



DELAWARE HIGH COURT EMPOWERED TO ANSWER FORMAL QUESTIONS FROM SEC

by
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Earlier this year, an amendment to the Delaware State Constitution became effective to permit the U.S. Securities and Exchange Commission (the “SEC”) to certify to the Delaware Supreme Court questions of law.¹ The amendment is intended to enhance the coordination between the SEC, which is charged with enforcing federal securities laws that govern publicly traded companies, and the Delaware Courts, which interpret the Delaware General Corporation Law (“DGCL”) that governs the internal affairs of a majority of those companies.

The federal securities laws and Delaware corporation law are largely consistent and compatible. Through its prescriptive and detailed requirements, federal securities regulation seeks to ensure that publicly traded companies make fair disclosure of their affairs to their stockholders through a comprehensive system of reporting and proxy regulation. By contrast, the DGCL is a broad enabling statute that aims at giving Delaware chartered corporations flexibility in ordering their internal affairs and management. Indeed, the compatibility of the Delaware and federal systems and the desirability of maintaining federal regulation of the securities markets with State control of chartering is well established. As explained by Brian G. Cartwright, SEC general counsel in a press release announcing the enactment of the amendment: “In our constitutional system, federal and state law coexist side by side, each with its distinctive role. As a result, the administration of the federal securities laws often requires interpretation of state laws. I am delighted that the SEC now has this new ability to obtain definitive answers to important questions of Delaware law.”² Delaware, like most state courts, already had a certification procedure in place that allows federal and other states’ courts to seek definitive interpretations of Delaware law. DELAWARE SUPREME COURT RULE 41. Delaware is the first state to permit the SEC to bring questions to its courts, reflecting the unique role the Delaware court’s hold in adjudicating corporate law disputes and the significance of Delaware corporation law generally.

Despite their similar goals, at some points along their adjoining borders, federal securities regulation and Delaware corporation law do not mesh as neatly as they might. Two recent cases show this uneasy overlap: *New Castle Partners L.P. v. Vesta Insurance Group, Inc.*, 887 A.2d 975 (Del. Ch.),

¹The amendment changed Article IV, § II, paragraph (8) of the Delaware Constitution of 1897. The amendment is codified at Delaware Supreme Court Rule 41(a).

²The press release is available at <http://courts.delaware.gov/Courts/SupremeCourt>.

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affirmed, 2005 Del. LEXIS 463 (Del. Supr. Nov. 16, 2005), and *Esopus Creek Value LP v. Hauf*, 913 A.2d 593 (Del. Ch. 2006).

In *New Castle Partners*, Vesta Insurance Group, Inc. attempted to defend its failure to schedule an annual stockholder meeting to vote on the election of directors on the basis that it had not produced its financial statements, it could not produce a proxy and, as a result, was incapable of holding an annual meeting. Federal securities regulation governing the dissemination of proxies requires that a corporation include its current financial statements in a proxy statement sent to its stockholders in connection of a corporation's annual meeting, where directors are typically elected. If the corporation cannot complete its financial statements, it cannot produce a proxy statement that would allow it to solicit proxies. Thus, without a proxy, Vesta could not, as a practical matter, hold an annual stockholder meeting to elect directors. Section 211 of the DGCL gives stockholders the right to compel an annual stockholders meeting if one has not been held for more than thirteen months since the last annual meeting. In *New Castle Partners*, the Delaware Court of Chancery ruled that, notwithstanding Vesta's inability to comply with federal proxy regulation, Section 211 required it to hold an annual meeting to elect directors anyway.

Similarly, Section 271 of the DGCL requires a stockholder vote before a corporation can sell "all or substantially all of its assets." In *Esopus Creek*, a stockholder, Esopus Creek Value L.P., successfully enjoined Metromedia International Group, Inc. from completing a sale of substantially all of its assets without holding a stockholder meeting. One of Metromedia's defenses was that it could not hold a stockholder meeting because it had been unable to issue financial statements and thus could not prepare a proxy in conformance with federal securities regulation. The Delaware Court of Chancery rejected this defense.

Both these decisions highlight that there has been no ready mechanism through which the Delaware courts and the SEC to consult with each other to resolve apparent conflicts or ambiguities between Delaware corporation law and federal securities regulation. The new certification process only provides a partial solution to this problem by opening a channel through which the SEC can put questions to the Delaware Supreme Court and obtain authoritative guidance. It does not address the dilemma Delaware courts face when asked to predict how the SEC would interpret its rules and regulations.

It is an open question how effective the certification process will be. *First*, it depends on the SEC seeking to have questions certified. It is not clear how often the SEC will use the certification mechanism and under what circumstances. *Second*, the amendment only opens the channel one way. As suggested by both the *Newcastle Partners* and *Esopus Creek* decisions, it may be more typical for the Delaware courts (or the parties before them) to need guidance concerning the SEC's position under the federal securities laws, than for the SEC to need the Delaware Court's guidance concerning Delaware corporation law. Although private parties can seek some guidance on the SEC's stance on a limited range of issues by seeking no action, interpretative, and exemptive letters, there remains no easy way for the Delaware courts to certify questions to the SEC.

Nonetheless, acknowledging the need for direct communication between the Delaware courts and the SEC and formalizing the method for those communications to take place (albeit only in one direction) is a significant step forward. The harmonization of corporations' obligations under the federal securities laws and Delaware corporation law would seem desirable for the corporations themselves and to promote comity between the federal and state systems.³ Corporations and their constituents should welcome a new method to reconcile potentially inconsistent obligations they may face under the federal and state statutory schemes. With hope it is a harbinger of even greater cooperation between the United States' leading state of corporation and the leading regulator of its financial markets.

³Leo E. Strine, *The Delaware Way, How We Do Corporate Law and New Challenges for Free Market Economies*, Washington Legal Foundation, WORKING PAPER No. 133 at 20-25(Sept. 2005) (noting the need for federal regulatory authorities to "stay in their lane").