EFiled: Jan 23 2023 09:07AM EST
Transaction ID 68952435
Case No. 2018-0408-KSJM

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

RICHARD J. TORNETTA, derivatively on behalf of all other similarly situated stockholders of TESLA, INC., Plaintiff, v. ELON MUSK, ROBYN M. DENHOLM, ANTONIO J. GRACIAS, JAMES MURDOCH, LINDA JOHNSON RICE, BRAD W. BUSS, and IRA EHRENPREIS, Defendants, and TESLA, INC., a Delaware corporation, Nominal Defendant.	:	C.A. No. 2018-0408-KSJM

AMICUS CURIAE BRIEF OF PROFESSOR CHARLES M. ELSON IN SUPPORT OF PLAINTIFF

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I. STATEMENT OF *AMICUS CURIAE*'S INTEREST IN THE CASE

Professor Charles Elson is the retired Edgar S. Woolard, Jr. Chair in Corporate Governance and the founding Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. He has published extensively on the subject of executive compensation and writes to provide the Court with broader context about the development and goals of equity-linked executive compensation.

II. INTRODUCTION

Elon Musk is not unique. Musk is an archetype that we have seen before and will see again: a confident, charismatic founder[1] with world-class sales ability and a "reality distortion field"[2] that inspires outsized enthusiasm in customers and employees alike. Musk is very special, but he is not a one of a kind.

Bill Gates. Jeff Bezos. Mark Zuckerberg. Larry Brin. Sergey Page. Not one was an "ordinary executive" or "typical CEO."[3] Each was "intimately involved in

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[1] Musk did not actually found Tesla, but he was a very early investor and its fourth CEO. Lora Kolodny and Erin Black, *Tesla founders Martin Eberhard and Marc Tarpenning talk about the early days and bringing on Elon Musk*, CNBC (Feb. 6, 2021), https://www.cnbc.com/2021/02/06/tesla-founders-martin-eberhard-marc-tarpenning-on-elon-musk.html.

[2] First applied to Steve Jobs, the idea of a "reality distortion field" has also been applied to Musk. Richard Waters, *Elon Musk, billionaire tech idealist and space entrepreneur*, FINANCIAL TIMES (Sept. 30, 2016), https://www.ft.com/content/8ca82034-86d0-11e6-bcfc-debbef66f80e.

[3] Defs' PTB 4.

all aspects of [their companies'] operations," and "instrumental in transforming" it.[4] Each had "a proven track record of visionary, transformational leadership[.]"[5]

None was paid like Elon Musk.

Just the opposite. After Facebook went public, Zuckerberg took a $1 annual salary with no stock compensation.[6] Same for Sergey Brin and Larry Page when Google went public.[7] After Amazon's IPO, Jeff Bezos' salary never exceeded $100,000 a year, and he never took a stock award.[8] When Microsoft went public, Bill Gates was paid as much $1 million per year in cash. He never took a stock award.[9]

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[4] *Id.*

[5] *Id.*

[6] Jena McGregor, *Mark Zuckerberg Joins The $1 Salary Club*, WASHINGTON POST (Apr. 3, 2014), https://www.washingtonpost.com/news/on-leadership/wp/2014/04/03/mark-zuckerberg-joins-the-1-salary-club/.

[7] Stephen Shankland, *Top Google execs: $1 salary, no bonus, no options*, CNET (Mar. 25, 2009), https://www.cnet.com/tech/services-and-software/top-google-execs-1-salary-no-bonus-no-options/. In 2013, Page and Brin received their pro rata share of a newly created class of non-voting Class C shares in a reclassification. The reclassification helped protect Page and Brin's voting control but did not increase their economic stake in the company.

[8] Tomi Kilgore, *Amazon CEO Jeff Bezos has had the same 'low salary' for decades, a little more than double the median U.S. employee's pay*, MARKET WATCH (Apr. 17, 2020), https://www.marketwatch.com/story/amazon-ceo-jeff-bezos-has-made-the-same-salary-for-decades-a-little-more-than-double-the-median-us-employees-pay-2020-04-16.

[9] Wayne Guay, *Stock Options: The End of the Affair?*, KNOWLEDGE AT WHARTON (July 30, 2003), https://knowledge.wharton.upenn.edu/article/stock-options-the-

These executives are not ascetics. Rather, they—and the boards that set their compensation—recognized that their large, preexisting ownership stakes were sufficient incentive to grow the companies they had built:

- "Messrs. Gates and Ballmer do not receive equity-based pay from the Company because they already own a significant amount of Company stock."[10]

- "Larry and Sergey have voluntarily elected to only receive nominal cash compensation. As significant stockholders, a large portion of their personal wealth is tied directly to Alphabet's stock price performance, which provides direct alignment with stockholder interests."[11]

- "Due to Mr. Bezos's substantial stock ownership, he believes he is appropriately incentivized and his interests are appropriately aligned with shareholders' interests. Accordingly, Mr. Bezos has never received any stock-based compensation from Amazon."[12]

- "Mr. Zuckerberg did not receive any additional equity awards … because our compensation & governance committee believed that his existing equity ownership position sufficiently aligns his interests with those of our stockholders."[13]

Every word could apply with equal force to Musk who owned 21.9% of Tesla at the time of the award. The massive grant was unnecessary to incentivize Musk or

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end-of-the-affair/.

[10] Microsoft, Annual Proxy filed on Schedule 14A (Oct. 4, 2006) at 14.

[11] Alphabet, Annual Proxy filed on Schedule 14A (Apr. 29, 2016) at 30.

[12] Amazon, Annual Proxy filed on Schedule 14A (Apr. 14. 2022) at 92.

[13] Facebook, Annual Proxy filed on Schedule 14A (Apr. 12, 2019) at 28.

align his interests with those of Tesla's public stockholders. And it has ushered in a new era of outsized awards for other executives. The award was unfair.

III. ARGUMENT

A. Equity-Linked Executive Compensation Is Designed To Align The Interests Of Managers And Owners

Equity compensation for corporate executives was designed to solve a specific problem at a specific time in American corporate history. The great trusts of the Gilded Age presented many challenges,[14] but a lack of motivation for corporate managers was not one of them. This was "the era of 'robber barons' or 'titans'—men like J.P. Morgan or Andrew Carnegie" who owned large stakes in the sprawling trusts that they ran and ruthlessly pursued their own self-interest.[15] "The middle of the twentieth century, in contrast, was the era of *The Man in the Gray Flannel Suit*," professional managers with little skin in the game.[16]

Executive equity compensation was designed to motivate the latter, not the former. It is not a novel suggestion that, in many ways, the history of modern corporate law begins with Berle and Means in 1932 who wrote that "in the largest American corporations, a new condition has developed .... [T]here are no dominant

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[14] *See generally* H.W. Brands, AMERICAN COLOSSUS: THE TRIUMPH OF CAPITALISM, 1865-1900 (2011).

[15] Amy Deen Westbrook & David A. Westbrook, *Unicorns, Guardians, and the Concentration of the U.S. Equity Markets*, 96 NEB. L. REV. 688, 694 (2018).

[16] *Id.*

owners, and control is maintained in large measure apart from ownership."[17] By the mid-20th century, most public companies were so-called "Berle-Means corporations":[18] companies with a widely dispersed stockholder base of passive investors run by professional managers with a minimal equity stake in the business.[19] "This separation" of ownership from control "and its consequences have provided the basic tension animating corporate law theory" ever since.[20]

The agency costs of a Berle-Means corporation run by salaried managers provided one of the primary intellectual justifications for the leveraged-buyout wave of the 1980s. "By reducing the separation between ownership and control, LBO firms diminish managerial agency costs and seem to offer a dramatically more efficient alternative to the traditional publicly held firm."[21]

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[17] Adolf A. Berle & Gardiner C. Means, THE MODERN CORPORATION & PRIVATE PROPERTY 117 (1932).

[18] The phrase was coined in Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 14 (1991).

[19] *See, e.g.*, Brian R. Cheffins, *The Rise and Fall (?) of the Berle-Means Corporation*, 42 SEATTLE U.L. REV. 445, 452-54 (2019).

[20] Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 683 (2011).

[21] David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1390 (1998); *see also* Robert Teitelman, BLOODSPORT: WHEN RUTHLESS DEALMAKERS, SHREWD IDEOLOGUES, AND BRAWLING LAWYERS TOPPLED THE CORPORATE ESTABLISHMENT 97 (2016) ("agency theory … would usher in a new rationale for M&A, mobilize the law professors, and send them into battle with a waiting Marty Lipton.").

The 1980s saw a similar drive to reduce the misalignment between the corporation's managers and its owners through a revolution in executive compensation. "Historically, executive compensation packages were cash-intensive, primarily comprised of cash salaries and bonuses."[22] "From the late 1930s through to the mid 1970s the pay executives received declined … on an inflation-adjusted basis" and "linking pay to performance … was not a priority."[23]

Beginning in the 1980s, however, "pressure built on companies to stop paying their executives like bureaucrats and to strengthen the link between pay and performance. Companies responded by using much more equity-based compensation … and pay/performance sensitivity increased" dramatically "accompanied by sky-rocketing managerial pay."[24] In 1993, Congress added fuel to this trend by adopting Section 162(m) of the Internal Revenue Code, which imposed strict limitations on the deductibility of non-performance-based executive

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[22] Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 977 (2004).

[23] Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 13–14 (2015) (cleaned up).

[24] *Id.* (cleaned up); *see also* Nitzan Shilon, *Replacing Executive Equity Compensation: The Case for Cash for Long-Term Performance*, 43 DEL. J. CORP. L. 1, 8 (2018) ("Equity pay costs are so high that, since it was introduced in the early 1980s, CEO compensation rose almost tenfold, doubling the growth in the stock market and making the gap between CEO pay and that of the average worker ten times larger.").

compensation in excess of $1 million per year. "Section 162(m) had the effect of shifting top level executive compensation [even further] toward equity-based compensation, particularly compensatory stock options."[25] Executive equity compensation has continued to spiral ever higher ever since.

B. Defendants Ignored The Purpose Of Equity-Linked Compensation In Crafting Musk's Award

Amicus was—and remains—a strong proponent of equity-linked compensation. He has written that "substantial director equity ownership … leads to better management monitoring."[26] And he served on the National Association of Corporate Directors' Best Practices Council on Preventing Fraud when it issued a report recommending "[b]road-based equity ownership throughout the organization by management, directors, and employees" as "the most effective motivation for continuous vigilance throughout the organization."[27] But equity compensation is a means to an end. It is a tool that should be used only to the extent necessary to accomplish the underlying goal: aligning management's interests with stockholders. Defendants ignored this critical point in approving Musk's award.

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[25] Matthew A. Melone, *The Section 83(b) Election and the Fallacy of "Earned Income,"* 10 BERKELEY BUS. L.J. 53, 62 (2013).

[26] Sanjai Bhagat, Dennis C. Carey, and Charles M. Elson, *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885, 918 (1999).

[27] REPORT OF THE NACD BEST PRACTICES COUNCIL: COPING WITH FRAUD AND OTHER ILLEGAL ACTIVITY 16 (1998).

Defendants' pretrial brief recites all of the shibboleths of the pro-equity-compensation movement. They say "[t]he Plan was designed to maximize stockholder value by incentivizing Musk,"[28] "Musk bore the risk associated with the 2018 Plan, while Tesla stockholders got the lion's share of the upside,"[29] and "the Plan motivated Musk to focus his exceptional talents on Tesla."[30] Meanwhile, they argue, "Plaintiff's allegations boil down to the position that Musk should be happy to work for free."[31]

This last assertion is the heart of Defendants' case. And it is flatly wrong. When the challenged award was made, Musk owned 21.9% of Tesla's outstanding common stock.[32] Thus, for every $50 billion dollars that Tesla's market capitalization increased, Musk would personally see a $10.95 billion benefit based solely on his existing holdings. In this critical respect, Musk could not be more dissimilar from the professional managers whom modern equity compensation packages were designed to motivate. As a founder-owner-manager, Musk is more like Gates, Bezos, Zuckerberg, Brin and Page. And like them, Musk's pre-existing

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[28] Defs' PTB 1.

[29] *Id.* at 2.

[30] *Id.* at 7.

[31] *Id.* at 43.

[32] PTO ¶64.

holdings should have been a more-than-adequate incentive for him to do whatever it took to help Tesla grow.

Defendants' pretrial brief studiously ignores the example set by Musk's Silicon Valley (and Seattle) predecessors who took no salary or equity compensation. The sole, glancing reference appears at page 66 where Defendants write that "the Board and its advisors reviewed the growth trajectory and historical performance of certain high-growth disruptive technology companies (*i.e.*, Amazon, Intel, Apple and Google), but understood that these firms do not engage in vehicle manufacture or energy production, limiting the value of the comparison."[33]

In support of this claim, Defendants do not cite a single document that was presented to the Board or its advisors; instead, they point to the report of their litigation expert, Professor Murphy.[34] But Professor Murphy's report stands for the opposite of the proposition for which Defendants cite it. Professor Murphy writes that "[w]hile Tesla manufactures electric vehicles, it is *not* a typical automotive firm," "Tesla is also *not* purely an energy firm," and that "Tesla is arguably *best* compared to 'disruptive technology' firms such as Apple, Alphabet (Google), Amazon, Facebook[.]"[35]

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[33] Defs' PTB at 66.

[34] *Id.* (citing JX1386.0080-81).

[35] JX1386.0079 (emphasis added).

For Musk's award to be justified, Defendants must somehow show that the *marginal* benefit to Musk—*i.e.*, above and beyond the benefits he would obtain from the increase in value of his significant existing holdings—would meaningfully affect his motivations. They make no serious effort to do so.

At best, Defendants can offer Professor Murphy's observation that Musk says he wants to get to Mars, "[a]chieving this objective requires financing well beyond what can be provided by a single private company," "Musk's personal wealth in early 2018 could … likely not finance this venture," and "[a]chieving the market-capitalization hurdles in the 2018 Performance Award … will generate monetary payouts … that could conceivably help Mr. Musk finance his Mars space missions."[36] Almost anything is "conceivable," and, of course, more money would always "help." But as a matter of simple arithmetic, the vast majority of the additional wealth that Musk obtained from increases in Tesla's market capitalization resulted from his existing holdings, not the incremental equity he obtained through the award. Professor Murphy's analysis falls galaxies short of a rigorous showing that the award had any significant effect on Musk's odds of making it to Mars.[37]

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[36] JX1386.0050-51.

[37] The Musk-to-Mars rationale is further undermined by Musk's recent decision to incinerate a significant portion of his net worth by buying an already-unprofitable social media company and destroying its relationship with advertisers.

C. Musk's Award Has Had A Gravitational Pull On The Lake Wobegon World Of Executive Compensation Awards

Finally, the Court should consider the effect that Musk's award has had beyond Tesla. As *amicus* and others have long observed, "executive compensation does not conform to market-based expectations" because "executives cannot acquire the necessary skills to successfully run a company except through actual experience at the company, therefore, executives do not typically move between firms."[38]

In place of normal market forces, most companies rely instead on outside compensation consultants.[39] The problem is that every company thinks its CEO is above-average. "Once the compensation consultant has collected the 'relevant' comparative data on peer compensation, the board almost always decides that it wants the firm to be at the fiftieth percentile of CEO salary or higher. … This leads to an ever increasing ratcheting-up of compensation[.]"[40]

Thus, it comes as no surprise that Musk's playbook was rapidly plagiarized,

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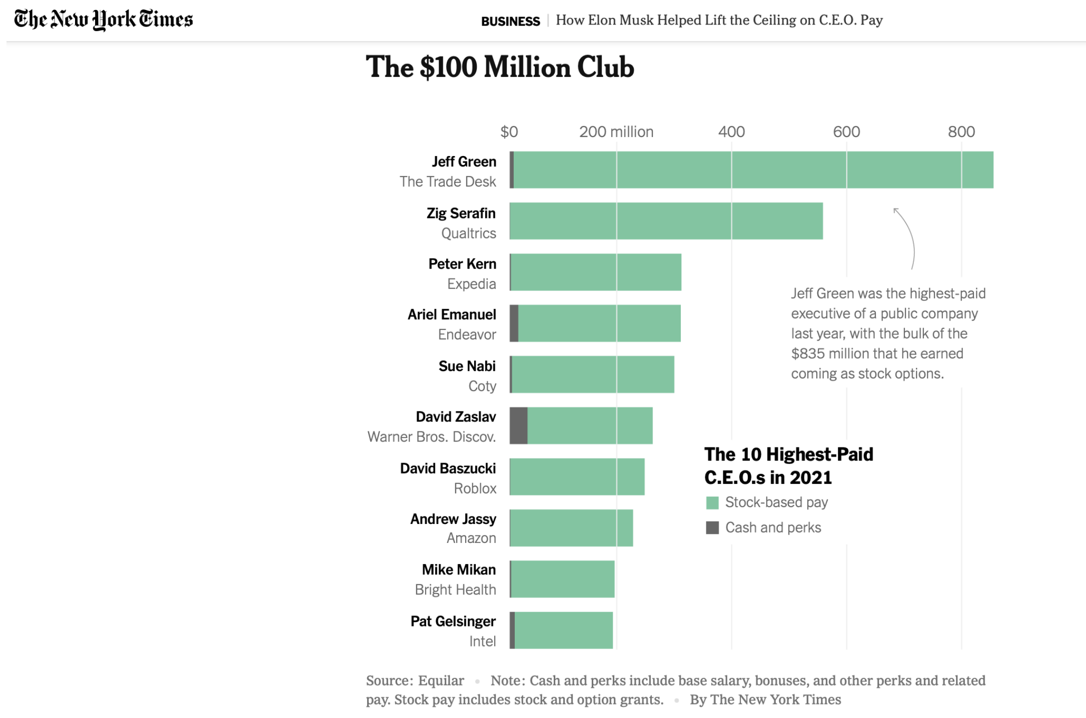
[38] Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution*, 38 J. CORP. L. 487, 503–04 (2013).

[39] Lucian Bebchuk, Jesse Fried, and David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 790 (2002).

[40] *Id.* at 791; *see also* Kenneth R. Davis, *Cash of the Titans: Arbitrating Challenges to Executive Compensation*, 86 TEMP. L. REV. 245, 270 (2014) ("This long-accepted practice results in a boomerang effect where competitors in an industry strive to outdistance each other in an exhausting race to pay their vaunted CEOs more than their peer groups pay.").

fueling a dramatic growth in equity compensation. In June 2022, Equilar, a leading compensation consulting firm, released a study in conjunction with the New York Times, which found dramatic increases in executive equity pay—a development linked directly to Musk's award:[41]



Notably, there were few household names on the list nor any evidence of a particular correlation with unique entrepreneurial genius. Thanks to the "Lake

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[41] Peter Eavis, *How Elon Musk Helped Lift the Ceiling on C.E.O. Pay*, N.Y. TIMES (June 25, 2022), https://www.nytimes.com/2022/06/25/business/highest-paid-ceos-elon-musk.html. ("in a world mesmerized by Mr. Musk and his successes at Tesla, boards are even more likely to view chief executives as indispensable — and give them huge pay deals."); Amit Batish, *Nine-figure Pay Packages are Becoming More Common*, EQUILAR (June 25, 2022), https://www.equilar.com/reports/95-equilar-new-york-times-top-200-highest-paid-ceos-2022.

Wobegon" dynamic of executive compensation,[42] Musk's unprecedented pay package soon became a baseline for CEOs of decidedly ordinary talents.

When this Court speaks, transaction planners listen. Whatever the result, the Court's resolution of this case will reverberate throughout boardrooms across the country. The Court can either slow the problematic ratchet effect of Musk's award on the broader market for executive compensation or accelerate it. The Court should take the former course.

IV. CONCLUSION

The Court should find that the terms of Musk's award were unfair.

Dated: January 23, 2022

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[42] Gretchen Morgenson, *Peer Pressure: Inflating Executive Pay*, N.Y. TIMES (Nov. 26, 2006), https://www.nytimes.com/2006/11/26/business/yourmoney/peer-pressure-inflating-executive-pay.html ("Like Lake Wobegon, Garrison Keillor's fictitious Minnesota town where all the children are above average, executive compensation practices often assume that corporate managers are equally superlative. When shareholders question lush pay, they are invariably met with a laundry list of reasons that businesses use to justify such packages. Among that data, no item is more crucial than the 'peer group,' a collection of companies that corporations measure themselves against when calculating compensation.").

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