove, with a vague consensus of moderately progressive social policy, moderately conservative fiscal policy and bipartisan deference to influential industries.

That was last year. After 30 years of snapping its suspenders, Delaware has been stripped of smugness. Banking has proven to be just as cyclical as the Old Economy. Bright young lawyers cannot find work. The new Governor’s ambitious vision has been thwarted by a revenue gap that may prove to be structural, not short-term. Neighboring states belatedly invaded Delaware’s regional gambling monopoly, and the Third Circuit short-circuited its attempt to become the East’s official bookmaker. Bad actors in the corporate and banking world have incited federal regulators to consider measures that would erode the advantages of a Delaware domicile. Attacks on the Delaware Holding Company tax exemption have succeeded in several states. The senior Senator has become a world leader as Vice President, no longer able to protect Delaware’s advantages from a perch on the Judiciary Committee.

Will Delaware become a modern version of Macedonia, a minute mammoth whose dominance of its larger neighbors was fated to end?

This issue presents some stout-hearted realists who believe that a new level of creativity can enable Delaware to be a resource for the corporate and banking industries, and an exemplar of sound government. Each author warns that pain, inconvenience and hazards lie ahead. An Era of Good Feelings is easy when times are flush. Now is a true test of our creativity, resolve and vision.

Chuck Durante
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Christopher A. Coons
is in his second term as New Castle County Executive. Chris is a graduate of Tower Hill School, Amherst College, where he majored in chemistry and political science, Yale Law School and Yale Divinity School, where he received a Master’s in Ethics. He also studied at the University of Nairobi in Kenya. He serves on the boards of the national “I Have A Dream” Foundation, Wilmington’s Riverfront Development Corporation and the Better Business Bureau of Delaware. He also serves on the advisory boards of the Newark/Bear Boys & Girls Club, First State Innovation, Delaware College of Art and Design, and the Hearts and Minds Film organization. He was among 24 elected officials in the nation to be selected as a 2009 Aspen-Rodel Fellow by the Aspen Institute’s Rodel Fellowships in Public Leadership.

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Dr. Samuel B. Hoff
is the George Washington Distinguished Professor of History and Political Science, and Law Studies Director, at Delaware State University. A nationally known specialist on the American presidency, Dr. Hoff served in staff positions in the U.S. Congress between 1978 and 1986. He has been an observer and commentator on Delaware politics since coming to DSU from Wichita State University in 1989. He has authored many articles and studies, notably the chapter on Delaware in State Party Profiles: A 50-State Guide to Development, Organization, and Resources, edited by Andrew Appleton and Daniel Ward, published in 1997 by Congressional Quarterly.

David C. McBride
has been at the center of much of the litigation that has steered the modern development of Delaware corporate law for the past 35 years. A partner at Young Conaway Stargatt & Taylor, LLP, he is a member of the Committee on Corporate Laws of the Section of Business Law of the ABA; the Executive Council of the Corporate Law Section of the Delaware State Bar Association, which he formerly chaired; the American Law Institute; and the American College of Trial Lawyers. He is one of Delaware's three Commissioners to the National Conference of Commissioners of Uniform State Law. He is a former Army captain, with service in Vietnam, he has been a member of the Delaware Economic and Financial Advisory Council and the Delaware Population Consortium since their inception. He also is the state's representative in work with the U.S. Bureau of Census.

Edward C. Ratledge
is director of the Center for Applied Demography & Survey Research at the University of Delaware, where he received his undergraduate and master’s degrees in economics. A former Army captain, with service in Vietnam, he has been a member of the Delaware Economic and Financial Advisory Council and the Delaware Population Consortium since their inception. He also is the state’s representative in work with the U.S. Bureau of Census.

His current work — which integrates economics, statistics, demography and computer science — includes developing the Delaware Health Information Network; building Delaware's hospital discharge data system; advising the Perinatal Board on scientific issues; implementing studies of travel behavior in Delaware and evaluating the impact on the state’s road network; producing small-area population and employment projections for the state; and developing measures of, and attitudes toward, options for long-term economic growth. He also works in applying computer technology to combat economic and organized crime, and has conducted research on prosecution, focusing on the prosecutor’s role from basic screening decisions to post-conviction strategies. He and his colleague Bill Boyer authored Delaware Politics and Government (University of Nebraska Press, 2009).
The benefits of this success are equally well known, most notably in the form of corporate franchise tax receipts and other business entity-related payments that collectively constitute more than 25 percent of the State’s revenues.

Threats to Delaware’s success have been thought to emanate primarily from two sources: from other states seeking to emulate or improve upon the advantages that Delaware offers, and from federal initiatives (both legislative and administrative) that might limit the scope and effectiveness of the advantages of Delaware incorporation.

Federal interference may not pose the greatest danger to the State’s future success.

We need not dwell long on our State’s well-known success in providing a legal home for corporations and other business entities. More than 850,000 entities, including over half of all U.S. publicly traded companies and over 60 percent of the Fortune 500 companies, are organized under Delaware law.

At the moment, competition from other states seems feeble at best. Those who thought that North Dakota’s putatively “shareholder friendly” public corporation statute adopted in 2007 might draw public companies away from Delaware have surely been disappointed by the track record:

- Shareholders have resoundingly defeated proposals to reincorporate to North Dakota. Even limiting the results to shares actually voted yes or no (as opposed to shares outstanding, abstentions and broker non-votes), levels of approval in 2009 averaged less than 8 percent.
• The leading proxy advisory firm (RiskMetrics, formerly known as ISS) chose Delaware over North Dakota as its jurisdiction of incorporation when it made its initial public offering.
• Only one public corporation has actually been formed under the 2007 North Dakota law, and that company is controlled by Carl Icahn, the key sponsor of the new law.

In contrast to the lack of serious competition from other states, there is a bewildering and rapidly evolving array of federal initiatives under consideration even as this article is being written. None of those initiatives would mandate or even authorize federal incorporation as such, nor do any of those initiatives attempt to define fiduciary standards or prescribe enforcement of fiduciary duties in federal courts. Thus, there is no direct threat to Delaware’s core roles of incorporation and of administering the law of fiduciary duty.

The concern, rather, is that these federal initiatives, by preemptively prohibiting otherwise valid governance arrangements authorized by state law, would limit Delaware’s unique advantages as a corporate home and, ultimately, eliminate the relative attractiveness of our State as a choice of jurisdiction of incorporation.

This article attempts to place this sort of concern in historical perspective by reviewing past movement along the federal-state continuum in the law of corporate governance. The article concludes that federal-state conflict has been exaggerated as a threat to Delaware, and that the more important issue is the effect of federal initiatives on business formation in the United States generally, and the possibility that a third source of competition — global, rather than federal or state — represents the greatest long-term threat to the interests of our State.

Federal Regulation of Corporate Governance

There was a time in U.S. business history, in the early 1900s, when matters associated with corporate governance — such as share transfers, disclosure obligations, share voting, and director duties — were entirely controlled by state law. Despite that predominance of state law, this era is not a period usually identified as the heyday of the Delaware corporate system: At least measured by revenue to the State, the triumph of the Delaware corporate law system is more appropriately identified with the period since 1980.

At any rate, the Great Depression shattered confidence in the early 20th-century regulatory system and brought about dramatic increases in the federal government’s role in corporate governance. Among other matters:
• The Securities Exchange Act of 1934 set up a comprehensive system of reporting corporate information to shareholders and the public. Indeed, it is conventional wisdom that the federal government since 1934 has totally occupied the field of disclosure requirements for publicly traded companies.1 Contrary to conventional wisdom, however, federal regulation of corporate governance has never been entirely limited to matters of disclosure.
• Section 14(a) of the Exchange Act empowered the SEC to adopt rules governing proxy voting. Exercising this power, the SEC has established rules that govern the form of proxies, require companies to provide shareholder lists (or mail solicitation materials) at the behest of proxy contestants, and require companies to include shareholder proposals in their proxy materials. Without that long history of federal involvement, all of these matters would ordinarily be thought to be matters of internal corporate governance controlled by state law.
• Although insiders’ use of nonpublic corporate information for personal gain unquestionably implicates state law issues of fiduciary duty, Section 16 of the Exchange Act created a federal cause of action to permit corporations (directly or by derivative suit) to recover specified short-swing trading profits by corporate insiders.

Section 19 of the Exchange Act also gave the SEC authority to adopt and approve stock exchange listing requirements. Using the power to establish listing requirements, or the threat of using that power, the SEC has approved many corporate governance rules since 1940. Reflected in New York Stock Exchange listing requirements, these rules include:
• Requiring minimum voting rights for preferred stock (1940);
• Establishing a minimum quorum requirement for stockholder meetings (1953);
• Requiring shareholder approval for issuance of more than 20 percent of voting shares for consideration.

The concern is that federal initiatives, by preemptively prohibiting otherwise valid governance arrangements authorized by state law, would limit Delaware’s unique advantages.
other than cash (1955);
• Requiring at least two independent directors (1956); and
• Requiring establishment of an audit committee (1977).²

These broad expansions of the federal role dramatically shifted the balance of regulatory power to Washington and away from the states, at least for companies that are publicly traded or listed on national stock exchanges. And yet, despite this shift, our own State’s role in incorporating not only survived, it flourished. It flourished after 1992, when Congress hamhandedly attempted to regulate executive compensation by limiting its tax deductibility, only to discover later that the exemption for “performance-based” compensation led to mushrooming levels of stock option compensation, putatively performance-based.

And Delaware’s dominant role continued to flourish even after 2002, when the Sarbanes-Oxley Act prohibited public companies from making personal loans to executive officers and mandated that stock exchanges require listed companies to have all-independent audit committees — in both instances limiting what state corporate law otherwise permitted.

Recent History and Current Federal Initiatives

The recession and collapse of major financial firms in 2008 have once again spawned federal interest in corporate governance. The Emergency Economic Stabilization Act of 2008, which addressed financial institutions selling “troubled assets” to the Treasury Department, authorized the Treasury Secretary to establish “appropriate standards for executive compensation and corporate governance,” including:

• “(A) limits on … incentives for senior executive officers … to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary holds an equity or debt position in the financial institution;
• (B) a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and
• (C) a prohibition on the financial institution making any golden parachute payment to its senior executive officer … .”³

Earlier this year, and just days after Treasury regulations were adopted to implement these Congressional mandates, Congress passed the American Recovery and Reinvestment Act, which expanded these compensation rules and mandated so-called “say on pay” — an advisory shareholder vote on overall executive compensation — for financial institutions receiving public financial support.

Invoking the blanket assertion that the “central causes of the financial and economic crises that the United States faces” include “a widespread failure of corporate governance,”⁴ Senator Charles Schumer and others in Congress have sought to introduce a variety of federal corporate governance mandates for all public companies, including:

• A prohibition against classified (staggered) boards of directors;
• A requirement that the positions of chief executive officer and chair of the board of directors be occupied by different individuals;
• Establishing that directors must be elected by majority vote, rather than the plurality vote standard prevalent in state corporate law; and
• Requiring the creation of a risk committee of the board of directors.

President Obama’s administration has also weighed into the mix, although more narrowly. The Administration’s overall financial regulatory reform proposal focuses on executive compensa-

tion, and would provide that:

• Overall executive compensation pay must be submitted to an annual, nonbinding shareholder vote;
• All compensation committee members must be independent (as current stock exchange listing rules already essentially require); and
• Compensation consultants to the committee must meet standards of independence.⁵

Unlike the laws enacted in the previous year, this legislation would not be limited to just financial institutions: absent exemption by the SEC, it would apply to all publicly held companies regardless of whether the company engaged in excessive risk-taking or accounting fraud.

Federal interest in establishing corporate governance rules has emanated not just from Congress. The SEC, under new leadership, has made it a priority to advance a proposal to promote “proxy access,” in which shareholders are entitled to require the company to include their director nominees in the company’s own proxy solicitation materials. On May 20, 2009, the Commission — by a party line, 3-2 vote — adopted a proposal with two principal elements: first, a new Rule 14a-11 that would mandate proxy access for shareholders owning at least 1 percent of the stock for at least one year; and second, an amendment to Rule 14a-8 that would allow shareholders to use the corporation’s proxy materials to propose bylaws that would establish the terms of proxy access, as long as those terms did not limit access rights otherwise available under Rule 14a-11 as proposed.⁶

This proposal, or at least the mandatory aspect of it, would plainly curtail the state law rights of stockholders and boards of directors to define their own systems of proxy access, or to refrain from adopting one at all. As such, the SEC proposal would be a further step toward reducing the range of flexibility...
in corporate governance currently afforded by state law. Indeed, acting for the Delaware State Bar Association, the Council of the Corporation Law Section took the unprecedented step of submitting a formal comment to the SEC opposing the mandatory aspect of the proxy access rule proposal.

Other notable commentators on corporate governance (including Professor and former SEC commissioner Joseph Grundfest, former TIAA-CREF chief counsel Peter Clapman, the ABA Section of Business Law, and a variety of corporate representatives including The Business Roundtable) took a similar approach in favor of private choice over public mandate.7

At this writing, the outcome of all of these federal corporate governance initiatives remains uncertain. The deadline for public comment on the SEC’s proxy access proposal has passed, and it is expected that the SEC will act on the proxy access proposal this fall. The U.S. House of Representatives has passed legislation to establish some corporate governance mandates, notably relating to executive compensation, but the fate of that legislation depends on its reception in the Senate.

Nevertheless, it would be unwise to predict that no further movement in corporate governance matters from state power to federal authority will occur in the coming year. It would be daring, too, to predict the impact of any such movement on Delaware’s important role in creating corporations and monitoring the behavior of their directors and officers. If prudence were a guide, then, this article would stop right here.

The Road Ahead

But it doesn’t.

1. So let’s begin with an assertion that few would contest. The key elements of Delaware’s corporate law system — a flexible and well-maintained enabling statute, efficient and professional administrators (the Division of Corporations), and a justly well-regarded system of private enforcement (the Court of Chancery and our Supreme Court) — will continue to be highly valued by the financial community. No other state is likely to put together a meaningfully competitive package as long as Delaware can maintain those key elements.

2. On the other hand, but still sticking to a relatively safe assertion, the economic benefits to Delaware of its corporate law system require ongoing maintenance of its public company base, particularly companies that pay the maximum franchise tax. Such companies regularly disappear from Delaware’s rolls, however, through mergers or bankruptcy, and
Delaware’s dominant market position cannot be maintained without a continuing influx of new incorporations of public companies.1

3. So what is the threat, if any, to this sort of replenishment? Here is the first speculative and eminently contestable prediction: Marginal federal encroachments on corporate governance rulemaking will not in and of themselves substantially reduce Delaware’s public company base. Such encroachments are unlikely to make other states’ systems more attractive, and they would do little if anything to detract from the advantages of Delaware’s system identified above, or to divert new public company formations from Delaware to other U.S. states.

4. What should concern all of us in Delaware and in the United States overall, however, are the trends in initial public offerings — a key driver of Delaware’s franchise tax base. A few years ago the Committee on Capital Markets Regulation issued an interim report8 with some alarming statistics: the U.S. share of the value of initial public offerings by companies outside their home country dropped from 50 percent in 2000 to just 5 percent in 2005; and in 2005, 94 percent of the capital raised by foreign companies in the U.S. was raised privately.10

As if those statistics weren’t alarming enough, the trend in U.S. initial public offerings overall has been most discouraging: in 2004-2007 the number of U.S. IPOs ranged from 172 to 206; in 2008 there were just 26, and 2009 of U.S. IPOs ranged from 172 to 206; of U.S. IPOs ranged from 172 to 206; encouraging: in 2004-2007 the number of U.S. IPOs ranged from 172 to 206; of U.S. IPOs ranged from 172 to 206; continuing influx of new incorporations of Delaware companies depends less on avoiding marginal federal intrusions into corporate governance than on whether the U.S. regulatory and financial environment overall can maintain the dominance and growth it enjoyed in the 1990s and earlier in this decade. In an era of increased global competition and new viability of other countries’ economies, maintaining that dominance and growth will depend on the vibrancy of our own economy and, in particular, on the robustness of our public capital markets.

What should be of most concern to us in Delaware, then, is whether federal initiatives will make our nation’s capital markets more or less attractive to businesses seeking capital and to investors who supply it. Our interests as a State should no longer focus (if they ever could) on whether those initiatives “federalize” matters of corporate governance; rather, our concern ought to be whether those initiatives contribute to, or detract from, the willingness of companies to tap the U.S. public capital markets.

This focus is one that should be a shared perspective of Delaware citizens and any others truly concerned about the national economy. Those who reflexively advocate inflexible federal governance rules of wide application — as opposed to regulatory reforms aimed carefully at unboundedly risky financial practices — should heed the advice of the recent report of the ABA’s Section of Business Law’s Task Force on Delegation of Governance Roles and Responsibilities:

Consideration of reforms that might alter roles and responsibilities within the corporation should be made with a clear understanding of the rationales for the current ordering and whether the risks associated with proposed changes outweigh potential benefits. The goal of any reform effort should be to ensure that the corporation is positioned to continue its successful role in our economy, ultimately for the benefit of society at large.12

The “current ordering” of Delaware’s flexible statute and the courts’ watchful eye on disloyal managerial conduct should be altered only with a clear understanding that the national economy will be sounder as a result.  

FOOTNOTES
1. Conventional, but not entirely accurate. The state law of fiduciary duty has continued to play a non-trivial role in establishing disclosure responsibilities of corporate directors. See, e.g., In re Transkaryotic Therapies, Inc., 954 A.2d 346, 357-361 (Del. Ch. 2008).
5. A version of this legislation passed the House of Representatives on July 31, 2009. H.R. 3269, available at http://thomas.loc.gov/cgi-bin/query/Dc111i3:/temp/-c111uhilMQ:.
6. This shorthand description of a 250-page rule release proposal is necessarily oversimplified. For the full text, see http://www.sec.gov/rules/proposed/2009/33-9046.pdf.1
10. Id. at x.
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TRANSPORTATION AVAILABLE
Delaware is certainly not alone in suffering through the aftermath of the credit crunch precipitated by the housing bubble and the vaporization of the asset-based securities market. The state also had a housing bubble, although not quite as extreme as that of Florida or California.

The bubble started to collapse in the fourth quarter of 2006 when the unemployment rate bottomed at 3.2 percent and total employment in Delaware was at a peak for the decade. Building permits began to fall precipitously and are still falling nearly three years later. At the same time, past-due mortgages and foreclosures in Delaware began to increase and are still increasing today.

Nationally and in Delaware, these conditions had a significant negative effect on two industries, namely construction and finance. Both sectors contributed to economic growth in the state over the past 15 years and are major contributors to employment. Delaware’s financial sector percentage of total employment is among the highest in the nation. The carnage in the financial industry is thus felt disproportionately in Delaware.

As the disarray in the financial and the housing sectors escalated, it began to spill over into the larger economy. The lack of credit and the resulting reduction in consumption nationally hit the auto sector particularly hard and hastened the closure of the Chrysler and GM plants in the state.

All of these factors have more than doubled the unemployment rate from

If any good results from the current economic calamity, perhaps it will be an overdue reexamination of Delaware tax policy.

A decline in revenue growth rates suggests the need for new approaches and improved administration.

Delaware’s Fiscal Health: Time For Tax Policy Reform?
the peak of the economy and have reduced overall employment to levels not seen since 1999. That there has been an impact on the state’s revenue is hardly surprising. That impact began in 2007 and probably will not be fully diminished until 2012.

Delaware’s Revenue Portfolio

In February 2008, a report from the Department of Finance, the Office of Management and Budget, and the Controller General’s Office was submitted to the General Assembly, detailing the good, the bad and the ugly of Delaware’s revenue portfolio. The document details the Risks and Opportunities, any Structural Issues and further Revenue Potential for each revenue source. The report, available with a related volume, the annual “Tax Preference Report,” at the Department of Finance’s Web site at http://finance.delaware.gov/publications/GP2008.pdf, offers a good starting point to guide the Governor and the General Assembly.

It is useful to divide the revenue portfolio into several collections according to some unifying characteristics. The first such collection, “Old Reliables,” includes two very important taxes, the Personal Income Tax and the Business and Occupational License and Gross Receipts Tax, better known simply as the Gross Receipts Tax.

Both of these taxes are broad-based and vary to some extent with economic conditions. For example, in the latest economic decline, the highest unemployment rates in 30 years and outright declines in employment (and thus wages) caused considerable decline in income taxes. This was exacerbated by falling bonuses in the financial sector, which had boosted income tax revenues considerably in previous years. Still, the volatility was small compared to the contraction in sales taxes of other states, which suffered from the reduction in consumption as well.

The Gross Receipts tax does not have the volatility of a sales tax but its volatility did increase with the variation in the price of oil over the past several years. Frankly, General Assembly action taken to reduce Gross Receipts tax rates causes more volatility than the economic cycles. Together these two taxes form a solid foundation for the portfolio that provides nearly 40 percent of the state’s revenue.

The second collection, which includes the Corporate Income Tax, the Bank Franchise Tax and the Realty Transfer Tax, is properly named “Wild Things.” In recent years, net Corporate Income Tax revenue has been as high as $178.5 million and as low as $126 million. The Corporate Income Tax is sensitive to the economy and can take awhile to recover since losses not taken in the current year can be carried forward. It is almost twice as variable as the Personal Income Tax.

The Bank Franchise Tax, until recently a star performer, fell from $175 million (2007) to $64 million (2009). The future is somewhat uncertain since there is no sign that the credit crunch is nearing an end or that consumers are ready to resume profligate use of their credit cards. Recent Federal legislation is also likely to impact this industry negatively. If the credit card banks do not return to their performance prior to the bubble, the productivity of the Bank Franchise Tax will be diminished for some time.

Finally, the Realty Transfer Tax, which reached $177 million in 2006 at the peak of the housing bubble, deflated to $44.5 million in 2009. The rapid annual revenue increases of 25 percent depended on new housing construction and increasing housing prices. Neither of those factors is in evidence at this time. While declines are not as evident, the signs of true recovery are for the most part absent. In all likelihood it will take a number of years for this revenue source to recover.

It also should be recognized that putting this tax in the hands of local government was a disservice. The up cycle is a real boon but the down cycle is a disaster. The Realty Transfer Tax needs to be in a portfolio of which it is a relatively small part. These three taxes currently provide 9 percent of the state’s revenue.

The third collection includes the Lottery, Alcoholic Beverage Tax and Cigarette and Tobacco Products Taxes, the “Sin Taxes.” They are regressive; they fall disproportionately on lower-income groups. These taxes tend not to be cyclical, which helps in a downturn but does not add to revenue growth in the upturn.

The consumption of alcohol and cigarettes is declining as the population ages, thus the only revenue growth is likely to come from higher tax rates, which further discourage consumption. More than 60 percent of cigarette sales are to out-of-state consumers. However, recent increases in federal cigarette taxes coupled with increases in Delaware taxes have decreased those sales by 35 percent. This means that cigarette tax revenues are likely to drift lower over time.

Alcoholic beverage taxes are a small player in the portfolio, accounting for less than 1 percent of the total. They are also resistant to tax increases since they touch more than half of the population in comparison to the 18 percent affected by the cigarette tax. An effort to increase the tax on alcohol failed in the last General Assembly.

The Lottery is not really a tax at all. There is the traditional lottery, which is a game with lousy odds that people play, hopefully, for fun and not to make money. The video lottery is also a game where the odds are in favor of the house, with the state receiving a percentage of the take. The state can increase its revenue by increasing the number of machines, by increasing operating hours (just about 24/7 at this time), by the addition of new games in the traditional lottery, and by attracting more players with the addition of sports betting or table games.
There are, however, uncertainties involved. How will other venues being added in Maryland and Pennsylvania affect gambling in Delaware? Currently, it is estimated that up to 40 percent of revenues could be lost to Maryland when gambling begins there.

It is unclear how much sports betting will generate because there is disagreement among analysts as to the assumptions. The Third Circuit decision that federal law prevents single-game bets, other possible legal challenges and the true cost of implementing the new forms of gambling add even more uncertainty. An educated guess might be that these new forms might offset some of the losses to Maryland but not fully replace them. These three taxes currently provide about 12 percent of the state’s revenue.

The final collection of taxes includes the Corporate Franchise Tax, Limited Partnerships & Limited Liability Companies and Abandoned Property. These “Privilege Taxes” are assessed on businesses. The Corporate Franchise Tax applies to all “C” and “S” Corporations incorporated in Delaware, whether they do business in Delaware or not. Thus it offers the ability to “export” the tax and reduce the cost of government services on Delaware residents. Over the years it has been a relatively stable source of revenue but does not usually respond strongly to the economic cycle.

The exception to this was during the infamous “dot-com” bubble. Many of these companies selling essentially vaporware but with hugely successful IPOs and stratospheric stock prices incorporated in Delaware and paid the maximum Corporate Franchise Tax. Many corporations simply disappeared through merger or liquidation when the bubble burst. Others converted into LLCs to avoid the new accounting rules promulgated by Congress and the more expensive Corporate Franchise Tax levy.

Today LLCs have grown rapidly and Corporate Franchise Tax revenue has been shrinking. In spite of increases in the Corporate Franchise Tax rate in 1991 and 2003 after the last two recessions, the tax revenue from this source is about the same level as at the peak in 2001. It is reasonable to expect further mergers and liquidations as the full impact of this latest recession affects the Corporate Franchise Tax over the next several years. The recently enacted increases to the tax rate will undoubtedly further hasten shifts to the LLC, and after the initial gains in revenue the growth will slow even further.

In short, the Corporate Franchise Tax and the annual levy on LLCs together produce about 19 percent of Delaware’s revenue and while exportable, are not
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The other part of this collection of sources is Abandoned Property. It is included here because it relates to corporations incorporated in Delaware. If, for example, a company has issued a gift certificate that is no longer valid for use by the original buyer, the company is not entitled to claim the value for its own use. The property must be “escheated” to the state of the owner’s address or if the owner’s name or address is unknown, the state of incorporation of the company holding the asset.

Abandoned Property has been a growing revenue source, now 12 percent of the portfolio. It depends on identifying companies that are likely to have such property and making sure that they report it. This depends on the thoroughness of the Division of Revenue and their audit firms that pursue abandoned property under contract.

There can be wide variations in the revenues produced from this source and thus it is very difficult to forecast. Together this collection produces more than 30 percent of the state’s revenues. Much of it would be at risk if, as some have suggested, federal incorporation supplants state corporation laws.

There are other small pieces in the revenue portfolio that collectively account for about 15 percent of the total. They do not measurably affect the stability or the growth potential of the portfolio.

While the property tax is technically not part of the revenue portfolio, it contributes about 30 percent of funds for the public school districts. This relieves part of the burden on the state’s General Fund, which provides the remaining 70 percent of the funding. In addition, the property tax is the primary tax base for all local government functions. Problems with the administration of this tax inevitably lead to requests for state revenue sharing such as that provided through the Realty Transfer Tax or further shifting of local government services to the state.

The most essential element in the administration of the property tax has been long neglected. The properties have not been reassessed in decades. Kent County’s last reassessment was in 1986, New Castle County last reassessed in 1983, and Sussex County property tax is based on a 1974 assessment. This leads to inequities between residential property owners and a parade of industrial and commercial property owners as they go to the Tax Appeal boards asking for redress.

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Kent County’s last reassessment was in 1986, New Castle County last reassessed in 1983, and Sussex County property tax is based on a 1974 assessment.

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The primary reason the properties have not been reassessed (politics aside) is the matter of expense. The counties — which would have to pay for any reassessment — are reluctant to do so, since the school districts are by far the largest users of the tax base. This needs to be fixed.

The General Assembly has taken notice. In 2008, House Joint Resolution 22, co-sponsored by 27 House members and seven Senators, and passed by a collective 56-5, directed the Office of Management and Budget, the Secretary of Finance, the Secretary of Education and the Controller General to make recommendations to the Governor and General Assembly for “a fair and equit-

able reassessment of all real property.”

The resolution noted that real estate tax is the major source of revenue for school districts and local governments, and pointed to the Delaware Constitution’s requirement that the tax burden be “uniform upon the same class of subjects.”

Where Do We Go From Here?

It appears that there are a number of factors that tend to slow the growth of the state’s revenue. Some are related to the structure of the tax, such as a flatter tax rate structure that reduces bracket creep in the income tax; shift from the standard corporation to the limited liability company; and the dual method of filing the bank franchise tax.

Others are economic in nature. For example, increasing fuel efficiency negatively impacts the motor fuel revenue; the meltdown in the financial sector decreases employment and annual bonuses; federal and state taxes on cigarettes decrease smoking and the export of cigarette purchases to surrounding states; the credit crunch decreases profits on credit cards and bank franchise payments.

Finally, demography is a factor. As the resident population ages and we encourage the in-migration of retirees, a smaller percentage will be working and paying taxes. At the same time, consumption is reduced as older residents spend less on high-ticket items while at the same time needing more government services. All of this adds up to a need to reexamine the revenue structure, looking to reverse the declining growth rate while improving tax administration and overall equity.

One of the most appropriate and least costly sources to reform is the property tax. Currently, the property tax is approximately 6 percent of all state and local tax revenues combined. The national average is 13 percent. The primary users of the property tax are local governments and the public school
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The schools are by far the largest recipient of these revenues. At the same time, the state provides roughly 70 percent of total public education funding from the General Fund. About $78 million of the General Fund is used to partially equalize the differences in the property tax base between districts. It would be appropriate to use the property tax for this purpose. In addition there are many functions currently left to the school districts that would be more appropriate funded at the state level, such as special schools and students with special needs.

It also would be appropriate to use the property tax for funding, in part, the Transportation Trust Fund. The Fund is underfunded and will continue to be so as fuel efficiency increases and the motor fuel tax declines. Infrastructure is directly related to the service of property, including residential, commercial and industrial uses. Approximately 40 percent of the tax is paid by businesses and nearly 15 percent of the tax is exported to non-residents.

During the housing bubble of 2003-2006, the Realty Transfer Tax provided substantial revenue to local governments. When the bubble burst, transfer tax revenues dropped to a fraction of prior levels, placing those governments in serious difficulty. While the same volatility exists at the state level, the proportion of total revenue provided by the tax is significantly lower. One approach to avoid this in the future is to repeal sharing the transfer tax and replace it with revenue sharing funded at the state level by the property tax.

The report called for in House Joint Resolution 22 of the 144th General Assembly recommends a complete overhaul of the property tax in Delaware. This should be implemented as soon as possible so that this source can be utilized immediately if the current revenue structure continues its lackluster performance. It also can act as a backup if the risks associated with the Lottery, Abandoned Property, Realty Transfer Tax, or the Corporate Franchise Tax materialize.

Any plan to improve the revenue portfolio should include a complete review of tax preferences. While most were implemented in good faith, conditions change and some may now require significant revision or outright elimination. For example, the pension exclusion for the older population (of which I am one) may become onerous and inequitable as the population of seniors doubles over the next 20 years.

There should also be a complete review of the earmarking of General Fund revenues. Examples include assigning part of abandoned property
revenues to school construction or to the Transportation Trust Fund. There is a legislative process for dealing with capital funds. Earmarking in general reduces flexibility in a downturn and puts receiving programs higher on the priority list when that may not be what was intended.

It also may be an appropriate time to revisit the foundations of the Transportation Trust Fund. Today nearly 60 percent (and rising) of state expenditures from the fund are for operations and administration of the Department of Transportation, which was not the original intent. By isolating this function of government, it both reduces flexibility of the General Fund and starves the Trust Fund.

Overall, it seems safe to conclude that the current portfolio will produce on average 4 percent growth on the up cycle and perhaps minus-5 percent on the down cycle. The Rainy Day Fund will protect the state for a single year but two down years would require immediate action for budget cuts or tax increases. The upside will accommodate small real increases in expenditures above inflation but will have difficulty with expenditures like Medicaid, which has been growing significantly faster than the portfolio.

Stimulus funds from the Federal government are currently being used to reduce the burden but those funds will be cut in 2011 and absent in 2012. (This applies to most, if not all, stimulus funds.)

Successive years of tax raising and budget cutting are not only debilitating to the political process, they are bad for business, for state employees, and for citizens of the state. An intense examination of programs that are growing faster than the revenue portfolio can support is needed. Most if not all programs have their past supporters, but not every program is a high-priority program. Adding a new program may make sense; however funding them may require ending older programs.

Adding to the revenue portfolio is not a casual decision either. There needs to be balance and there needs to be foresight. The General Assembly should ask for a report from the Department of Finance, the Office of Management and Budget, and the Controller General’s Office that details the long-range (five years) needs for state government services and the likely cost thereof.

Such a report would include not only the General Fund but also special funds, both appropriated and non-appropriated. Having an up-to-date and complete picture of the state’s fiscal health is the foundation required for leading and managing in these difficult times. ♦

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In this environment, what has county government done to balance demands for service with falling revenues? What are governments at all levels doing to retain and attract business?

New Castle County government has primary responsibility over land use, development and construction in the unincorporated area of the County. With the majority of the state’s population and economic activity, New Castle County, in its land use role alone, plays a critical part in the overall health of Delaware’s economy.

The current crisis, which has hit the commercial and residential development sectors extremely hard, sharpened the focus of County and state leaders on the need to streamline our processes and improve our ability to retain and attract high-wage employers to New Castle County.

The crisis has affected every aspect of government. County policy-makers have had to approach budgeting, zoning and economic development in new ways. Intergovernmental cooperation has become more critical than ever. Stimulus funding has been indispensable. County government has had to focus like never before on the difficult
potential trade-offs between short-term and long-term consequences of actions to promote growth.

Like private enterprise, the County has had to re-align itself to new market realities. Yet, it has been important not to let the current economy deflect the County from a long-term vision for land use policy.

The Great Recession

In the past year, we have witnessed changes not seen in a generation, first in the housing market, then the broader financial markets, then our entire national economy. The stresses on the County’s finances were exacerbated by the national collapse, far beyond anyone’s expectations. When County Council adopted the budget for fiscal year 2009 in May 2008, the County expected to take in $31 million in real estate transfer taxes. By December, that figure had dropped to $18 million and our budget deficit for the fiscal year doubled.

As fiscal 2010 approached, we faced a growing deficit and dwindling reserves that could have bankrupted the County within a year. Projections showed a $200-million deficit over the coming five years, which threatened the continuation of critical County services.

Rather than slashing services extremely, or raising property taxes beyond what our community can fairly bear, New Castle County took a middle course. We began by restraining growth in our budget, cutting capital projects and operating expenses, and asking for a five percent salary giveback from the County workforce. We also asked for a similar amount in increased revenue from every homeowner and business in order to sustain our essential services.

After also conducting a Countywide listening campaign, followed by six public hearings, County Council adopted our 2010 operating budget of $228.9 million by a bipartisan 10-3 vote, a decrease of $11.4 million from fiscal 2009. The County budget shrank more than any other budget in 40 years.

We cut $23 million in spending out of County government and raised $21 million in new revenue. The average annual property tax bill in the unincorporated part of the County rose by $100, and more than 1,200 County employees gave back five percent of their compensation. We eliminated or defunded 97 vacant County positions, and cancelled more than $75 million in capital projects.

Overall, we sustained core County services and stabilized the County’s short-term budget. Still, our County faces ongoing projected deficits that demand continuing budget discipline, with more efficiencies, reductions in personnel costs and new sources of revenue.

Federal and Regulatory Issues

Federal matching funds built most of the current 1,800-mile sanitary sewer system in unincorporated New Castle County, in the decades before the federal government largely withdrew from funding sewer and wastewater projects. Over the past decade, increasingly stringent enforcement of the Clean Water Act resulted in increasing attention to local government investment in sanitary sewer and storm water management.

This has compelled New Castle County to invest heavily in rehabilitat-

In May 2008, the County expected to take in $31 million in real estate transfer taxes. By December, that figure had dropped to $18 million.
and resell foreclosed properties; summer youth employment; emergency shelter grants; community crime enforcement; and public safety.

We also anticipate receiving a $3,740,000 grant to improve energy efficiency at County-owned buildings. This population-based grant will further drive efforts to create permanent local jobs while attacking rising energy costs that continue to affect our bottom line.

**Lawyers, Lawyers Everywhere**

Litigation and lawyers are the other area of concern regarding containing costs. In early 2005, New Castle County faced about 70 lawsuits ranging from automobile accident litigations or bankruptcy collection to a dozen actions arising from a federal investigation and numerous §1983 actions by County employees alleging constitutional violations by former County officials.

The County was spending more than $1 million annually on outside counsel and faced millions in potential liability. Since then, most of that litigation has been resolved, and the County has significantly reduced its ongoing litigation costs.

While the County still faces the routine litigation that arises from having regulatory authority, many public facilities and County-owned vehicles, the results of three major cases have saved County taxpayers money and improved governmental efficiency:

- Most notable was the landmark case of *Wilmington Hospitality, LLC v. New Castle County*, 963 A.2d 738 (Del. 2008), in which the Delaware Supreme Court overturned a Superior Court judgment of $9.7 million in damages and interest against the County.
- In *Korn v. New Castle County*, 2005 WL 2266590 (Del. Ch., September 13, 2005, revised September 27, 2005), the County ultimately prevailed on numerous legal challenges to its financial reserves to cope with the current economic crisis.
- The Delaware Supreme Court rendered an advisory opinion concerning Article III, Section 11 of the Delaware Constitution, which had previously been understood to require one-year residency before appointment to a County office such as police chief. After a thorough review of the relevant Delaware Constitution history, U.S. Supreme Court decisional law and policy considerations, the Delaware Court concluded that the Constitutional provision only applied to County officers appointed by the Governor, and not officers appointed by the County.

**Working Together**

State and County government must cooperate in economic development, particularly during times like these. The state has both the resources to provide incentives for economic development, and regulatory oversight of areas critical to growth. New Castle County’s role in regulating land use plans, development, and sewer infrastructure directly impact economic development efforts at the macro and micro levels.

New Castle County’s land use approval process has been challenged by the development community as being overly bureaucratic and burdensome. Yet, much of the time required to review and approve a major land use plan is dictated by reviews by the state departments with oversight over transportation, environment, planning and fire safety. Internal County coordination between our departments responsible for stormwater and sewer with those responsible for land use has also been a challenge, which the County is working to resolve.

In partnership with the State Chamber of Commerce, the County and state have engaged an outside facilitator to lead a review of our land use and permitting process and suggest ways to improve coordination and to make substantive changes to our processes. Many of the insights gained through this effort have been incorporated into ordinances that will soon be reviewed by the Planning Board and considered by County Council.

The most significant are rooted in the two-year public process that produced the 2007 County Comprehensive Development Plan. This document, summarizing the input of more than 150 citizens from a wide range of backgrounds who participated in four working groups, was ultimately approved by Council. The Land Use Department and Executive Office distilled these recommendations into an overall plan that sets the course for land use and development in New Castle County for the coming five years. Several of those improvements were already well underway when the downturn struck.

The policy change most fully implemented is a redirection of future growth in the County to redevelopment sites, places that have already been developed and have available road or sewer capacity. Redevelopment as a serious initiative in New Castle County began with the passage of the first redevelopment ordinance in 2003 (*New Castle County Ordinance 03-069*) and evolved with
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three additional amendments in 2004 (New Castle County Ordinance 04-054), 2006 (New Castle County Ordinance 06-007), and 2008 (New Castle County Ordinance 08-001) to further incentivize redevelopment.

Essentially, redevelopment allows us to reconcile the tension between preservation of open space and greenfields with the need for land for future growth, while reducing the impact of future growth on County budgets. Studies have shown that sprawl growth into previously undeveloped rural areas typically costs local governments more in future service demands than it generates in future tax revenues. See Sierra Club, How Your Taxes Fuel Suburban Sprawl, Spring 2000, available at http://www.sierraclub.org/sprawl/report00.

While some citizens assume that a county government in a recession will encourage residential sprawl in order to benefit from increased transfer tax revenue, it is clear that this strategy would simply cost county taxpayers more in the long term. Since refocusing our efforts on redevelopment, a total of 8.7 million square feet of redevelopment plans and 61 projects have been approved in New Castle County alone. Further work needs to be done to invest in infrastructure and to revise codes to ensure redevelopment continues to be a strong part of our County’s future.

Another main goal of the County’s Comprehensive Development Plan is the creation of a diverse housing stock. With the adoption of the Unified Development Code (UDC) came residential housing selling for more than $400,000 due to the cost of building. We developed the workforce housing ordinance as a way to provide developers incentives for voluntarily agreeing to set aside 20 percent of new residential developments to be sold at an affordable rate for 15 years.

Critics of the program argue that the housing market crash eliminated the need for affably priced housing, but that view takes only the immediate situation into account instead of looking at the medium and long terms. In fact, the only segment of the local housing market where current inventory is being sold rapidly is in the “affordable” range ($160,000 to $280,000).

The workforce housing plans currently moving through the County land use process will not be fully built out for at least another three to five years, when they will help ensure the continuation of an affordable sector in our market for another decade. Our collective focus on the immediate economic situation is understandable, but it is vital that we not lose sight of the need for housing that working families can continue to afford once our economy recovers and housing prices begin bouncing back to previous levels.

Additional areas of ongoing change in our County building code include revisions to the Mixed Use and Village/Hamlet sections of the UDC, which are designed to encourage modern development styles that incorporate places to work, shop and live into better-planned communities. This further reduces the need for new transportation infrastructure and promotes efficient use of our remaining land resources.

We are working on legislation that will add new use categories for incubator businesses, high-tech, biotech, life sciences and other technology-related industries that will permit them within our commercial business, office park and light industrial zoning districts and provide incentives that increase building density and reduce opacity, landscaping and open space ratios. These amendments will encourage small businesses to locate and expand in New Castle County.

The Enhanced Review Process ordinance will streamline our land use process, provide for certainty, engage state agencies earlier and allow the public to have more meaningful input. While appropriately streamlining our processes, we must maintain a role for the civic community and not lose sight of the quality of life which we enjoy in New Castle County.

Welcoming New Businesses to New Castle County

It is also important to recruit new companies to our area. The planned relocation of technology units to the Aberdeen Proving Ground represents a great opportunity to attract new business and grow our economy. The Aberdeen BRAC (Base Realignment and Closure Committee) is expected to bring about 28,000 technology-based jobs to the region by 2011.

New Castle County was an early leader in doing its part to attract military contractors to Delaware. In 2006, New Castle County joined Baltimore, Harford and Cecil counties in Maryland to sign a Memorandum of Agreement creating the Chesapeake Science and Security Corridor, which meets to address regional coordination and planning to support the military build-out through 2012.

The Aberdeen build-out represents a great opportunity for governments to
cooperate with the private sector to attract new businesses to our area. Several initiatives are now underway to address these long-standing issues. First, state and County officials – from the Governor and Executive offices on down – have come together to establish strong, regular working relationships between our internal offices responsible for growth. We recently announced the creation of a new County-State Rapid Response Team to facilitate quick resolution of issues related to the review and consideration of significant economic development projects.

We also have convened weekly meetings between the relevant economic development leaders to improve State-County communications on ongoing strategies to recruit and retain employers. Efforts are underway to further streamline the permitting and licensing process at the state and local levels to remove one more regulatory hurdle.

**The Path Forward**

A combination of hard budget decisions and stimulus funding have shored up the state and local budgets for the current year, but more difficult decisions lie ahead as the recession continues and governments continue to see declining revenues.

Serious discussions about ways to improve services while reducing areas of overlap and inefficiency between state and local governments must begin, and some valued but non-essential services may have to end.

In County government, we continue to look at our operations and seek ways to improve efficiencies. As our limited revenue sources are all tied to the value and use of property, only a strong recovery will restore County revenues to the robust growth experienced during the housing boom of the last decade.

We must make wise choices in the year ahead to encourage sustainable growth, and to ensure the services we provide are essential and valued.
It is predictable and understandable that the financial crisis, now entering its third year, has caused many to propose federal economic and financial reforms and regulation, including some that would encroach — either directly or indirectly — on internal corporate governance, an area currently controlled by state corporation law.

Many of the proposed changes are necessary and for the better. The financial markets need to be restructured in material respects; the problem of too-big-to-fail needs to be addressed; and the economic strength of the middle class needs to be improved and protected.

Many of the proposed changes also are not necessary, are misguided and will result in unintended, adverse consequences. More than a few babies may be thrown out with the bathwater. The final tally of the good changes versus the bad changes will be written by historians decades from now, and they will marvel at our wisdom or our stupidity — and, probably, both.

While the ultimate fate and wisdom of most of these proposals is unresolved at this writing, they raise two important questions. Did Delaware corporate law contribute in some way to the financial crisis, and are changes to internal corporate governance a remedy to any of the problems that caused the financial crisis?

The financial crisis has numerous causes, but one thread weaves its way through many, although not all of them. In the modern gilded age of the past 30 years, we have accomplished good things, but the pursuit of money, power and fame has become the primary
objective of far too many.

Doing a good job or accomplishing a meaningful contribution to long-term economic prosperity have become secondary concerns, only relevant to the extent they lead to wealth, fame or power.

Some may contend that this critique is both too harsh and too simplistic, and it would be if it were offered as the whole explanation. But it is a significant enough component of what went wrong that we cannot ignore it.

In one sense, it is as simple as the “golden rule” to treat others as you hope to be treated. If each of us were asked whether we want decisions that affect our lives made on the basis of what is in the long-term interest of our community or in the short-term interest of the person making the decision, I cannot imagine any of us would choose the latter.

Yet too many of us (this author included) find it too easy to do what is in our selfish, short-term interest regardless of the long-term consequences to others and ourselves.

In a world governed by the Golden Rule we would not: (a) issue mortgages to people who cannot repay them on the theory that we can foreclose on their homes and sell them for the amount of the debt; (b) sell securities of packaged subprime debt relabeled as AAA debt by compliant rating agencies to investors who do not understand the underlying risk they are incurring; (c) use our credit cards to buy more than we can afford or cause our public or private institutions to incur more debt than can ever be repaid; (d) fund and develop weapon systems that even the Pentagon does not want or deregulate huge markets we do not understand because it serves the interest of campaign contributors; (e) ignore environmental danger because there is a present-day cost of fixing the danger, even when the present cost is much smaller than the long-term cost of not addressing the problem; or (f) rescind the health care insurance of a critically ill person because of an unintentional and irrelevant error on an insurance application.

The litany could continue and culminate in Bernard Madoff and other financial frauds or abuses being uncovered.

The simple truth behind this elementary principle of practical human ethics has been given more elaborate treatment in many places. In Non-zero: The Logic of Human Destiny, Robert Wright explains the operation of this principle throughout history in terms of “game theory.” In essence, economic and social structures that produce “non-zero” sum interactions — interactions in which both parties gain or lose together — prevail in the long term over economic and social structures that promote “zero sum” interactions — interactions in which one party gains only from the loss of the other.

In The Origin of Wealth: Evolution, Complexity and the Radical Remaking of Economics, Eric Beinhocker — a senior advisor to McKinsey & Company — explains how “reciprocal altruism” is necessary to the successful operation of any economic order. Trust is as intrinsically necessary to a healthy economy as it is to non-economic relationships, and trust is based upon confidence that our sacrifices for others will be reciprocated when we need them to sacrifice for us.

The critical need now is to grasp that this diagnosis is not “pie-in-the-sky” idealism or simple-minded moralizing. It is at the core of what went wrong. And reform does not require us to become saints or to forsake the pursuit of wealth, power or fame. It simply requires a change in priorities, so that wealth, power and fame are the hoped for byproducts of our primary objective: doing the right thing or doing a good job.

But this lesson is far from learned. As the crisis fades and things return to normal, we risk creating an economic problem in the future that we will be unable to cure if, collectively, we do not shift our priorities.

Three columns in the Sept. 8 New York Times evidence awareness of this same problem. Conservative David Brooks asks, “Can the state do anything to effectively promote virtuous behavior? Because when you get into the core problems, whether in Washington, California or Wall Street, you keep seeing the same moral deficiencies: self-indulgence, irresponsibility and imprudence.”

Liberal Bob Herbert “wonder[s] if the country isn’t going through a nervous breakdown … We’ve forgotten many of the fundamentals: how to live within our means, the benefit of shared sacrifice, the responsibilities that go with citizenship, the importance of a well-rounded education, and tolerance.”

Even Oliver Stone is preparing a sequel to his 1987 movie Wall Street, where Gordon Gekko (played by Michael Douglas) famously declared that “greed is good.” In his article about the coming sequel, Michael Douglas, who played Gekko in the original movie, says that many young people told him that they sought jobs on Wall Street because they admired Gordon Gekko, who was sent to prison at the end of the movie.

What does this have to do with Delaware corporate law? If the financial crisis is caused by a misguided cultural emphasis on money, power and fame, certain types of regulation will not be helpful in curing the problem and avoiding a repeat of the crisis.

The most obvious implication is that changing the process by which decisions are made — and maybe even changing the decision-makers — will not lead to any improvement if those processes and decision-makers are part of the same cultural attitudes that produced the problems in the first place. Almost by definition, corporate governance concerns process. It involves the process by which business decisions are made...
and the process by which the persons who will make those decisions are chosen.

Mandating changes to corporate governance will not alter the culture that affects the decision-makers, and we have proof of this lack of effectiveness. Sarbanes-Oxley was passed years ago in response to the last financial crisis. It sought to improve corporate governance in various respects. State law also was amended subsequent to the last crisis to provide stockholders with greater power in selecting directors.

And yet after these governance reforms the excesses and abuses only expanded and became worse — because little was done about the culture. Changes in corporate governance will be as inconsequential this time as they were last time if the culture does not change; changes in corporate governance will not be needed if the culture does change.

Worse, some changes in corporate governance may exacerbate the cultural problem. Many of the changes being considered are designed to enhance the power of stockholders within the corporation. The theory is that stockholders will hold directors accountable for the excesses and abuses committed by boards of directors or management.

But the theory is flawed because the stockholders who are being empowered are not your next-door neighbors who are appalled by Wall Street “wheeling and dealing.” Rather, the stockholders being empowered are financial institutions who are deeply embedded in and likely the genesis of the very culture that has failed us.

By definition, these institutions are primarily concerned with the profits derived from their investments and are only secondarily concerned with the quality of the service or goods provided by a corporation when it affects profits. Moreover, these institutions have time horizons as short as nanoseconds — evidenced by the computerized trading now being discussed in the financial press — and no longer than several years when investors in their funds or institutions demand their investments be repaid. They hope to reap their profits before long-term problems caused by their strategies become evident.

This diagnosis also has implications for how Delaware responds to proposals to regulate corporate governance. First, we need to directly confront the proposition — recently advanced by the SEC — that poor corporate governance was one of the significant causes of the financial collapse.

While the corporate decision-makers were, almost by definition, responsible for bad decisions made by corporations, it was not the governance process that contributed to the problem. It was the culture; and the culture affected more than American business. It extends to many public and private institutions.

The irony is that those decision-makers may be just as happy as the SEC to blame their process — and not their own attitudes and beliefs — as the cause of the problem.

But Delaware may not succeed — despite the arguments and analysis — in persuading others that mandated changes in corporate governance are unnecessary and may be counterproductive. Regulatory reform may encroach upon corporate governance in a variety of respects — some direct and some indirect.

So we come to the question posed in the title to this piece. Is the bell of regulatory reform tolling for Delaware corporate law? Will these changes, if they occur, be the end of Delaware corporate law as we have known it? Will federal intervention cause the neutering of Delaware law? I think not. I believe that for many reasons, but two are most basic.

First, we have been here before and survived to tell of it. State corporation laws have flourished despite regulatory reforms in the Progressive Era and the New Deal. Then, as now, some of those reforms — such as laws regulating the proxy process for publicly-traded Delaware corporations — impacted directly or indirectly the corporate governance of state-chartered corporations.

Second, past reforms did not diminish the efficacy of Delaware and other state-chartered corporations because the Delaware corporate law serves important purposes that will exist despite any reforms that may be enacted. The corporate laws are designed to provide the flexibility and freedom to facilitate private enterprise. Over the arc of a century, those laws have been remarkably successful at facilitating private enterprise and that enterprise has created not simply a wealthier America, but also a more ethical and caring America.

Whatever reforms are enacted — needed or otherwise — the goals behind the Delaware corporate law will remain as vital as they always have been — maybe even more so as the economy attempts to grow. The goals of reducing financial abuse and facilitating enterprise are not mutually exclusive. In the long run they reinforce each other.

Arguments against misguided efforts to regulate internal corporate governance ought not blind us to the reality that Delaware corporate law will play a vital role in the American economy regardless of whether those regulations are enacted or not. The bell may be tolling, but it ought not be tolling for the important function played by state incorporation law in promoting private enterprise.

Delaware needs to highlight this fundamental truth. We might not like certain regulatory changes, but the goals being served by Delaware corporate law will remain as important in the next 100 years as they were in the past, regardless of the proposed regulatory changes, and we ought not be arguing otherwise. ☑
FEATURE

(Continued from page 32)

in the process. With that outcome, Delaware joins 25 other states in having Democratic control of both chambers of the state legislature.


**Present Conditions**

While the political climate still heavily favors Democrats within Delaware, there are a number of challenges facing elected officials. Although he won the governorship in impressive style, Jack Markell’s outsider status during his party’s primary has somewhat reappeared during his service as chief executive.

Rather than counting on permanent Democratic majorities for backing on legislative priorities, the Markell administration has had to cull together short-term coalitions. Further, there have already been complaints by Republican party leaders that they are being ignored rather than consulted in the passage of bills.

The state’s financial crisis is not unlike that being experienced on a national level. Delaware suffered the loss of large businesses in the automotive and banking areas. Though somewhat lower than the national average, Delaware unemployment has hovered above 8 percent for much of 2009.

Amid having to eliminate an $800-million deficit, Delaware officials reduced spending in the 2010 budget from the previous year, the first time that transpired in more than a decade. Given these economic woes, Delaware Republicans have the opportunity to propose alternatives to those favored by Democrats.

In the current political environment, it probably does not make sense for a Republican to consider running for higher office in Delaware. Yet, Michael Castle is hoping to exchange his U.S. House seat for one in the U.S. Senate. With Senate appointee Ted Kaufman stepping down in 2010, the seat will be in play in the midterm election.

Whether or not Delaware Attorney General Beau Biden declares himself a candidate for the U.S. Senate, Castle stands better than a 50-50 chance in breaking the Democratic string of Senate victories in the state. He will surely be aided by the declining popularity of President Barack Obama during the second half of 2009 together with the routine loss of seats belonging to the president’s party in midterm election years.

**Future Projections**

A number of signs point to long-term Democratic majorities in Delaware politics. Not least among these is the pattern of migration to the state, which has included an increase in young and minority voters along with immigrants. Among black voters and those aged 18-29, both of which comprise approximately a fifth of Delaware citizens, Barack Obama defeated John McCain by 99-1 percent and 71-25 percent respectively.

Though the average Delaware voter is a Caucasian male with a high school education in a white-collar, private-sector job, the latter figures portend consistent Democratic support by a significant percentage of the electorate.

There are certainly advantages to being designated as a “blue state,” or one with Democratic majorities at all levels of government. The fact that both the national and state executive branches are controlled by Democrats means that there may be more similarity in certain intergovernmental priorities than otherwise.

Same-party control of the governorship and state legislature also provides the potential for productive policy output. Of course, that is not a guarantee of success or smooth sailing, as the process of passing the sports betting proposal recently demonstrated.

With Democratic party registration nearing 50 percent of registered voters in Delaware, Republicans will have to rely on conversion strategies during campaigns and split tickets on election day.

Finally, having a Democratic governor and Democratic majorities in the General Assembly will make it easier for the party to solidify its gains during post-2010 reapportionment.

There are drawbacks to Democratic dominance as well. With same-party control of both the governorship and state legislature, the Democrats will be counted on to quickly turn around the economic crisis. Just as voters nationally defeated the incumbent president’s party in the 1992, 2000, and 2008 elections and reversed party control of Congress in 1994 and 2006, so Delaware voters could be similarly intolerant of scandal, unpopular policies, or ineffectiveness in future races.

Ironically, another casualty of being tagged as a solid “blue state” is that, because of Delaware’s small population and paucity of both delegates and electoral votes, it is unlikely that presidential candidates will be motivated to afford Delaware any special attention.

In the end, it is unlikely that Delaware will ever abandon a strong two-party tradition, albeit one with alternate majorities between Democrats and Republicans.

For now, Sussex County remains a bastion of Republican strength, as it has been for generations. Delaware’s geographical location along the Mason-Dixon line won’t change any more than its schizophrenic history dealing with slavery. Finally, Delaware retains a tradition of unity beyond political party differences in its Return Day event and in its status as the First State to ratify the American Constitution.

FALL 2009 DELAWARE LAWYER 31
Delaware’s Changing Political Landscape

The party controlling the State sets business policy. Can the Democrats’ hegemony last?

As we near completion of the first decade of the 21st century, Delaware’s political climate is changing. These trends have had a discernible impact on governance within the state. Each party has had a strong tradition in Delaware, taking turns at dominance. Changing demographic and policy trends are creating new political behavior in the Diamond State.

Delaware’s Party History Since The Civil War

Events during the Civil War — including the invasion by Union soldiers to disarm militants, the suspension of habeas corpus rights, the imprisonment of suspected Southern sympathizers and the required oaths of loyalty to the Lincoln administration — led to a three-decade dominance by the Democratic Party in Delaware against national trends.

Between 1866 and 1896 Democrats won eight of nine gubernatorial elections and 13 of 16 U.S. House elections. Additionally, Democrats took the state in every presidential election from 1864 through 1892 except 1872.

The realignment of 1896 brought Delaware in line with national party dynamics favoring Republicans. From 1900 to 1932, Republicans won all nine gubernatorial elections in Delaware. From 1898 through 1932, Republicans controlled the General Assembly for 26 of 36 years, including 18 years of simultaneous control of both chambers.

In U.S. House contests between 1898 and 1932, Republicans were victorious in 13 of 18 elections. Delaware voted Republican in every presidential election from 1896 to 1932, except 1912.

The period from 1936 to 1996 was one of relative equity for Delaware Democrats and Republicans in electing candidates to office. Though Franklin Roosevelt carried the state in each of his last three presidential races, Delaware voters backed Republican candidates in eight of the ensuing 11 presidential elections. During this period, Delaware voted for the eventual winning candidate for president in every election from 1952 through 1996.

The results of other races displayed similar partisan balance: Republicans captured nine of 15 gubernatorial contests, 12 of 18 U.S. Senate elections, and 16 of 29 U.S. House elections over the 60-year span.

From 2000 On, A Blue State

The process of Delaware becoming a predominantly Democratic state politically did not occur overnight but started in earnest in 1992. In that year Delawareans elected a Democratic president, Bill Clinton, and Democratic governor, Thomas Carper, both of whom were reelected by the state’s voters in 1996.

In 2000, Delaware lost its bellwether status by supporting Democrat Al Gore for president. Likewise in 2000, Carper defeated long-serving Republican William Roth for the U.S. Senate and Democrat Ruth Ann Minner was elected as the first woman governor of Delaware.

Delaware voters continued to support Democrats for national office in 2002 by reelecting Joe Biden to the U.S. Senate. In 2004, Delaware stayed with Democrats against national trends, supporting John Kerry for president and reelecting Minner as governor. Although the 2006 midterm election resulted in large Democratic gains in Congress, Delaware elections that year maintained the status quo.

A confluence of factors produced overwhelming Democratic gains in Delaware during the 2008 election cycle. First, the unpopularity of incumbent president George W. Bush negatively affected Republicans at all levels. By the time the election was held, three-quarters of Delaware citizens disapproved of Bush’s job performance. Second, voters backed charismatic but non-establishment candidates for president and governor in Barack Obama and Jack Markell. Third, Delaware’s population continued to increase among the young and immigrants; both groups strongly supported Democratic candidates and policies. Fourth, partly as a result of these factors, new voter registration surged and most affiliated with Democrats. Finally, Joe Biden’s selection as vice presidential nominee gave Delaware voters an extra incentive to back his party.

The outcome of the 2008 election left no doubt about the continuing Democratic influence in Delaware politics. Presidential candidate Barack Obama won Delaware with 61.9 percent of the popular vote, which was one of the five largest margins of victory among all states where the Democrat triumphed. Though he vacated his seat after winning the vice presidency, Joe Biden won reelection to the U.S. Senate with 65 percent of the vote.

Democrats not only registered strong gains legislatively at the national level, but at the state level as well. Republicans lost a total of seven seats in the Delaware General Assembly, and ceded control of the long-held House of Representatives (Continued on page 31)
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