Court File No. CV-23-00696017-CL

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

IN THE MATTER OF THE *COMPANIES CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF LOYALTYONE, CO.

Applicant

US BOOK OF AUTHORITIES OF THE MONITOR

(Motion Returnable June 13 and 14, 2024)

May 28, 2024

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UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Superior Court of Delaware.

BEAUTYCON MEDIA ABC TRUST, Acting THROUGH SACCULLO BUSINESS CONSULTING, LLC, in Its Capacity as Trustee of the Trust and Assignee for the Benefit of Creditors of Assignor BeautyCon Media, Inc., Plaintiff,

v.

NEW GENERAL MARKET PARTNERS, LLC, Defendant.

C.A. No. N22C-12-143 MAA CCLD

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Submitted: May 16, 2023

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Decided: August 11, 2023

Upon Defendants' Motion to Dismiss: **GRANTED in part and DENIED in part.**

Attorneys and Law Firms

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MEMORANDUM OPINION

Adams, J.

INTRODUCTION

***1** This action was filed by BeautyCon Media ABC Trust ("Plaintiff") in its capacity as Trustee of the BeautyCon Media Company (the "Company") against the Company's investor, New General Market Partners, LLC ("Defendant" or "NGMP"). Plaintiff brought claims for breach of contract, fraudulent inducement, and tortious interference with prospective contractual relations.[1] This is the Court's decision on Defendant's motion to dismiss these claims. For the reasons stated herein, Defendant's motion is GRANTED in part and DENIED in part.

FACTS

I. The BeautyCon Media Company

The Company was founded in 2013 and created as a "fashion and beauty community portal that connected consumers with beauty brands and creators."[2] Over several years, the Company grew its business to include media and e-commerce, in addition to the beauty and fashion industry. While the Company attracted the attention of various investors, by 2018 it was struggling to fund its Series A financing. Additional funding was critical to the Company's ability to host and operate its signature event scheduled in 2018: "BeautyCon LA." In March 2018, one of the Company's investors, A&E network, rescinded its funding commitment, leaving the Company in a precarious financial situation.

II. Defendant's Involvement with the Company

In May 2018, the Company's then CEO, Moj Mahdara ("Mahdara"), met with the head of investment of NGMP, Darryl Thompson ("Thompson"), to discuss the possibility of NGMP providing the Company with a bridge loan. Richelieu Dennis ("Dennis") of Essence Ventures (a private equity company), and founder of NGMP, had been a previous sponsor of the Company's events. Defendant committed to funding $3 million but never executed the note ("May 2018 Note") pursuant to the original terms, despite repeated assurances from Thompson.[3]

In connection with the May 2018 Note, the Company agreed to Defendant's demand that the Company "cease all conversations with other interested investors." In June 2018, Defendant made a second offer of $5 million ("NGMP 2018 Revised Offer"), which the Company accepted. The Company and Defendant also entered into a Memorandum of Understanding (the "Original MOU") in June 2018, outlining

their understanding of Defendant's future investment in, and commercial partnership with, the Company.[4] Plaintiff alleges that in 2018 Defendant pushed the Company to move forward with a plan to expand its retail business—"BeautyCon POP"—and indicated future funding was contingent upon the Company's compliance with this expansion. The Company's pursuit of BeautyCon POP worsened its financial situation.[5]

***2** In 2019, the Company and Defendant entered into an Amended Memorandum of Understanding ("Amended MOU") which "extended the deadlines [in the Original MOU] for NGMP to establish a long-term commercial partnership with the Company ....[6] "Once BeautyCon POP failed to materialize," Plaintiff alleges it became clear Defendant was not going to provide the funding as contained in the MOUs or complete the common share acquisition.[7] Plaintiff alleges that after the Company hired an investment banker in July 2019 to remedy its growing funding concerns, "[Defendant] demanded that they receive 51% of the Company as part of any transaction[ ]" and "backchanneled with other Series A lead investors" who "chilled" new investors at NGMP's direction.[8]

III. The Live Nation Deal

Toward the end of 2019, the Company began to seek other avenues of financing to compensate for the insufficient funding it was receiving from Defendant. In December 2019, the Company reached a deal in principle with Live Nation—an events promoter and venue operator—where Live Nation would receive a 51% stake in the Company in exchange for $4 million. Live Nation confirmed its support via emails sent on December 20 and 21, 2019.

Plaintiff alleges Defendant had been interested in acquiring the Company as early as 2018[9] and cites to a letter (the "Letter") from Thompson to Laurent Ohana ("Ohana"), the CEO of an investment bank providing advisory services to the Company.[10] In the Letter, dated December 21, 2019, Thompson indicated that he was aware the Company was seeking additional capital, voiced NGMP's belief that there was special value in having the Company operate within the Essence Ventures ecosystem, and indicated Essence Ventures' preliminary interest in purchasing the Company.[11] Plaintiff alleges Defendant attempted to "dampen" the deal with Live Nation and that the Company's management was aware of this interference as of January 22, 2020.[12] The Company's tentative deal with Live Nation did not materialize.

IV. Defendant's May 2020 Investment

In the spring of 2020, the Company approached Defendant for additional funding needed to weather additional financial distress caused by the COVID-19 Pandemic. NGMP originally committed to loaning the Company an additional $2 million, but ultimately agreed to only fund $500,000 (May 2020 Note).

Pursuant to the terms of the May 2020 Note, the Company was prohibited from raising additional capital unless Defendant approved the terms. Plaintiff alleges it was "forced to pass on two prospective investors interested in investing at least $4 million" as a "direct result" of the terms of the May 2020 Note. Plaintiff alleges that "[t]he loans orchestrated by NGMP granted it unfettered control over the Company to the ultimate benefit of NGMP."

On April 26, 2021, the Company entered into the Assignment Agreement which transferred the assets of the Assignor to the Trust. On April 28, 2021, the Trust filed a Petition for Assignment for the Benefit of Creditors and Related Injunctive Relief in the Court of Chancery.[13] At a virtual public auction, Defendant's assignee, NGM1, lodged the successful secured party credit bid. Defendant thereafter foreclosed on substantially all of the Company's assets.

PROCEDURAL HISTORY

Plaintiff filed its complaint on December 13, 2022, alleging five counts: Breach of Contract regarding the Original MOU and Amended MOU (Count I); Fraud in the Inducement (Count II); Tortious Interference with Prospective Contractual Relations (Count III); Breach of Fiduciary Duty (Count IV); and Aiding and Abetting Breach of Fiduciary Duty by the Company's Directors and Officers. Defendant filed its motion to dismiss on January 31, 2023. Briefing concluded on April 6, 2023. On May 16, 2023, the Court held oral argument on the motion. After the parties presented their arguments, the Court dismissed Counts IV and V for the reasons stated on the record and reserved decision on Counts I-III.[14] This is the Court's decision on Defendant's motion to dismiss the remaining counts.

STANDARD OF REVIEW

***3** On a Rule 12(b)(6) motion to dismiss, the Court must accept all well pled allegations as true.[15] A complaint's allegations are sufficiently " 'well-pleaded' if they put the opposing party on notice of the claims being brought against it."[16] While "[v]agueness or lack of detail ... are insufficient grounds upon which to dismiss a complaint under Rule 12(b)(6)[,]"[17] courts are not "required to accept as true conclusory allegations 'without specific supporting factual allegations' or 'every strained interpretation of the allegations ....' "[18] The court must assess whether the claimant "may recover under any reasonably conceivable set of circumstances susceptible of proof."[19] The court must draw every reasonable factual inference in favor of the non-moving party and must deny the motion to dismiss if the claimant may recover under that standard.[20] Dismissal will not be granted unless a claim is clearly without merit.[21]

As a general matter, when deciding a motion to dismiss pursuant to Rule 12(b)(6), the court is limited to reviewing the allegations in the complaint. The Court may review, however, documents extrinsic to the complaint when one or both of the following conditions are present: (1) when the document is "integral to a plaintiff's claim and incorporated into the complaint[;]" or (2) "when the document is not being relied upon to prove the truth of its contents."[22]

ANALYSIS

I. Defendant's motion to dismiss the claim for tortious interference with prospective contractual relations (Count III) is DENIED.

In Plaintiff's claim for tortious interference with prospective contractual relations ("tortious interference"), it alleges that Defendant intentionally interfered with and damaged the Live Nation commitment. Defendant alleges three grounds for dismissal of this claim pursuant to Superior Court Civil Rule 12(b)(3) and (b)(6): (1) the claim is barred by California's statute of limitations, (2) Plaintiff has failed to allege Defendant committed an independent wrongful act, and (3) Plaintiff fails to plausibly allege Defendant's intentional interference. For the reasons that follow, Defendant's motion to dismiss this claim is DENIED.

A. Plaintiff's claim is not barred by California's statute of limitations.

Defendant alleges that California's statute of limitations applies to this claim because California has the most significant relationship to the action relative to Delaware, the forum state. California's statute of limitations requires a plaintiff to file their claims within two years from the date when the plaintiff discovered the loss caused by a defendant's interference.[23] Defendant alleges Plaintiff was aware of the loss caused by its alleged interference on or around January 22, 2020.[24] As Plaintiff filed its complaint on December 13, 2022, this claim would not be timely filed if California's limitation period applied. Delaware's statute of limitations for this claim provides a plaintiff with three years from the date of the tortious act causing injury.[25]

***4** California's statute of limitations does not apply for two reasons: (1) 10 *Del. C.* § 8121 dictates that Delaware's statute of limitations applies, and (2) statutes of limitations govern matters of procedure and the procedural law of the forum state generally applies.

Pursuant to 10 *Del. C.* § 8121, for causes of action that arise outside of Delaware, the shorter statute of limitations applies, which in this case is the California statute.[26] Section 8121, however, provides for an exception for Delaware residents: "[w]here the cause of action originally accrued in favor of a person who at the time of such accrual was a resident of this State, the time limited by the law of this State shall apply."[27] "Our courts have held this to mean that a Delaware corporation is a Delaware 'resident' for the purpose of bringing an action in Delaware court."[28] The Company was a resident of Delaware when this cause of action accrued,[29] therefore, Delaware's statute of limitations applies.

Additionally, under a conflicts of law analysis, as a general rule the forum state applies its own statute of limitations.[30] "This is consistent with the general principle that the procedural law of the forum state (here, Delaware) usually applies."[31] The Court will apply Delaware's three-year statute of limitations because this is purely a procedural matter.[32] Defendant only argues that Plaintiff does not meet California's two-year statute of limitations, therefore, the Court declines to analyze whether Plaintiff timely filed its claim within Delaware's longer statute of limitations.

B. Delaware substantive law applies to the tortious interference claim because there is no actual conflict between California and Delaware law.

Defendant alleges that Plaintiff has failed to state a claim for tortious interference because Plaintiff has failed to allege that Defendant committed an independent wrongful act, which is an element of tortious interference with prospective contractual relations pursuant to California law.[33] Plaintiff argues that Delaware law applies and that this element is not required under Delaware law. Determining the elements of a legal claim and whether such elements are sufficiently pled involves issues of substantive law. The Court, therefore, must first engage in a choice of law analysis to determine whether California or Delaware's substantive law applies.

***5** A conflicts of tort law analysis consists of two steps.[34] The court must first determine whether there is an actual conflict between the elements of the tort as they are defined by the jurisdictions at issue.[35] If there is an actual conflict, courts must then determine which state has the "most significant relationship" to the case.[36] If there is not an actual conflict, the court applies the substantive law of the forum state.[37] "Delaware law recognizes two situations in which a conflict of law is false."[38] If one of the two states have not addressed the legal question presented, then there can be no conflict and the court must apply the law of the state that has "settled law" on the matter.[39] The court also need not engage in a choice of law analysis if the result would be the same under either state's law.[40]

The first situation does not apply to this case because both "California and Delaware have addressed the elements of, and defenses to, tortious interference with prospective contractual relations claims."[41] Because the parties argue that the result would be different depending on which State's law applies, the Court will analyze whether an actual conflict exists between California and Delaware's definition of tortious interference with prospective contractual relations.

The Court finds that the elements of tortious interference between California and Delaware are the same in all important respects, therefore, no actual conflict exists. Because no actual conflict exists, the substantive law of Delaware, the forum state, applies.

Pursuant to California law, a claim for tortious interference with prospective economic advantage consists of the following elements:

(i) an economic relationship between the plaintiff and some third party, with the probability of future economic benefit to the plaintiff;

(ii) the defendant's knowledge of the relationship;

(iii) intentional acts on the part of the defendant designed to disrupt the relationship;

(iv) actual disruption of the relationship; and

(v) economic harm to the plaintiff proximately caused by the acts of the defendant.[42]

***6** California law also requires a plaintiff to prove that the defendant has committed an "independent wrongful act." An act is independently wrongful if it is "unlawful, [*i.e.*,] proscribed by some constitutional, statutory, regulatory, common law or other determinable legal standard."[43] California imposes the requirement of an independent wrongful act to make unlawful "improper methods of disrupting or diverting the business relationship" while also protecting "fair competition."[44]

A claim for tortious interference with prospective contractual relations pursuant to Delaware law consists of the following elements:

(i) the reasonable probability of a business opportunity;

(ii) intentional interference by a defendant with that opportunity;

(iii) proximate causation; and

(iv) damages.[45]

Delaware courts are "to consider these elements 'in light of a defendant's privilege to compete or protect his business interests in a fair and lawful manner' "[46] so that this tort does not unduly restrict free competition.[47] If a defendant acts within his privilege to compete, those actions are protected by the business competition exception, and are not independently wrongful.[48] Delaware courts look to the following elements in the Second Restatement of Torts to

assess whether competition constitutes proper or improper interference:

> (a) the relation concerns a matter involved in the competition between the actor and the other and
>
> (b) the actor does not employ wrongful means and
>
> (c) his action does not create or continue an unlawful restraint of trade and
>
> (d) his purpose is at least in part to advance his interest in competing with the other.[49]

Courts must find that all four factors are met to conclude that a defendant's competitive actions are proper.[50] If a defendant's actions violate statutory or common law, this satisfies the independent wrongfulness requirement pursuant to Delaware law and the conduct would not be protected by the business competition exception.[51] The nature of the defendant's conduct is the principal factor in analyzing whether a defendant's conduct is independently wrongful.[52]

***7** The Court finds that the elements of this tort under California and Delaware law are the same in all important respects. Both require some form of prospective economic relationship between the plaintiff and a third party. Delaware requires the "probability of a business opportunity" whereas California law requires the "probability of an economic benefit." The Court finds these terms to be substantially similar.

Both states also require defendant's knowledge of the relationship between the plaintiff and the third party. California law requires that a plaintiff show the defendant's knowledge of the plaintiff's relationship with the third party while Delaware requires a showing of intentional interference with the prospective business relationship. It is not logically possible for a defendant to intentionally interfere with the relationship without first having knowledge of that relationship, thus both states have a knowledge requirement.[53]

Both states require that the act causing interference was committed intentionally and that the interference results in damages. Additionally, both states require that defendant's conduct be independently wrongful to safeguard against the infringement of free competition.[54] "To be independently wrongful, each state asks whether the defendant's conduct constitutes a violation of positive law, judicial rulings, or expressly or by implication, a 'determinable legal standard.' "[55] Because the result would be the same under either state's law, the conflict is false and Delaware law applies.

C. Plaintiff sufficiently alleged Defendant committed an independent wrongful act.[56]

***8** For Plaintiff to show that Defendant tortiously interfered with Plaintiff's prospective contractual relations with Live Nation, it must show Defendant's conduct was wrongful independent of the interference and not protected by the business competition exception.[57] The business competition exception "rests on the belief that competition is a necessary or desirable incident of free enterprise"[58] and exists to prevent "wholesome competitive practices" from being "made tortious."[59] Competition is not necessarily an improper basis for interference.[60] "If one party is seeking to acquire a prospective contractual relation, the other can seek to acquire it too."[61]

The second element in § 768 asks whether the defendant has employed wrongful means. Delaware courts look to the factors listed in § 767 to determine whether a defendant has employed wrongful means. When a plaintiff has only a prospective contractual relationship with a third party as opposed to a present contractual relationship, there is a higher burden on the plaintiff to show that the defendant improperly interfered with that relationship.[62] The burden for the plaintiff is lower in the context of a present contractual relationship because of "the greater definiteness of the [plaintiff's] expectancy and his stronger claim to security for it and in part to the lesser social utility of the [defendant's] conduct."[63]

While the nature of Defendant's conduct related to the Live Nation deal when viewed in isolation is not improper, the Court finds that when viewed within the larger context of Defendant's actions, Plaintiff has sufficiently pled that Defendant committed an independent wrongful act pursuant to § 767 and § 768. Plaintiff has pled sufficient facts at this stage to establish that Defendant's conduct was part of a larger scheme of economic pressure it wrongfully exerted upon the Company for the ultimate purpose of takeover. This finding is based primarily on an analysis of certain enumerated factors in § 767, specifically Defendant and the Company's ("the Parties") interests, and Defendant's purpose or motivation for

interfering with the Live Nation deal.[64] Because the Court finds Defendant has employed wrongful means, it will not address the remaining elements of the business competition exception.[65]

1. The Nature of Defendant's Conduct Relating to the Live Nation Deal

***9** The "chief factor in determining whether the conduct is privileged despite its harm to the other person," is the nature of a defendant's conduct.[66] As stated above, the Company and Live Nation reached a deal in principle in December 2019, with Live Nation confirming its support in writing on December 20 and 21, 2019. Plaintiff alleges the nature of Defendant's conduct in response to the deal as follows:

- Thompson's letter to Ohana wherein he expressed awareness that the Company was "seeking to raise additional equity capital[,]" conveying Essence Ventures' "preliminary indication of interest to purchase certain assets of [the Company,]" and conveying Essence Ventures' belief that "there is special value [ ] by having [the Company] operate within the Essence Ventures ecosystem."[67]

- "[U]pon information and belief, [Defendant] was in contact with Live Nation about [Defendant's] non-support of the proposed Live Nation deal" and told Live Nation that it preferred to "roll-up" the Company with other brands to sell as one package.[68]

To summarize, Plaintiff alleges that Defendant intentionally interfered with the Live Nation deal when Defendant's head of investment contacted the Company's investment banker to discourage the Live Nation deal and encouraged the sale of the Company to Essence Ventures; and when Defendant allegedly contacted Live Nation directly around January 2020 to discourage the deal.

This conduct is not in itself wrongful. Plaintiff does not identify any of Defendant's conduct as violative of statutory law, common law or "legal standards of behavior more broadly."[69] There is no allegation that Defendant committed any acts of physical violence, threatened suit, or made any false representations to Live Nation to induce it to pull away from the deal.[70]

2. Plaintiff sufficiently alleged that Defendant exerted improper economic pressure on the Company.

The nature of Defendant's conduct with respect to the Live Nation deal, in isolation, is not wrongful. The question remains, however, whether this conduct was proper when viewed within the larger context of Defendant's dealings with the Company.[71] For the reasons that follow, the Court finds that, viewing the complaint as a whole and drawing all reasonable inferences therefrom, Plaintiff has sufficiently alleged Defendant's conduct with respect to Live Nation was committed in furtherance of Defendant's goal to weaken the Company's capital structure and position itself to take over the Company. As an investor who also entered into MOUs to negotiate a long-term commercial partnership with the Company, the Court finds that Defendant's conduct was improper and not protected by the business competition exception.

"A party loses its privilege to compete if it exerts improper economic pressure .... Propriety of economic pressure is a contextual inquiry: there is no 'crystallized set of definite rules,' and the 'decision therefore depends upon a judgment and choice of values in each situation.' "[72] When analyzing whether a defendant's conduct was independently wrongful due to economic pressure, "it is proper to look at the entire picture to understand the economic pressure applied."[73] Although a defendant may exert limited economic pressure, "Delaware law also recognizes that when a defendant intends the interference to drive a competitor out of business and 'shut its doors,' this constitutes wrongful means, and the conduct is not privileged."[74]

***10** At the motion to dismiss phase, Plaintiff sufficiently alleges Defendant exerted wrongful economic pressure in a concerted effort to take ownership of the Company.[75] Plaintiff alleges Defendant accomplished this by delaying or refusing to fully fund promised investments,[76] demanding the Company not solicit other investors,[77] discouraging other investors from investing in the company,[78] and conditioning future investment on the Company's pursuit of commercial endeavors harmful to its financial interests,[79] all while Defendant allegedly knew of the Company's dire financial situation.[80] Defendant's conduct with respect to the Live Nation deal, when viewed in this broader context, sufficiently

alleges that Defendant interfered with the Deal as a means of exerting improper economic pressure on the Company.

The presence of economic pressure in this case shares similarities with that found in *Preston Hollow, LLC v. Nuveen, LLC.*[81] In *Preston Hollow,* the court found that, while each of the defendant's interactions with third parties may not have amounted to wrongful means of shutting down the plaintiff's ability to do business, when the court considered the defendant's conduct as a whole, it revealed the defendant's systematic efforts to push the plaintiff out of business.[82] Here, while Defendant's alleged interaction with Live Nation and letter communication with the Company's investment banker may not be sufficient to establish wrongful means of interfering with the Live Nation deal, when these alleged acts are viewed in the context of Defendant's broader efforts to control and take ownership of the Company, it is reasonably conceivable at the pleading stage that this conduct was part of a broader campaign of exerting economic pressure on the Company.

***11** The Court notes that additional factors in § 767, namely Defendant's motivation, the Parties' relationship, their respective interests, and social interests weigh in favor of a finding that Defendant's conduct is not protected by the business competition exception. It is not necessary at this stage to analyze these factors as the Court has already found Plaintiff sufficiently alleged Defendant exerted improper economic pressure on the Company.

D. Plaintiff has plausibly alleged Defendant intentionally interfered with the Live Nation deal.

Defendant also argues Plaintiff's tortious interference claim should be dismissed because Plaintiff failed to plausible allege that Defendant intentionally interfered with the Live Nation deal. The analysis required for the intentional interference requirement overlaps substantially with the above analysis on the independent wrongful act requirement. The Court will not unnecessarily duplicate that analysis here and briefly sets forth the reasons demonstrating that Plaintiff has plausibly alleged intentional interference.

"The interference with the other's prospective contractual relation is intentional if the actor desires to bring it about or if he knows that the interference is certain or substantially certain to occur as a result of his action."[83] At this stage of the proceedings, the Court must accept all non-conclusory allegations as true. Plaintiff's allegation of intentional interference would be conclusory if, for example, it stated only that "Defendant intentionally interfered because Defendant intentionally interfered." This example is not to suggest that an allegation of any greater specificity would adequately plead this element. Plaintiff's allegations, however, go far enough beyond this by including: (1) how Defendant interfered, (2) when Defendant interfered, (3) the individuals involved in the interference, (4) why Defendant may have interfered (to purchase the Company), (5) and the proximity in time between the acts of interference and the deal's failure.

Plaintiff alleged Defendant interfered by way of the Letter that Thompson sent on the same day Live Nation confirmed its support. The Letter in no uncertain terms expressed Defendant's dislike for the deal. When drawing all reasonable inference from the complaint, it is no far inferential leap that Defendant contacted Live Nation with the intent to quelch the deal, especially considering that this deal would likely decrease Defendant's stake in the Company.[84] For these reasons, the Court finds Plaintiff has sufficiently stated that Defendant desired to bring about the interference, or at the very least knew that its actions made it substantially certain interference would occur.

II. Defendant's motion to dismiss the claim for breach of contract regarding of the Original MOU and Amended MOU (Count I) is GRANTED in part.

A. California law applies to Plaintiff's claim for breach of the MOUs.

The MOUs contain identical California choice-of-law provisions. The choice-of-law provision states, "This Agreement and all actions arising out of or in connection with this Agreement shall be governed by and construed in accordance with the laws of the State of California, without regard to the conflicts of law provisions of the State of California or of any other state."[85] As a general matter, where parties specify a choice of law, Section 187 of the Restatement (Second) of Conflicts "allows the law of the state chosen by the parties to govern contractual rights and duties unless the chosen state lacks a substantial relationship to the parties or transaction or applying the law of the chosen state will offend a fundamental policy of a state with a material greater interest."[86] The parties do not dispute that California law applies to Plaintiff's breach of contract claims. The Court finds that this choice-of-law provision is valid and enforceable and that the exceptions listed in Section 187 do

not apply to this case.[87] Principles of contract law as applied by California courts therefore apply to this claim.[88]

B. Defendant's motion to dismiss the claim for breach of the Original MOU is GRANTED.

***12** In Count I of the complaint, Plaintiff alleges that Defendant breached both the Original MOU and the Amended MOU. In Defendant's first ground for dismissal, it argues that Plaintiff's claim of breach of the original MOU is barred by the Amended MOU based on the integration clause in the Amended MOU:

> This Agreement constitutes the sole and entire agreement of the parties to this agreement with respect to the subject matter contained herein, and supersedes all prior contemporaneous understandings and agreements, both written and oral, with respect to such subject matter.

Pursuant to California law,

> "[w]hen the parties to an agreement express their intention that it is the final and complete expression of their agreement, an integration occurs. Such a contract may not be contradicted by evidence of other agreements. Whether an agreement is an integration, i.e., intended as the final and complete expression of the parties' agreement, is a question of law ...."[89]

As Plaintiff correctly asserts, the MOUs are identical except for the fact that the Amended MOU extended the deadlines for performance. Curiously, Plaintiff does not contest the validity or enforceability of the integration clause and simply states that it has pled a viable claim of breach of both MOUs.

The Court finds no merit to Plaintiff's claim that the original MOU is still actionable in light of the integration clause. The parties agreed in unequivocal language that the Amended MOU superseded all prior written agreements, which includes the Original MOU. Any deadlines in the Original MOU, therefore, were superseded by the new deadlines in the Amended MOU. Defendant's motion to dismiss Plaintiff's claim of breach of the Original MOU is GRANTED.

C. Defendant's motion to dismiss the claim for breach of the Amended MOU is GRANTED in part.

The parties executed the Amended MOU on December 16, 2018, which "sets forth certain agreements and understandings" between the Parties. The purpose of the document, as stated in paragraph 1, is "to outline the terms and conditions under which the parties intend that Investor [Defendant] will provide subsequent investment in the Company." Paragraph 2, titled "Partnership framework" states that "[t]he Parties would like to enter into an understanding for a larger partnership going forward, which is connected, but not contingent on, Investor's [Defendant] investment of $5.0M." The MOU lists the following key elements of this partnership: "Qualified Financing Investment," "Common Share Acquisition," and "Commercial Agreement(s)."

1. The Partnership Framework

Under the "Qualified Financing Investment" provision ("QFI Provision"), the parties agreed that the Company would use "commercially reasonable efforts to provide that Investor [Defendant] will be permitted to invest additional amounts in the first Qualified Financing (as defined in the Note) after the date hereof, which may occur ... no later than June 2019."[90] The parties agreed:

> "within 6 months of the closing of the Note investment, the Company and Investor shall negotiate in good faith with respect to the terms and conditions upon which Investor would serve as the lead investor in the Qualified Financing, with an investment of at least $10 million in additional capital."[91]

***13** The "Common Share Acquisition" provision ("CSA Provision") of the partnership framework provides that the Company believed certain existing holders of Common Stock would be willing to sell their existing shares to Defendant. The Parties agreed that the Company would use "commercially reasonable efforts to cooperate with Investor [Defendant]" so that Defendant could acquire such shares. This provision also memorialized Defendant's understanding that the number of shares and pricing was "not guaranteed." The Parties agreed to cooperate to complete this acquisition by March 1, 2019.[92] The "Commercial Agreement(s)" provision provides that the parties agreed to "negotiate in good faith to establish a long-term commercial partnership across multiple lines of business no later than March 31, 2019."[93]

2. Plaintiff's Allegations of Breach of the Amended MOU

Plaintiff alleges Defendant breached the three provisions summarized above in the following ways:

- "[A]mong other things ... [Defendant] fail[ed] to serve as the lead investor in the Qualified Financing, with an investment of at least $10M in additional capital."[94]
- Defendant failed to complete the common shares acquisition.[95]
- "[A]mong other things[,] ... failing to establish a long-term commercial partnership ...."[96]

Plaintiff alleges damages of no less than $10 million. Defendant asserts Plaintiff's claims under the MOUs should be dismissed because the terms are not sufficiently definite to support a breach of contract claim.

For the reasons that follow, Defendant's motion to dismiss Plaintiff's claim for breach of the Common Shares Acquisition Provision is GRANTED; Defendant's motion to dismiss Plaintiff's claim for breach of the Qualified Financing Provision and the Commercial Agreement(s) Provision is GRANTED in part, because the agreement to "negotiate in good faith" is enforceable pursuant to California law.

3. Principles of California Contract Law

For a contract to be enforceable, the terms must be sufficiently definite.[97] A contract's terms are sufficiently definite if they create a reasonable certainty of performance and "provide a basis for determining breach and fashioning a remedy."[98] "If, by contrast, a supposed 'contract' does not provide a basis for determining what obligations the parties have agreed to, and hence does not make possible a determination of whether those agreed obligations have been breached, there is no contract."[99]

An "agreement to agree" is not sufficiently definite to be enforceable.[100] "It is still the general rule that where any of the essential elements of a promise are reserved for the future agreement of both parties, no legal obligation arises 'until such future agreement is made.' "[101] "Whether a term is essential depends on its relative importance to the parties and whether its absence from the contract would make enforcing the contract unfair to any party."[102]

4. Defendant's motion to dismiss Plaintiff's claim for breach of the Qualified Financing Provision is GRANTED in part.

***14** The second sentence of the QFI Provision states that "[w]ithin 6 months of the closing of the Note investment, the company and [Defendant] *shall negotiate in good faith* with respect to the terms and conditions" on which Defendant would become the lead investor and invest at least an additional $10 million. For the reasons that follow, this provision did not obligate Defendant to invest at least $10 million, thus there can be no breach on this basis; however, the Parties' agreement to negotiate in good faith to determine the means by which Defendant would become the lead investor and invest this minimum amount is enforceable.

Copeland v. Baskin Robbins U.S.A, issued by the California Court of Appeals, Second District, speaks directly to the narrow issue presented by Plaintiff's claim for breach of the Amended MOU.[103] In *Baskin Robbins,* the plaintiff-buyer entered into a contract with the defendant-seller to buy an ice cream factory.[104] The contract provided that the parties agreed to negotiate a separate co-packing agreement wherein the defendant would agree to provide the ice cream to the plaintiff over a three-year period.[105] The contract stated that the parties agreed to negotiate the specific terms of the co-packing agreement.[106] Negotiations over the co-packing agreement failed and the plaintiff filed suit alleging the defendant breached the contract by refusing to enter into a co-packing agreement.[107] The trial court granted summary judgment to the defendant and the plaintiff appealed.[108] The appellate court distinguished an "agreement to negotiate" from an "agreement to agree" and found that, while the latter was unenforceable, the former was enforceable.[109] When parties have agreed to negotiate a specific term or provision, "[f]ailure to agree is not, itself, a breach of the contract to negotiate. A party will be liable only if a failure to reach ultimate agreement resulted from a breach of that party's obligation to negotiate or to negotiate in good faith."[110] When parties have agreed to negotiate in good faith, the defendant has performed his obligations under the contract when it has made a good faith effort to reach an ultimate agreement.[111]

***15** Here, Defendant was obligated to negotiate in good faith to determine the terms and conditions under which it would become the lead investor and provide at least $10 million,

but was not obligated to reach an ultimate agreement on the necessary terms. Plaintiff's claim for breach of contract on the basis that Defendant did not provide at least $10 million in additional financing and by not becoming the lead investor is DISMISSED. Plaintiff's claim that Defendant failed to negotiate in good faith to establish the terms under which Defendant could accomplish the goals in the QFI Provision remains pending.

5. Defendant's motion to dismiss Plaintiff's claim for breach of the Commercial Agreements Provision is GRANTED in part.

The Commercial Agreements Provision states that "the Parties *agree to negotiate in good faith* to establish a *long-term commercial partnership* across multiple lines of business no later than March 31, 2019."[112] Due to the language in the Amended MOU, Plaintiff's characterization of Defendant's breach, as stated above, is particularly important in adjudicating Defendant's motion to dismiss.

The Court applies the analysis used for the QFI provision to the Commercial Agreements Provision (the "Provision"). Like the QFI Provision, Defendant's alleged failure to establish a "long-term commercial partnership" is not a breach of this Provision. The Amended MOU did not require that the parties reach an ultimate agreement on the nature and scope of a long-term commercial partnership. The failure to "negotiate in good faith" to establish this partnership, however, is sufficiently definite to establish that Defendant had an obligation to negotiate the establishment of this partnership.[113]

a. Plaintiff has stated a claim for breach based on Defendant's failure to "negotiate in good faith."

Defendant asserts that the complaint does not include a claim for breach of the duty to negotiate in good faith and that Plaintiff therefore cannot raise this claim of breach in its opposition to the motion to dismiss.[114] Although Plaintiff does not expressly allege in its complaint that Defendant breached the Amended MOU by failing to negotiate in good faith, the Court has an obligation to generously construe the allegations in the complaint at this stage in the litigation. Plaintiff has alleged generally that Defendant breached the Amended MOU, which includes a provision to "negotiate in good faith." In the factual background section to Plaintiff's complaint, Plaintiff makes several allegations related to Defendant's alleged refusal to negotiate in good faith.[115] For these reasons, the Court finds that Plaintiff has alleged breach of contract based on Defendant's alleged failure to negotiate in good faith a long-term commercial partnership.

b. Plaintiff has not stated a claim for breach based on Defendant's failure to establish a "long-term commercial partnership" with the Company.

***16** Although Plaintiff claims that Defendant had an obligation to enter into a commercial partnership, the phrase "agree to negotiate in good faith" itself shows that the term "long-term commercial partnership" was left to the future agreement of both parties. Where an essential element of an agreement is left to the "future agreement of both parties, no legal obligation arises 'until such future agreement is made.' "[116] The plain language of the Provision shows that at the time the Amended MOU was signed, the parties had yet to negotiate, or at least complete negotiations, to finalize the parameters of a "long-term commercial partnership." If the parties had already reached an agreement on this term, there would be no need specify that the parties were agreeing to negotiate its establishment.

Even if this Provision had not included the phrase, "agree to negotiate," and had unambiguously stated that "the parties shall establish a long-term commercial partnership," it would still not be sufficiently definite for the Court to determine breach or fashion a remedy. The provision does not define the parameters of a "long-term commercial partnership." It does not specify what amount of time would qualify as "long term." Would Plaintiff have had a claim for breach if the commercial partnership with Defendant broke down after five years, for example, or would Defendant have met its obligation under this provision? Furthermore, while the provision does state that this partnership was to span across "multiple lines of business," there is a lacuna of information as to what would constitute the partnership itself. The Provision does not define the nature and extent of the parties' collaboration or whether it would include any profit-sharing arrangement. Even if the MOU had obligated Defendant to engage in a commercial partnership, without this term being further fleshed out, it would not be possible to determine whether Defendant had breached.

6. Defendant's motion to dismiss Plaintiff's claim for breach of the Common Share Acquisition Provision is GRANTED.

The Court finds that the CSA Provision is not enforceable because its terms are not sufficiently definite to determine Defendant's performance obligations with respect to acquiring shares. While the CSA Provision states that Defendant was to complete acquisition of the shares by a date certain, the provision does not specify whether any shares needed to be acquired for Defendant to have performed. Subsection 3 of the CSA Provision states that Defendant "acknowledges that the total number of shares available for acquisition (*if any*) and the exact pricing is not guaranteed" and is subject to the Company and shareholders receiving approvals for transfer.[117]

The CSA Provision plainly provides for the possibility that Defendant would not acquire any shares because this acquisition depended in part on factors outside of Defendant's control. Thus, under the CSA Provision, it was possible for Defendant to acquire zero shares and not be in breach. In fact, the weight of the obligations in this provision appears to be on the Company rather than Defendant. The Company agreed to use "commercially reasonable efforts" to cooperate with Defendant and determine the optimal structure and mechanism to complete the acquisition. It is fair to assume that the Company's agreement to cooperate with Defendant implies Defendant's agreement to reciprocate that cooperation. The CSA Provision fails, however, to sufficiently define what Defendant had to do or refrain from doing to cooperate in accordance with this Provision.[118] For these reasons, there is no workable basis to identify Defendant's obligations and whether Defendant is in breach.

III. Fraud in the Inducement

***17** Plaintiff alleges that Defendant fraudulently induced it into executing the MOUs. Plaintiff claims that during negotiations leading up to the execution of the MOUs Defendant represented that Defendant would perform under them if the Company ceased discussions with other investors. Defendant asserts three grounds for dismissal: (1) Plaintiff's claim is barred by California's statute of limitations; (2) Plaintiff's claim violates the economic loss doctrine; and (3) the allegations of fraudulent inducement do not satisfy Superior Court Civil Rule 9(b).

Delaware law applies to the procedural ground for dismissal.

As a threshold matter, both Delaware and California have a three-year statute of limitations for the claim of fraud in the inducement. Plaintiff does not contest that it did not file this claim within the three-year time period, but argues that the statute of limitations was tolled pursuant to Delaware law for the following reasons: the discovery rule tolls Plaintiffs claims, Defendant fraudulently concealed facts regarding this claim, this claim is equitably tolled, and the filing of the assignment tolls the statute. Defendant argues in its reply that the statute of limitations is not tolled and also cites exclusively to Delaware law, however, Defendant also asserts California law applies because of the California choice-of-law provision in the MOUs. Although the statutory time period is equivalent, because the parties appear to disagree on which state's law applies, the Court will briefly address the conflict of law issue presented.

As stated above, the MOUs contain a choice-of-law provision wherein the Parties agreed that California law would apply to "all actions arising out of or in connection with this Agreement ... without regard to the conflicts of law provisions of the State of California or of any other state." However, pursuant to Delaware law, "choice-of-law provisions in contracts do not apply to statutes of limitations, unless a provision expressly includes it. If no provision expressly includes it, then the law of the forum applies because the statute of limitations is a procedural matter."[119] Here, the choice of law provision does not specify whether it includes California's statute of limitations. As such, because statutes of limitations relate to matters of procedure, Delaware law applies. Because Delaware's statute of limitations applies, Delaware law with respect to tolling also applies.

"[C]ourts apply a three-step analysis to determine whether a claim is time-barred. First, the court determines when the cause of action accrues. Second, the court determines whether the statute of limitations may be tolled so that the cause of action accrues after the time of breach or injury."[120] If a plaintiff has not filed within the statutory time period, it "bear[s] the burden of pleading specific facts demonstrating that the statute was tolled."[121] The third step in the analysis, assuming tolling applies, is to determine when the plaintiff was on inquiry notice, which is the date the statute of limitations begins to run.[122] Once the plaintiff has discovered "facts sufficient to put a person of ordinary intelligence on inquiry which, if pursued, would lead to discovery" the

plaintiff has inquiry notice.[123] A plaintiff need not know of every aspect of the alleged wrongful conduct for the court to find the plaintiff is on inquiry notice, but only when the plaintiff should have discovered the "general fraudulent scheme."[124] "[N]o theory will toll the statute beyond the point where the plaintiff was objectively aware, or should have been aware, of facts giving rise to the wrong."[125]

***18** With respect to the first step in the analysis, a claim for fraudulent inducement accrues at the time of the wrongful act, *i.e.*, when the fraudulent statements were made, not when the harmful effects of the wrongful act were felt.[126] "The fraudulent statements must have occurred on or before the date when the parties entered into the contract."[127] With respect to the dates of execution of the MOUs, the original MOU does not contain the date that it was signed, though Plaintiff alleges in the complaint that the parties entered into the original MOU in June 2018.[128] The Company's board of directors approved the original MOU on June 24, 2018. For the purpose of Defendant's motion, the Court assumes that the original MOU was executed between June 24 and June 30, 2018. For Plaintiff's claim to be timely filed with respect to the Original MOU, it would have to be filed no later than June 30, 2021, unless the statute is tolled. The Amended MOU is dated December 16, 2018. For Plaintiff's claim to be timely filed with respect to the Amended MOU, it would have to be filed within three years of that date, unless the statute is tolled. Plaintiff filed its complaint on December 13, 2022, therefore, unless a tolling exception applies, Plaintiff's claim is time-barred.

With respect to the second step in the analysis, statutes of limitations may be tolled in "certain circumstances, including fraudulent concealment, inherently unknowable injury [known as the "discovery rule"], and equitable tolling."[129] To toll the statute of limitations based on fraudulent concealment "the plaintiff must allege some affirmative act by the defendant that either prevented the plaintiff from gaining knowledge of material facts or led the plaintiff away from the truth."[130] The discovery rule applies where the injury was "inherently unknowable" and the injured party was "blamelessly ignorant."[131] "When these 'factual requisites' are met, " 'the limitations period commence[s] to run when the person ha[s] reason to know that a wrong ha[s] been committed.' "[132] The limitations period is only tolled until the plaintiff is on inquiry notice.

Plaintiff asserts that its fraudulent inducement claim is tolled by the discovery rule because it was not on notice that it possessed this claim until December 21, 2019, the date Thompson sent the Letter to Ohana. In support of its position that it was not on notice until this date, Plaintiff cites to paragraphs 32, 38, and 39 of its complaint.[133] Paragraphs 38 and 39 discuss the Letter wherein Thompson indicated Essence Ventures' interest in purchasing the Company. If Plaintiff was not on inquiry notice until December 21, 2019, this would toll the statute until December 20, 2022, seven days after Plaintiff filed the complaint.

The Court does not find that the discovery rule applies because the injury was not inherently unknowable before Thompson sent the Letter on December 21, 2019. Plaintiff alleged that "it was no secret going back to 2018" that Defendant wished to control the Company.[134] Plaintiff also alleges that the Company had to hire an investment banker in July 2019 due to Defendant's failure to provide the promised financing—a little over a year after entering into the original MOU and about seven months after entering into the Amended MOU. The Court finds that Plaintiff has established by its own allegations that it was on inquiry notice it had a claim for fraudulent inducement for more than three years before it filed this claim.

***19** Plaintiff asserts the same grounds in its fraudulent concealment argument as it does for its discovery rule argument, namely the Letter. Plaintiff, however, has failed to articulate how the Letter amounts to an affirmative act that prevented Plaintiff from gaining knowledge of material facts or lead it away from the truth that Defendant did not intend to fund the MOUs.[135] Plaintiff bears the burden of asserting specific facts of fraudulent concealment and it has not done so.

Plaintiff's claim of equitable tolling is without merit as it relies on Defendant's alleged role as a fiduciary. The Court dismissed the claim for breach of fiduciary duty on the record after oral argument.[136] Finally, Plaintiff argues the filing of the Assignment tolls the statute. The Court finds that there is no merit to this claim. The Assignment was filed twenty months before Plaintiff filed its claim which provided a reasonable amount of time for the Trust to file the complaint within the statutory time period. Plaintiff has not identified any relevant Delaware caselaw to support its position, and the Court has not identified a case to support tolling on this basis.

Plaintiff's claim for fraud in the inducement is barred by Delaware's statute of limitations because Plaintiff did not file it within the statutory time period and no tolling exception applies. Because Plaintiff's claim is time barred, the Court will not address Defendant's remaining two grounds for dismissal for this claim.

CONCLUSION

For the reasons stated herein:

1. Defendant's motion to dismiss Plaintiff's claim of tortious interference with prospective contractual relations is DENIED.

2. Defendant's motion to dismiss Plaintiff's claim of breach of the Original MOU and Amended MOU is GRANTED in part.

   a. Defendant's motion to dismiss Plaintiff's claim of breach of the Original MOU is GRANTED.

   b. Defendant's motion to dismiss Plaintiff's claim of breach of the Amended MOU is DENIED in part.

      i. Plaintiff's claim of breach of the CSA Provision is DISMISSED.

      ii. Plaintiff's claim of breach of the QFI and Commercial Agreements provisions based on Defendant's alleged failure to negotiate those provisions in good faith remains pending; the balance of Plaintiff's claims of breach of these provisions is DISMISSED.

3. Defendant's motion to dismiss Plaintiff's claim of fraud in the inducement is GRANTED, because it was not timely filed and no exception applies to toll the statute.

IT IS SO ORDERED.

All Citations

Not Reported in Atl. Rptr., 2023 WL 5164148

Footnotes

1 Plaintiff also filed claims of breach of fiduciary duty and aiding and abetting breach of fiduciary duty. Compl. ¶¶ 73-88. On May 16, 2023, the Court dismissed these claims on the record after oral argument on Defendant's motion to dismiss. *BeautyCon Media ABC v. New General Market Partners,* C.A. No. N22C-12-143 MAA CCLD, Adams, J., Transaction ID 70026953 (Del. Super. May 16, 2023).

2 Compl. ¶ 16. Unless otherwise stated, the facts are drawn from Plaintiff's Complaint and the attached exhibits. The Court accepts these allegations as true for purposes of a motion to dismiss.

3 In August 2018, Defendant reduced the amount of pledged capital from $3 million to $1.678 million. Compl. ¶ 27.

4 *See infra* ANALYSIS Section II.C. for additional information on the contents of the Amended MOU, which is identical to the Original MOU, except for the deadlines in various provisions.

5 Compl. ¶ 28.

6 Compl. ¶ 29.

7 Compl. ¶ 30.

8 Compl. ¶¶ 31-32.

9 Compl. ¶ 38; Ex. 13. All exhibits referenced were attached to the complaint.

10 Ex. 12.

11 Ex. 12; Compl. ¶ 38 (citing to Exs. 12-15).

12 Compl. 37; Ex. 11

13 *In re: BeautyCon Media, Inc. Assignor to: Saccullo Business Consulting LLC*, C.A. No. 2021-0368 (PAF).

14 *BeautyCon Media ABC v. New General Market Partners,* C.A. No. N22C-12-143 CCLD (MAA) (Del. Super. May 16, 2023) (TRANSCRIPT at 62). The Court ruled that it lacked jurisdiction over counts IV and V and that any narrow exception that may provide the Superior Court with jurisdiction did not apply to these claims.

15 *Spence v. Funk*, 396 A.2d 967, 968 (Del. 1978).

16 *Hale v. Elizabeth W. Murphey School, Inc.,* 2014 WL 2119652, at *2 (Del. Super. May 20, 2014) (citing *Precision Air, Inc. v. Standard Chlorine of Delaware, Inc.*, 654 A.2d 403, 406 (Del. 1995)); *Bramble v. Old Republic Gen. Ins. Corp.,* 2017 WL 345144, at *3 (Del. Super. Jan. 20, 2017) (internal citations omitted).

17 *Bramble,* 2017 WL 345144, at *3 (internal citations omitted).

18 *Clouser v. Doherty,* 175 A.3d 86 (TABLE), 2017 WL 3947404, at *4 (Del. 2017) (cleaned up).

19 *Hackett v. TD Bank, N.A.,* 2023 WL 3750378, at *2 (Del. Super. May 31, 2023) (internal quotations omitted).

20 *Hackett,* 2023 WL 3750378, at *2.

21 *Bramble,* 2017 WL 345144, at *3 (internal citations omitted).

22 *Id.* (quoting *Vanderbilt Income & Growth Assocs., L.L.C., v. Arvida/JMB Managers, Inc.*, 691 A.2d 609, 613 (Del. 1996)).

23 Cal. Civ. P. § 339(1).

24 Def. Op. Br. at 22; Compl. ¶ 37 (“The Company knew something was amiss on January 22, 2020, because the Company's management believed that NGMP (or its affiliates) were trying to ‘dampen’ the Live Nation deal.”).

25 10 *Del. C.* § 8106. *Clouser v. Doherty,* 175 A.3d 86 (TABLE), 2017 WL 3947404, at *10 (Del. 2017) (“Tortious interference with prospective business relations is subject to a three-year statute of limitations.”); *WaveDivisions Holdings, LLC.,* 2011 WL 13175837, at *9 (“In Delaware, claims for tortious interference with contractual relations are governed by the three year statute of limitations.”); *BTIG, LLC v. Palantir Technologies, Inc.,* 2020 WL 95660, at *3 (Del. Super. Jan. 3, 2020) (“For tort claims, ‘the wrongful act is a tortious act causing injury, and the cause of action accrues at the time of injury.’ ”).

26 *Supra* n. 23; 10 *Del. C.* § 8121.

27 10 *Del. C.* § 8121.

28 *WaveDivision Holdings, LLC,* 2011 WL 13175837, at *8.

29 Compl. ¶ 11.

30 *US Dominion v. Fox Corp.,* 2022 WL 2229781, at *6 (Del. Super., June 21, 2022) (cleaned up); *Weinstein v. Luxeyard, Inc.*, 2022 WL 130973, at *3 (Del. Super. Jan. 14, 2022).

31 *US Dominion,* 2022 WL 2229781, at *6 (cleaned up); *Weinstein*, 2022 WL 130973, at *3.

32 *Am. Energy Tech., Inc. v. Colley & McCoy Co.,* 1999 WL 301648, at *2 (D. Del. Apr. 15, 1999) (“Statutes of limitations are generally considered to be procedural rather than substantive law.”); *Weinstein,* 2022 WL 130973, at *3 (quoting *MPEG LA, L.L.C. v. Dell Global B.V.*, 2013 WL 812489, at *3 (Del. Ch. Mar. 6, 2013)) (A modification of the general rule that the procedural law of the forum state applies may be necessary when “the procedural law of the foreign state is so inseparably interwoven with substantive rights[,]” such that a modification is necessary to safeguard a party's legal rights).

33 Defendant also alleges that Plaintiff failed to plausibly allege Defendant's intentional interference. The Court addresses this ground separately in the section to follow. Def. Op. Br. at 24-27.

34 *KT4 Partners LLC v. Palantir Tech., Inc.*, 2021 WL 2823567, at *12 (Del. Super. June 24, 2021); *Otto Candies, LLC v. KPMG, LLC,* 2020 WL 4917596, at *5 (Del. Ch. Aug. 21, 2020).

35 *Bell Helicopter Textron, Inc.*, 113 A.3d 1045, 1050 (Del. 2015).

36 *Travelers Indem. Co. v. Lake,* 594 A.2d 38, 47 (Del. 1991).

37 *Otto Candies, LLC,* 2020 WL 4917596, at *6, 18, 21; *KT4 Partners, LLC*, 2021 WL 2823567, at *12.

38 *KT4 Partners LLC*, 2021 WL 2823567, at *12; *see also In re Bay Hills Emerging Partners I, LP,* 2018 WL 3217650, at *5 (Del. Ch. July 2, 2018) (stating there is a false conflict when "there is no material difference between the laws of competing jurisdictions").

39 *Arch Insurance Co. v. Murdoch,* 2018 WL 1129110, at *8 (Del. Super. Mar. 1, 2018) ("When one state's laws failed to address a particular issue, it cannot conflict with the laws of another state. Where one state fails to address a particular issue, the Court should apply the settled law.") (cleaned up); *KT4 Partners LLC*, 2021 WL 2823567, at *12.

40 *Deuley v. DynCorp Int'l, Inc.,* 8 A.3d 1156, 1161 (Del. 2010); *KT4 Partners LLC*, 2021 WL 2823567, at *12.

41 *KT4 Partners LLC*, 2021 WL 2823567, at *12; *Great American Opportunities, Inc. v. Cherrydale Fundraising, Inc.,* 2010 WL 338219, at *8 (Del. Ch. Jan. 29, 2010) (stating both California and Delaware require the same basic elements to establish a claim for tortious interference with prospective contractual relations.).

42 *Golden Eagle Land Investment, LP v. Rancho Santa Fe Ass'n.,* 227 Cal. Rptr. 3d 903, at 927 (Cal. Ct. App. 4th Jan. 12, 2018) (cleaned up); *SC Manufactured Homes, Inc. v. Canyon View Estates, Inc.*, 56 Cal. Rptr. 3d 79, n. 7 (Cal. Ct. App. 2d Mar. 15, 2007). California courts typically identify this tort by the name "tortious interference with prospective economic advantage." *See, e.g., Golden Eagle Land Investment, LP,* 227 Cal. Rptr. 3d at 927. Delaware identifies this tort as either tortious interference with prospective "economic advantage," "contractual relations" or business relations. *See, e.g., KT4 Partners,* 2021 WL 2823567, at *13; *Clouser v. Doherty,* 175 A.3d 86 (TABLE), 2017 WL 3947404, at *10 (Del. 2017); *Organovo Holdings, Inc. v. Dimitrov,* 162 A.3d 102, 122 (Del. Ch. June 5, 2017). Regardless of the slight variations in names, the elements of the torts, however, are the same in all important respects.

43 *KT4 Partners,* 2021 WL 2823567, at *13 (quoting *Edwards v. Arthur Anderson, LLP*, 189 P.3d 285, 290 (Cal. 2008)).

44 *Golden Eagle Land Investment, LP,* 227 Cal. Rptr. 3d at 927 (quoting *Settimo Associates v. Environ Systems, Inc.* 17 Cal. Rptr. 2d 757, 758 (Cal. Ct. App. 4th Mar. 26, 1993)).

45 *Clouser v. Doherty,* 175 A.3d 86 (TABLE), 2017 WL 3947404, at *10 (Del. 2017).

46 *KT4 Partners LLC*, 2021 WL 2823567, at *13 (quoting *Kable Products Services, Inc. v. TNG GP*, 2017 WL 2558270, at *10 (Del. Super. June 13, 2017) (internal quotation marks omitted)).

47 *See Agilent Technologies v. Kirkland,* 2009 WL 119865, at *8 (Del. Super. Jan. 20, 2009).

48 *Preston Hollow, LLC v. Nuveen, LLC,* 2020 WL 1814756, at *17 (Del. Ch. Apr. 9, 2020).

49 Restatement (Second) of Torts § 767 (1979). To assess whether a defendant's actions are independently wrongful, Delaware courts analyze the following factors: (i) the nature of the actor's conduct; (ii) the actor's motive; (iii) the interests of the other with which the actor's conduct interferes; (iv) the interests sought to be advanced by the actor; (v) the social interests in protecting the freedom of action of the actor and the contractual interests of the other; (vi) the proximity or remoteness of the actor's conduct to the interference; and (vii) the relations between the parties. Restatement (Second) of Torts § 767 (1979); *Preston Hollow Capital, LLC*, 2020 WL 1814756, at *17 (citing Restatement (Second) of Torts § 767 (1979)).

50 Restatement (Second) of Torts § 768; *Preston Hollow Capital, LLC,* 2020 WL 1814756, at *17 (stating the court must find all four factors are met before excusing the defendant under this analysis.).

51 Restatement (Second) of Torts § 767 cmt. c.

52 *Preston Hollow*, 2020 WL 1814756, at *17.

53 *DG BF, LLC v. Ray*, 2021 WL 776742, at n. 146 (Del. Ch. Mar. 1, 2021).

54 *Kable Products Services, Inc. v. TNG GP*, 2017 WL 2558270, at *10 (Del. Super. June 13, 2017) (quoting *DeBonaventura v. Nationwide Mut. Ins. Co.*, 419 A.2d 942, 947 (Del. Ch. 1980)) (stating elements of this claim "must be considered in light of a defendant's privilege to compete or protect his business interests in a fair and lawful manner."); *Orthopaedic Assoc. of S. Delaware, PA v. Pfaff*, 2018 WL 822020, at *2 (Del. Super. Feb. 9, 2018); *Preston Hollow Capital,* 2020 WL 1814756, at *12 ("The tort is unusual, in that its application, even if these elements are met, is circumscribed by consideration of competing rights. Thus, the elements of the tort must be considered in light of a defendant's privilege to compete in a lawful manner."); *Beard Research, Inc. v. Kates,* 8 A.3d 573, 608 (Del. Ch. Apr. 23, 2010) ("The tortious interference with prospective business relations standard is arguably more favorable to a defendant than the tortious interference with contractual relations standard because, under the former standard, a court must consider the defendant's privilege to compete or protect his business interests in a fair and lawful manner."); *Agilent Technologies v. Kirkland,* 2009 WL 119865, at *5 (Del. Super. Jan. 20, 2009); *Korea Supply Co. v. Lockheed Martin Corp.*, 63 P.3d 937, 953 (Cal. 2003) (stating a plaintiff bringing a claim for interference with prospective economic advance must show defendant's conduct was independently wrongful); *Quelimane Co. v. Stewart Title Guaranty Co.*, 960 P.2d 513, 530 (Cal. 1998) (stating claim for tortious interference with prospective economic advantage, unlike tortious interference with an existing contract, requires plaintiffs to establish conduct was wrongful); *Ixchel Pharma, LLC v. Biogen, Inc.*, 470 P.3d 571, 576 (Cal. 2020) ("intentionally interfering with prospective economic advantage requires pleading that the defendant committed an independently wrongful act.").

55 *KT4 Partners LLC v. Palantir Tech., Inc.*, 2021 WL 2823567, at *14 (Del. Super. June 24, 2021) (cleaned up).

56 Because Defendant contests only that Plaintiff has failed to sufficiently plead that Defendant committed an independent wrongful act and intentionally interfered, the Court limits its Rule 12(b)(6) analysis to these two elements.

57 *KT4 Partners, LLC*, 2021 WL 2823567, at *13; *Preston Hollow Capital, LLC,* 2020 WL 1814756, at *12. The Court notes that Plaintiff did not expressly include the term "independent wrongful act" in its count for tortious interference. Defendant raised this requirement as an affirmative defense to the claim of tortious interference. Def. Op. Br. at 23-24. In Plaintiff's brief in opposition to Defendant's motion to dismiss, Plaintiff only asserts that independent wrongfulness is not a requirement pursuant to Delaware law. Pl. Br. at 32-33. As explained above, Delaware does require plaintiffs to plead an independent wrongful act. Because this is a requirement and because Defendant raised this as an affirmative defense in the motion to dismiss, the Court will analyze whether Plaintiff has sufficiently alleged that Defendant committed an independent wrongful act.

58 Restatement (Second) of Torts § 768 cmt. on Clause (b).

59 *NuVasive, Inc. v. Miles*, 2020 WL 5106554, at *12 (Del. Ch. Aug. 31, 2020).

60 Restatement (Second) of Torts § 768 cmt. a.

61 *Id.*

62 § 767 cmt. on Clause (c) ("the actor's conduct in interfering with the other's prospective contractual relations with a third party may be held to be not improper, although his interference would be improper if it involved persuading the third party to commit a breach of an existing contract with the other.").

63 *Id.*

64 For the sake of economy, the Court hereinafter refers to "Defendant and the Company" collectively as "the parties," while noting that Plaintiff is not the Company, but the BeautyCon Media ABC Trust in its capacity as Trustee of the Company.

65 *See* § 767; *Preston Hollow Capital, LLC v. Nuveen, LLC,* 2020 WL 1814756, at *17 (Del. Ch. Apr. 9, 2020) (declining to address the remaining elements, having found defendant employed wrongful means in its competition with plaintiff.).

66 § 767 cmt. on Clause (a).

67 Compl. ¶ 38; Ex. 12.

68 Compl. ¶ 36.

69 *KT4 Partners LLC v. Palantir Tech., Inc.*, 2021 WL 2823567, at *19 (Del. Super. June 24, 2021).

70 § 767 cmt. on Clause (a).

71 *Preston Hollow Capital, LLC,* 2020 WL 1814756, at *17.

72 *Id.* at *18 (quoting § 767 cmt. b.); § 767 cmt. on Clause (a) (To examine the propriety of economic pressure, courts should assess "the circumstances in which it is exerted, the object sought to be accomplished by the actor, the degree of coercion involved, the extent of the harm that it threatens, the effect upon the neutral parties drawn into the situation, the effects upon competition, and the general reasonableness and appropriateness of this pressure as a means of accomplishing the actor's objective.").

73 *Preston Hollow LLC,* 2020 WL 1814756, at *18.

74 *Id.* (citing *Beard Research, Inc. v. Kates*, 8 A.3d 573, 611–12 (Del. Ch. Apr. 23, 2010)), *aff'd sub nom. ASDI, Inc. v. Beard Research, Inc.*, 11 A.3d 749 (Del. 2010). Limited economic pressure is permitted as long as a defendant avoids an illegal restraint on trade and does not intentionally interfere to drive a competitor out of business. *Id.*

75 The Letter expressed a desire that Essence Ventures purchase the Company. Ex. 12. Plaintiff also alleged "numerous conversations" from 2018 forward wherein Thompson allegedly expressed a desire to own the Company. Compl. ¶ 38.

76 Plaintiff alleges: Defendant committed to a $3 million investment in the May 2018 Note, but reduced the amount of pledged capital to $1.678 million in August 2018; in June 2018, Defendant committed to funding a $5 million convertible note based on a $27 million valuation, as opposed to the $60 million valuation agreed upon approximately one month earlier ("NGMP 2018 Revised Offer"); instead of timely funding $2 million promised in the May 2020 Note, Defendant delayed and only funded $500,000, and with the knowledge that this amount "left many vendors and other customers" of the Company unpaid during the pandemic; Defendant never completed its commitments under the Amended MOU).

77 In conjunction with the May 2018 Note, Plaintiff alleges Defendant demanded the Company cease all conversations with other interested investors; the May 2020 Note prohibited the Company from raising additional capital without preapproval from Defendant, resulting in the Company foregoing two prospective investment offers which could have delivered at least $4 million in capital. *See* Ex. 20.

78 Plaintiff alleges Defendant demanded it receive 51% of the Company once it learned that the Company had hired an investment banker, which allegedly deterred potential investors; Defendant consorted with other Series A lead investors to chill new investors; Defendant expressed to Live Nation its non-support of Live Nation's $5 million investment and "dampened" the deal.

79 Dennis and Thompson allegedly told the Company it would only fund the Original MOU if the Company moved forward with BeautyCon POP, which the Company allegedly told Defendant was stretching to the "breaking point."

80 Compl. ¶ 42. "Upon information and belief, [Defendant] was aware that funding only 25% of the promised amount left many vendors and other customers of [the Company] unpaid during the middle of a global pandemic ....").

81 2020 WL 1814756 (Del. Ch. Apr. 9, 2020). The Court notes that *Preston Hollow* is a post-trial memorandum opinion. The Court of Chancery found by a preponderance of the evidence that the defendant committed tortious interference with prospective business relations after a review of the evidence submitted at trial. *Id.* at *11-12; *see Robinson v. Oakwood Village, LLC,* 2017 WL 1548549, at *11 (Del. Ch. Apr. 28, 2017) (stating plaintiffs bare the burden of proving each element

of their claims by a preponderance of the evidence). The Court does not have the benefit of viewing evidence and testimony that would be submitted at trial, however, Plaintiff has a lesser burden here defending against the motion to dismiss compared to proving this claim at trial by a preponderance of the evidence. At this stage in the litigation, Plaintiff need not prove that Defendant did in fact tortiously interfere, but only that it has alleged "a reasonably conceivable set of facts susceptible to proof entitling it to relief." *See* *Hackett v. TD Bank, N.A.,* 2023 WL 3750378, at *2 (Del. Super. May 31, 2023) (internal quotations omitted).

82 *See* *Preston Hollow,* 2020 WL 1814756, at *18-19 (finding defendant exerted improper economic pressure because "[t]he record, taken as a whole, shows consistent, systematic efforts by [the defendant] to shut down [the plaintiff's] ability to continue to do business."). *Id.* at *18.

83 Restatement (Second) of Torts § 766B cmt. d. (1979).

84 Plaintiff also alleged that Defendant contacted Live Nation directly to convey its non-support of the deal and preference to combine the Company with various brands to sell as one package. Compl. ¶ 36.

85 Exs. 5, 5-A.

86 *SIGA Technologies, Inc. v. PharmaAthene, Inc.,* 67 A.3d 330, 342 (Del. 2013) (citing Restatement (Second) of Conflicts of Laws § 187 (1971), then quoting *Abry Partners V, L.P. v. F & W Acq. LLC,* 891 A.2d 1032, 1047 (Del. Ch. Feb. 14, 2006)); *Change Capital Partners Fund I, LLC v. Volt Electrical Sys., LLC*, 2018 WL 1635006, at * 1 (Del. Super. Apr. 3, 2018) ("Delaware courts are generally reluctant to subvert parties' agreed-upon choice-of-law provisions.").

87 The Court does not find that California lacks a substantial relationship to the parties or transaction. The Company's headquarters were located in California, the parties' relationship was centered in California, injury to the Company was suffered in California, and key witnesses are located in California.

88 *See infra* ANALYSIS Section II.C.4.

89 *Williams v. Atria Las Posas,* 235 Cal. Rptr. 3d 341, 344 (Cal. Ct. App. 2d. June 27, 2018) (internal citations omitted).

90 By the terms of the Original MOU, the deadline for the qualified financing investment was March 2019.

91 Am. MOU (emphasis added).

92 By the terms of the Original MOU, the deadline for the common shares acquisition was December 31, 2018.

93 Am. MOU (emphasis added). By the terms of the Original MOU, the deadline to establish a long-term commercial partnership was December 31, 2018.

94 Compl. ¶ 56. Plaintiff does not allege that Defendant failed to fund the NGMP 2018 Revised Offer referenced in Paragraph 2.a. of the Amended MOU and the first sentence of the QFI Provision.

95 Compl. ¶ 57.

96 Compl. ¶ 57.

97 *Ladas v. California State Auto. Ass'n,* 23 Cal. Rptr. 2d 810, 814 (Cal. Ct. App. 1st Oct. 22, 1993).

98 *Gordon v. Rother,* 2019 WL 762151, at *5 (Cal. Ct. App. 2d Feb. 21, 2019); *Weddington Productions Inc. v. Flick,* 71 Cal. Rptr. 2d 265, 277 (Cal. Ct. App. 2d Jan. 7, 1998).

99 *Weddington Productions Inc.*, 71 Cal. Rptr. 2d at 277.

100 *Gordon,* 2019 WL 762151, at *5 (quoting *Copeland v. Baskin Robbins USA,* 117 Cal. Rptr. 2d 875 (Cal. App. Ct. 2d. Mar. 19, 2002)).

101 *Id.* (quoting *Baskin Robbins* 117 Cal. Rptr. 2d 875, 879).

102 *Id.* (quoting *Baskin Robbins* 117 Cal. Rptr. 2d at n. 3).

103 *Baskin Robbins,* 117 Cal. Rptr. 2d 875.

104 *Id.* at 878-89.

105 *Id.* at 878.

106 *Id.*

107 *Id.* at 878-79.

108 *Id.* at 879.

109 *Id.* at 880-83.

110 *Id.* at 880 (internal citations omitted). California courts have repeatedly affirmed and cited to the holding in *Baskin Robbins* that an agreement to negotiate or negotiate in good faith is an enforceable agreement. *See, e.g.,* *Sheen v. Wells Fargo Bank, NA,* 505 P.3d 625, nn. 4-5 (Cal. 2022); *Machado v. Myers,* 252 Cal. Rptr. 3d 493, n. 9 (Cal. Ct. App. 4th Aug. 16, 2019) (holding "parties' agreement to 'meet and confer' regarding conditions for revocation of the license agreement does not render the agreement unenforceable" (citing *Baskin Robbins*)); *Cedar Fair, LP v. City of Santa Clara,* 123 Cal. Rptr. 3d 667, 681 (Cal. Ct. App. 6th Apr. 6, 2011) (holding term sheet expressly bound parties to continue negotiating in good faith); *Brehm v. 21st Century Ins. Co.,* 83 Cal. Rptr. 3d 410, 423 (Cal. Ct. App. 2d. Sept. 16, 2008) (holding defendant's "express contractual right to resolve any remaining disputes by arbitration is not inconsistent with its implied obligation to attempt in good faith to reach agreement with its insured prior to arbitration"); *Keystone Land & Development Co. v. Xerox Corp.*, 353 F.3d 1093, 1097 (9th Cir. 2003) (finding "[m]ost jurisdictions recognize the enforceability of contracts to negotiate in an appropriate case" (citing *Baskin Robbins* and collecting cases in accord)); *In re Sony Gaming networks and Customer Data Security Breach Litigation,* 996 F. Supp. 2d 942, 1013-1014 (S.D. Cal. 2014) (holding "[p]laintiff's claim could be based on an alleged breach of an 'agreement to negotiation' " (citing to *Baskin Robbins*)).

111 *Baskin Robbins,* 117 Cal. Rptr. 2d at 880-81.

112 Am. MOU (emphasis added).

113 *See supra* nn. 103-111 and accompanying text. Pursuant to California law, reliance damages (including out of pocket costs of negotiating or perhaps lost opportunity costs) are the only form of damages available for a breach of an agreement to negotiate in good faith. *Baskin Robbins,* 117 Cal. Rptr. 2d at 885. Expectation damages are not permitted because courts have "no way of knowing what the ultimate terms of the agreement would have been or even if there would have been an ultimate agreement." *Id.* Plaintiff has not alleged reliance damages for this claim. Plaintiff only alleges damages in the amount of $10 million or more based on a breach of the QFI provision. Although Defendant does not raise this issue, it could constitute an independent ground for dismissal.

114 Def. Reply Br. at 18-19.

115 Compl. ¶¶ 23, 28, 29, 42 (shortly after Defendant signed the May 2018 commitment, Defendant refused to respond to numerous communications and "went dark" as the Company "sought to secure the promised funds with BeautyCon LA looming"; Defendant refused to completely fund its loan agreements and conditioned funding on the Company's pursuit of BeautyCon POP which "stretched the Company to the breaking point"; Defendant's chief of retail was unable (or unwilling) to support BeautyCon POP as Defendant promised; Upon information and belief, Defendant was aware that funding only 25% of the May 2020 Note left many vendors and Company customers unpaid during the pandemic.).

116 *Baskin Robbins,* 117 Cal. Rptr. 2d at 879 (quoting *City of Los Angeles v. Superior Court*, 333 P.2d 745, 750 (Cal. 1959)).

117 Am. MOU (emphasis added).

118 *See Ladas v. California State Auto. Ass'n.,* 23 Cal. Rptr. 2d 810, 814 (Cal. Ct. App. 1st, Oct. 22, 1993) (affirming trial court's holding that insurance company's alleged promise to pay parity in setting commission rates "is too vague and indefinite to give rise to an enforceable contractual duty."); *Peterson Development Co. v. Torrey Pines Bank,* 284 Cal. Rptr. 367, 374-75 (Cal. Ct. App. 4th Aug. 9, 1991) (holding loan commitment was not enforceable where it did not specify identity of the potential borrower, loan amount, percentage of purchase price, interest rates or repayment terms); *Goldberg v. Santa Clara,* 98 Cal. Rptr. 862, 862-63 (Cal. Ct. App. 1st, Dec. 6, 1971) (finding contract calling for additional compensation if plaintiff achieved "savings to the City of such magnitude" to justify that compensation was too vague to be enforceable).

119 *Pivotal Payments Direct Corp. v. Planet Payment, Inc.,* 2015 WL 11120934, at *3 (Del. Super. Dec. 29, 2015) (internal citations omitted); *see also Weinstein v. Luxeyard, Inc.,* 2022 WL 130973, at *3 (Del. Super. Jan. 14, 2022); *In re Rehabilitation of Manhattan Re-Insurance Co.,* 2011 WL 4553582, at *8 (Del. Ch. Oct. 4, 2011); *B.E. Capital Management Fund LP v. Fnd.com, Inc.,* 171 A.3d 140, 147 (Del. Ch. Oct. 4, 2017).

120 *AssuredPartners of Virginia, LLC v. Sheehan,* 2020 WL 2789706, at *12 (Del. Super. May 29, 2020).

121 *Puig v. Seminole Night Club, LLC,* 2011 WL 3275948, n. 21 (Del. Ch. July 29, 2011) (quoting *In re Coca–Cola Enters., Inc.,* 2007 WL 3122370, at *6 (Del. Ch. Oct. 17, 2007); *see also Solow v. Aspect Resources, LLC,* 2004 WL 2694916, at *3 (Del. Ch. Oct. 19, 2004)).

122 *AssuredPartners of Virginia, LLC,* 2020 WL 2789706, at *12.

123 *S&R Associates, LP v. Shell Oil Co.,* 725 A.2d 431, 439 (Del. Super. Sept. 30, 1998); *Jeter v. RevolutionWear, Inc.,* 2016 WL 3947951, at *10 (Del. Ch. July 19, 2016); *Pivotal Payments Direct Corp. v. Planet Payment, Inc.,* 2015 WL 11120934, at *5 (Del. Super. Dec. 29, 2015).

124 *Ocimum Biosolutions (India) Ltd. v. AstraZeneca UK Ltd.*, 2019 WL 672836, at *9 (Del. Super. Dec. 4, 2019).

125 *In re Tyson Foods, Inc.,* 919 A.2d 563, 585 (Del. Ch. Feb. 6, 2007).

126 *See Pivotal Payments Direct Corp.,* 2015 WL 11120934, at *4.

127 *Id.*

128 The Note referred to in the original MOU is dated June 18, 2018.

129 *Pivotal Payments Direct Corp.,* 2015 WL 11120934, at *5.

130 *Jeter v. RevolutionWear, Inc.,* 2016 WL 3947951, at *10 (internal quotations omitted).

131 *Morton v. Sky Nails,* 884 A.2d 480, 482 (Del. 2005); *Pack & Process, Inc. v. Celotex Corp.,* 503 A.2d 646, 650 (Del. Super. Oct. 16, 1985) (quoting *Pioneer Nat. Title Ins. Co. v. Sabo,* 382 A.2d 265 (Del. Super. Jan. 17, 1978)); *S&R Associates, LP v. Shell Oil Co.,* 725 A.2d 431, 439 (Del. Super. Sept. 30, 1998).

132 *Pack & Process, Inc.,* 503 A.2d at 650 (quoting *Pioneer Nat. Title Ins. Co.,* 382 A.2d 266-67).

133 Paragraph 32 of the complaint alleges that Defendant backchannelled with other Series A investors to chill new investors but does not provide a time frame as to when this occurred.

134 Compl. ¶ 38.

135 *See Jeter v. RevolutionWear, Inc.,* 2016 WL 3947951, at *10.

136 *See BeautyCon Media ABC v. New General Market Partners,* C.A. No. N22C-12-143 MAA CCLD, Adams, J., Transaction ID 70026953 (Del. Super. May 16, 2023).

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2

27 Del.Ch. 273
Supreme Court of Delaware.

BODLEY
v.
JONES.

April 26, 1943.

Synopsis
Bill in equity by Rhoda E. Jones, also known as Rhodie E. Jones, against Harley R. Bodley, executor of the estate of William Fortner, deceased, to impress a trust upon a certain bond and mortgage held by defendant executor. From a decree for complainant, 27 A.2d 84, the defendant executor appeals.

Reversed and remanded.

West Headnotes (13)

[1] **Equity** Motions Relating to Pleadings

On complainant's motion for a decree notwithstanding the answer as amended, averments of amended answer were admitted to be true.

2 Cases that cite this headnote

[2] **Pleading** Allegations on knowledge, or on information and belief

Where party states that he is informed, believes, and therefore, avers the truth of a fact, it is more than an averment of confidence in source of information, and is a sufficiently positive "allegation of fact".

1 Case that cites this headnote

[3] **Trusts** Nature and essentials of trusts

The intention of owner of personal property to change position from that of owner to one of trustee for benefit of another is that which is outwardly manifested by either written or spoken words or by conduct.

3 Cases that cite this headnote

[4] **Trusts** Property which may be subject of trusts

Trusts Consideration

The owner of personalty may, by a declaration of trust, constitute himself a "trustee" of the property for benefit of another, even without receiving consideration therefor, and technical words are not necessary nor is any particular form required.

[5] **Trusts** Trusts taking effect in future

That owner of bond and mortgage regularly collected and applied to his own use income from the investment until his death nearly five years after executing a written instrument declaring that money invested in the bond and mortgage belonged to a named person, and that bond and mortgage should be turned over to such person after owner's death in event it had not already been done, indicated that owner did not intend to make a present gift of bond and mortgage with a "trust" attached.

2 Cases that cite this headnote

[6] **Trusts** Trusts taking effect in future

Where written instrument, stating that money invested in a bond and mortgage belonged to a named person, and that the bond and mortgage should be turned over to such person after maker's death in event it had not already been done, instrument was not enforceable after maker's death as a declaration of "trust", notwithstanding that maker during his lifetime had delivered instrument to the named person.

2 Cases that cite this headnote

[7] **Trusts** Trusts taking effect in future

Where written instrument, stating that money invested in a bond and mortgage belonged to named person and that bond and mortgage should be turned over to such person after

maker's death in event it had not already been done, was unenforceable as a trust after maker's death, if money invested in bond and mortgage was named person's money as the instrument declared, such person would be entitled to proceeds of bond and mortgage, but if money so invested was actually maker's money, the executor of maker's estate would be entitled to proceeds.

[8] **Trusts** Sufficiency of Language Used

In order to create an "express trust", the intention to do so must be evidenced by definite, explicit and unequivocal words, or by circumstances so revealing and compelling as to manifest the intention with all reasonable certainty.

9 Cases that cite this headnote

[9] **Trusts** Sufficiency of Language Used

The words or circumstances relied upon to create a trust must admit of but one interpretation, and no trust is created if the transaction is as consistent with another form of undertaking as with that of a trust.

3 Cases that cite this headnote

[10] **Trusts** Necessity and sufficiency of delivery of property

In order to create a "trust", it is not essential that the declaration of trust be delivered to beneficiary, nor that he be informed of its existence.

1 Case that cites this headnote

[11] **Trusts** Necessity and sufficiency of delivery of property

Fact of delivery of declaration of trust to beneficiary alone does not supply inadequacy of the declaration as a sufficient disclosure of an intention to create a "trust".

1 Case that cites this headnote

[12] **Trusts** Weight and Sufficiency

Where a written instrument declared that money invested in a bond and mortgage belonged to a named person and that bond and mortgage should be turned over to such person after maker's death in event it had not already been done, fact that person named in instrument made no demand for interest on the investment as it accrued indicated that such person did not believe that she was entitled to any present right and interest in the bond and mortgage.

1 Case that cites this headnote

[13] **Trusts** Interest remaining in settlor or creator of trust

The intention of owner of personal property to constitute himself a "trustee" of the property for benefit of another when effectuated, means a present gift of the equitable estate with reservation of the legal title.

2 Cases that cite this headnote

***437** LAYTON, C. J., and RICHARDS, RODNEY, SPEAKMAN, and TERRY, JJ., sitting.

Attorneys and Law Firms

William Prickett, of Wilmington, for appellant.

Philip Cohen, of Wilmington, for appellee.

Supreme Court, February Session, 1943. Appeal from a decree of the Court of Chancery for New Castle County

Opinion

LAYTON, Chief Justice.

This is an appeal from a decree of the Court of Chancery impressing a trust in favor of the appellee upon the proceeds of a bond and mortgage.

The appellant is the executor of the last will and testament of William Fortner, deceased, who, at the time of his death, was the mortgagee and obligee named in a certain mortgage

and bond given and executed by one Royden Caulk, bearing date October 8, 1935, to secure the payment of the sum of $3500.00, and of record in the office of the Recorder of Deeds for New Castle County.

Subsequent to the mortgage, on October 16, 1935, William Fortner, signed, sealed and delivered to the appellee a paper writing in these words:

"To Whom It May Concern:

"This is to certify that the money invested in the Royden Caulk bond and mortgage for Thirty Five Hundred Dollars ($3500.00) belonged to Miss Rhodie E. Jones of Appoquimink Hundred and in the event of my death this bond and mortgage is to be turned over to her by my executor if I have not done so previously".

William Fortner died on July 21, 1940, without having transferred the bond and mortgage to the appellee. The appellant, as executor, refused to make the transfer. Consequently, on January 17, 1941, the appellee filed a bill of complaint in the court below against the executor praying that the bond and mortgage be impressed with a trust in her favor; and that the appellant, as executor, be directed to transfer the bond and mortgage to her.

The appellant in his answer averred that the money invested in the bond and mortgage was not the money of the appellee; and that the paper writing made and delivered by the deceased to the appellee was not sufficient to, and did not, transfer title to the bond and mortgage to her.

The appellee promptly moved for a decree notwithstanding the answer. Thereupon, the appellant was allowed to amend his answer by averring that the money ***438** invested in the mortgage was the money of William Fortner, the deceased; and that he, from the date of the bond and mortgage to the time of his death, took all payments of interest on the bond and mortgage for his own use.

On June 24, 1942, the Chancellor filed an opinion in which it was stated that a decree would be entered in favor of the appellee pursuant to the prayers of his bill. To clarify an averment in the answer to which reference was made in the opinion, the appellant, upon leave granted, filed a further amendment to his answer in which it was averred that the interest on the bond and mortgage became due and payable at regular intervals, and that at all times the interest was paid to and collected by the deceased mortgagee, who received and used the payments of interest for his own benefit and purposes; and that during the lifetime of the deceased, the appellee never made demand for the payment to her of the interest as it accrued. It was held, however, that the amended answer did not affect the conclusion reached in the opinion filed that the deceased intended to declare a trust. Jones v. Bodley, Del.Ch., 27 A.2d 84. A final decree was entered, and this appeal followed. Since the hearing, and by consent, the mortgage debt was paid, and the proceeds are in the possession of the appellant.

[1] There is a preliminary comment to be made. At one place in the opinion of the Chancellor he is careful to say that the allegations of the first amendment to the answer were on information and belief. Standing alone the statement is of small significance; but again, in the note appended to the opinion proper having relation to the second amendment to the answer, the Chancellor stated that the defendant was subsequently permitted further to amend his amended answer by specifically alleging, "though on information and belief" the facts averred therein. The reiteration of the statement that the averments of the amendments were on information and belief has given rise to some speculation whether the fact was given weight in arriving at the conclusion. If the statements were not idly made and were intended to have significance, it must have been for the reason that the allegations of the amendments were not regarded as positive in character. The language of the pleader in each instance, however, was that the respondent "is informed, believes, and, therefore, avers". There are cases holding that an averment on information and belief puts in issue only the party's information and belief, and not the truth or falsity of the facts referred to. 21 C.J. 395; 30 C.J.S., Equity, § 223; 3 Ency.Pl. & Pr. 360. But where the party states that he is informed, believes and, therefore, avers the truth of a fact, it is more than an averment of confidence in the source of information, and is a sufficiently positive allegation of fact. 21 C.J. 395; 30 C.J.S., Equity, § 223; Read v. Walker, 18 Ala. 323; Coryell v. Klehm, 157 Ill. 462, 41 N.E. 864.

[2] [3] [4] [5] [6] The applicable principles of law are well settled. The legal owner of personal property is prima facie entitled to its beneficial use and enjoyment. He may, by a declaration of trust, constitute himself a trustee of the property for the use and benefit of another even without receiving consideration therefor. Technical words are not necessary, nor is any particular form required. It is the intention of the donor that is to be discovered; and the intention to change position from that of owner to one of trustee is that which is outwardly manifested by either written or spoken words or by conduct. Such intention effectuated means a present gift of the

equitable estate with reservation of the legal title. Instability of titles with dangerous and far reaching consequences would ensue if an express trust could be created by language or circumstances capable of another construction, or consistent with a different intention; and the authorities are agreed that in order to create an express trust the intention so to do must be evidenced by definite, explicit and unequivocal words, or by circumstances so revealing and compelling as to manifest the intention with all reasonable certainty. It follows, necessarily, that the words or the circumstances must admit of but one interpretation, and no trust is created if the transaction is as consistent with another form of undertaking as with that of a trust. Elliott v. Gordon, 10 Cir., 70 F.2d 9; Beaver v. Beaver, 117 N.Y. 421, 22 N.E. 940, 6 L.R.A. 403, 15 Am.St.Rep. 531; 65 C.J. 280; 1 Scott, Trusts, 147. See Maxfield v. Terry, 4 Del.Ch. 618.

[7] There is nothing in the opinion of the Chancellor to suggest any disagreement with these accepted principles. The conclusion reached was that the fair and reasonable inference to be drawn from the ***439** language of the document was that the deceased intended to declare himself a trustee for the benefit of the appellee. The averments of the answer as amended, which for the purposes of the motion for a decree were admitted to be true, that the money invested in the bond and mortgage was the money of the deceased, that the interest on the investment was regularly paid to the deceased and was used by him as his own, and that the appellee never made demand for the interest in the lifetime of the deceased, were waived aside as without importance.

[8] [9] [10] [11] This conception of an intention to create a trust as manifested solely by the language used would be understandable enough, although disagreement with the view is permitted, were it not that the learned Chancellor surprisingly proceeded to say that the language of the document was sufficiently ambiguous to permit the use of surrounding circumstances to aid in determining the intent. This is, perforce, an admission that the language itself is inadequate to discover the declarant's intention with the certainty that is required, and in such case the doubtfulness of intention as disclosed by the words must be set at rest by extrinsic circumstances. If resort be had to circumstances, the fact that the deceased delivered the document to the appellee is not to be entirely ignored; but it is not essential that the declaration of trust be delivered to the beneficiary nor that he be informed of its existence. In re Brown's Will, 252 N.Y. 366, 169 N.E. 612; 1 Scott, Trusts, 150. The fact of delivery alone does not supply the inadequacy of the writing as a sufficient disclosure of an intention to create a trust; and other circumstances tend to negative such an intention. The fact that the deceased for nearly five years regularly collected and applied to his own use the income from the investment strongly suggests that he did not intend to make, nor understand that he had made, a present gift of the bond and mortgage with a trust attached, and that he held them for the benefit of the appellee. And, likewise, the fact that during these years the appellee made no demand for the interest, as it accrued and became payable from time to time, indicates forcibly that she did not understand and believe that she was entitled to any present right and interest in the bond and mortgage. Elliott v. Gordon, supra. These strongly persuasive circumstances were thought to be unimportant; and, reading the opinion as a whole, it seems to have been held that the declaration, although ambiguously phrased, was, nevertheless, an adequate manifestation of the deceased's intention to create a trust for the benefit of the appellee.

[12] With deference to the conclusion reached, we are compelled to take a different view of the language of the document. Standing alone, and giving to the words used their plain meaning, the declaration seems to be no more than a written acknowledgment of a type of trust, called a resulting trust, raised by implication of law, and presumed to have been contemplated by the parties, in favor of the person furnishing the consideration for the transaction. The document declares that the money invested in the bond and mortgage belonged to the appellee. If this be true and certainly the deceased took the security in his own name, the equitable title both to the money and the security which represented the money vested eo instanti in the appellee. The deceased was not dealing with his own property, and by a declaration changing his position from that of owner to one of trustee. The law made him trustee at the outset.

But here, as well as in the Court below, the theory of a resulting trust, for whatever reason, is expressly disavowed. It is insisted that the writing itself is entirely adequate as a declaration of trust; and it is when the attempt is made to twist the plain language of the document into an unequivocal expression of an intention to create an express trust in favor of the appellee that formidable difficulty arises. The language used is insufficient for the purpose; and when extrinsic circumstances are considered the doubt grows as to the type of transaction intended. Reading the document in the light of the admitted fact that the money invested in the bond and mortgage was the money of the deceased and not of the appellee, what remains is but an expression of an intention on

the part of the deceased to transfer in his lifetime the bond and mortgage to the appellee, and failing which, a direction to his executor to make the transfer. Conceding, arguendo, that the language of the writing and the surrounding circumstances may possibly be interpreted as evidencing an intention to create a trust in the appellee's favor, other interpretations are more allowable; one is that it was the deceased's intention to make a gift in futuro of the ***440** bond and mortgage to the appellee; another that he attempted a testamentary disposition not in a manner authorized by law. In either of the last mentioned situations a court of equity is powerless.

[13] We are satisfied that a decree in favor of the complainant should not have been rendered, and the cause will be remanded to the court below for such other and further proceedings as may be thought necessary or expedient. We do not know what course the appellee may pursue, nor what the truth of the matter may prove to be. If it shall be proved that the money invested in the bond and mortgage was the appellee's money, as the document declares, she would be entitled to a decree in the absence of countervailing circumstances. If, on the other hand, the money so invested was the money of the deceased, in the absence of facts and circumstances showing clearly and unequivocally the deceased's intention to declare a trust in the appellee's favor, the appellee would not be entitled to relief.

Reversed and remanded.

All Citations

27 Del.Ch. 273, 32 A.2d 436

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3

27 Del.Ch. 33
Court of Chancery of Delaware.

BOVAY et al.

v.

H. M. BYLLESBY & CO. et al.

Jan. 7, 1943.

Synopsis

Suit by Harry E. Bovay and another, trustees in bankruptcy of Vicksburg Bridge and Terminal Company, a corporation of the State of Delaware, against H. M. Byllesby and Company, a corporation of the State of Delaware, and another, to recover money which defendants allegedly, illegally, and improperly caused the bankrupt to pay them at a time when fiduciary relation existed between defendants and the bankrupt, and for an accounting. On complainants' motion to strike from the record the defendants' plea of the Statute of Limitations.

Motion denied.

West Headnotes (19)

[1] **Bankruptcy** Limitations and time to sue; computation

Under the Bankruptcy Act the right of trustees in bankruptcy of corporation to sue for fraudulent breach of fiduciary relation by promoters was limited to two years from date when reorganization proceedings took effect or to such further period as might be permitted by state laws. Bankr.Act § 11, sub. e, § 77B, 11 U.S.C.A. § 29, sub. e, § 207.

[2] **Bankruptcy** Limitations and time to sue; computation

The provision of the Bankruptcy Act suspending running of limitations during pendency of reorganization proceedings does not affect the meaning of another provision that receiver or trustee may, within two years subsequent to date of adjudication or within such further period as federal or state law may permit, institute proceedings in behalf of the estate upon any claim against which limitation period had not expired at time of filing of petition in bankruptcy. Bankr.Act § 11, sub. e, § 77B, sub. b, 11 U.S.C.A. § 29, sub. e, § 207, sub. b.

1 Case that cites this headnote

[3] **Corporations and Business Organizations** Fiduciary nature of relation

The officers and directors of a corporation are "fiduciaries" but they are not real "trustees of an express trust" and do not hold the legal title to corporate property.

2 Cases that cite this headnote

[4] **Equity** Fiduciary rights and obligations

Limitation of Actions Actions to which statute applies

An express trust is within exclusive jurisdiction of a court of equity and the statute of limitations does not ordinarily run against the rights of beneficiary.

1 Case that cites this headnote

[5] **Equity** Fiduciary rights and obligations

Limitation of Actions Actions to which statute applies

Implied trusts are not within the exclusive jurisdiction of a court of equity, and the statute of limitations is applicable and may be pleaded accordingly.

[6] **Equity** Loss of legal remedy by limitations

In cases coming within its exclusive jurisdiction, a court of equity need not follow the statutory period of limitations governing similar actions at law in determining whether the complainant is guilty of laches barring his right of action.

3 Cases that cite this headnote

[7] **Equity** Loss of legal remedy by limitations

In absence of some unusual circumstances, the analogous statutory period of limitations is frequently applied in determining whether a complainant is barred from maintaining an action by laches.

3 Cases that cite this headnote

[8] **Equity** Loss of legal remedy by limitations

In cases coming within their concurrent jurisdiction, courts of equity consider themselves bound to apply the analogous statutory period of limitations governing actions at law.

3 Cases that cite this headnote

[9] **Equity** Loss of legal remedy by limitations

If a legal right gets into equity, the statute of limitations governs rather than the doctrine of laches and may be pleaded accordingly.

[10] **Limitation of Actions** Nature of statutory limitation

"Statutes of limitations" are intended to prevent the enforcement of stale demands, and are based on reasons of sound policy, and are statutes of repose, intended to exact diligence.

6 Cases that cite this headnote

[11] **Limitation of Actions** Construction of Limitation Laws in General

Generally courts will not read into statutes of limitations conditions or exceptions that do not appear, and usually no considerations of mere inconvenience or hardship will control their apparent meaning.

1 Case that cites this headnote

[12] **Limitation of Actions** Actions to which statute applies

In determining whether a suit by trustees in bankruptcy of a corporation for alleged fraudulent breach of fiduciary relation by promoters was barred by limitations, promoters who were stockholders and who controlled the actions of a majority of corporation's officers and agents when transactions complained of occurred, were in position of "fiduciaries" but were not necessarily "trustees of an express trust". Rev.Code 1935, § 5124 et seq.

1 Case that cites this headnote

[13] **Limitation of Actions** Actions to which statute applies

In determining whether suit by trustees in bankruptcy of corporation for alleged fraudulent breach of fiduciary relation by promoters was barred by limitation, that the corporation was insolvent since its very organization did not change the rule that officers and directors of a corporation are "fiduciaries" and not "trustees of an express trust". Rev.Code 1935, § 5124 et seq.

2 Cases that cite this headnote

[14] **Limitation of Actions** Discovery of Fraud

Limitation of Actions Diligence in discovering fraud

The statute of limitations does not apply when the alleged fraudulent acts are concealed from the plaintiff and in such cases its application is suspended until plaintiff's rights are discovered or could have been discovered by exercise of reasonable diligence. Rev.Code 1935, § 5124 et seq.

2 Cases that cite this headnote

[15] **Limitation of Actions** Discovery of Fraud

The Delaware limitation statute permits suits to be brought within three years from discovery of the fraud. Rev.Code 1935, § 5124 et seq.

1 Case that cites this headnote

[16] **Limitation of Actions** Pendency of proceedings under assignment for creditors or in insolvency or bankruptcy

A suit by trustees in bankruptcy of corporation in reorganization proceedings for fraudulent breach

of fiduciary relation by promoters, which suit was filed more than three years after discovery of alleged fraud was barred by the three-year statute of limitations as against contention that statute was suspended on ground of necessity because suit was started shortly after bankruptcy court had authorized it, since trustees were mere "agents" of bankruptcy court which could have directed prosecution of claim within statutory time. Rev.Code 1935, § 5124 et seq.; Bankr.Act. § 77B, 11 U.S.C.A. § 207.

2 Cases that cite this headnote

[17] **Limitation of Actions** Pendency of proceedings under assignment for creditors or in insolvency or bankruptcy

The purpose of provision of Bankruptcy Act suspending running of limitations during pendency of corporate reorganization proceedings is to preserve the rights of creditors of bankrupt as they existed at commencement of proceedings, to give time for a proper consideration of reorganization plan, and to prevent precipitate action by creditors. Bankr.Act. § 77B, sub. b, 11 U.S.C.A. § 207 sub. b.

3 Cases that cite this headnote

[18] **Limitation of Actions** Pendency of proceedings under assignment for creditors or in insolvency or bankruptcy

A suit by trustees in bankruptcy of corporation in reorganization proceedings for alleged breach of fiduciary relation by promoters, which suit was commenced more than three years after discovery of alleged fraud was barred by the three-year statute of limitations, as against contention that running of limitation was suspended by the Bankruptcy Act. Rev.Code 1935, § 5124 et seq.; Bankr.Act. § 11, sub. e, § 77B, sub. b, § 102, 11 U.S.C.A. § 29, sub. e, § 207, sub. b, § 502.

[19] **Trusts** Possession, use, and care of property

Until the relation is clearly repudiated the possession of trustee is presumed to be the possession of the beneficiary.

***803** Bill in Equity, filed by the Trustees in Bankruptcy of the Vicksburg Bridge & Terminal Company, to recover certain specified large sums of money, alleged to have been improperly procured from that corporation, by contract or otherwise, by H. M. Byllesby and Company, and applied to its use, at a time when a fiduciary relation existed between the two corporations.

Byllesby and Company demurred to the original bill: (1) That no ground of equitable jurisdiction was alleged, and (2) that the complainants had an adequate remedy at law. The demurrer was sustained on the first ground. Del.Ch., 12 A.2d 178. An amended bill was subsequently filed, and was demurred to for the same reasons, and on the additional ground that it appeared therefrom that the complainants were guilty of laches, barring any possible right of action. That demurrer was overruled. Del. Ch., 22 A.2d 138. In the opinion filed, it was held that the apparent unreasonable delay in filing the complainants' bill had been sufficiently excused by its allegations. Del. Ch., 22 A.2d 138, supra. The defendants subsequently filed a plea of the statute of limitations, alleging that the bill had not been filed within three years after the discovery of the alleged fraud, and that the complainants, therefore, had no enforceable right of action. On motion of the complainants, the legal sufficiency of that plea was set down for argument; the motion, also, included a request that it be stricken from the record for insufficiency in both form and substance.

The case was heard on those issues.

Attorneys and Law Firms

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Aaron Finger (of Richards, Layton & Finger), of Wilmington, for defendants.

Opinion

THE CHANCELLOR.

The real question is whether the statute of limitations is a good plea.

[1] [2] [3] In cases coming within its exclusive jurisdiction, a Court of Equity is not bound to follow the statutory period of limitations, governing similar actions at law, in determining whether a complainant is guilty of laches, barring his right of action. Bovay et al. v. Byllesby & Co., Del. Ch., 12 A.2d 178; Id., Del.Ch., 22 A.2d 138. In the absence of some unusual circumstances, the analogous statutory period of limitations is frequently, and, perhaps, usually applied, in determining that question. Id. Its application is, however, merely by analogy, rather than by compulsion. Godden v. Kimmell, 99 U.S. 201, 25 L.Ed. 431; 2 Pomeroy's Eq.Jur., 5th Ed., §§ 419 a, 419 e. In such cases, an apparent unreasonable delay could, perhaps, be excused, and a plea of the statute of limitations would be unnecessary. See Story's Eq.Pl. §§ 756, 760; Talmash v. Mugleston, 4 L.J. Ch. (O.S.) 200 (2 Chafee and Simpson Cases on Equity 1259). But, in cases coming within their concurrent jurisdiction, it seems that Courts of Equity consider themselves bound to apply the analogous statutory period of limitations, governing actions at law. The Old Court of Errors and Appeals so held in Perkins v. Cartmell's Adm'r, 4 Har. 270, 42 Am.Dec. 753; see, also, Dodd, Adm'r v. Wilson, 4 Del.Ch. 399; Gootee v. Riggin, 12 Del.Ch. 91, 107 A. 452; Bush v. Hillman Land Co., 22 Del. Ch. 374, 2 A.2d 133; Haas v. Sinaloa, etc., Co., 17 Del.Ch. 253, 152 A. 216; Rugan v. Sabin, 9 Cir., 53 F. 415; Blue v. Everett, 56 N.J.Eq. 455, 39 A. 765; Kane v. Bloodgood, 7 Johns.Ch., N.Y., 90, 11 Am.Dec. 417; 2 Pomeroy's Eq.Jur., 5th Ed., § 419 e.

In Perkins v. Cartmell's Adm'r, supra, referring to that rule, the Court said:

"Courts of equity consider themselves within their [Statutes of Limitations] spirit and meaning; and that sound policy and public convenience require their adoption".

They, apparently, take the view that it would be unjust to permit a litigant, having a legal right, to evade the statute, barring its enforcement, by seeking the aid of another court, having concurrent jurisdiction, merely because it could give more adequate and complete relief. Blue v. Everett, supra; Wood on Limitations 277; 2 Pomeroy's Eq.Jur., 5th Ed., § 419 e; 34 Amer.Jur. 55.

***804** [4] In other words, it seems that if a "legal right gets into equity, the statute governs". 2 Pom.Eq.Jur., 5th Ed., § 419 e; 17 R.C.L. 736. In such cases, the statute of limitations, as such, rather than the doctrine of laches, is applicable, and may be pleaded accordingly. Story's Eq.Pl. § 756; Talmash v. Mugleston, supra. This distinction was overlooked in both of the opinions previously filed. Bovay et al. v. Byllesby & Co., Del.Ch., 12 A.2d 178; Id., Del. Ch., 22 A.2d 138.

[5] [6] [7] In determining whether the statute of limitations is a valid plea, the precise question is whether it appears that the defendant company is in the position of a trustee of an express trust; but the above principles govern the case. An express trust is within the exclusive jurisdiction of a Court of Equity, and the statute of limitations, therefore, does not, ordinarily, run against the rights of the cestuis que trust. Colwell v. Miles, 2 Del.Ch. 110; Hayden v. Thompson, 8 Cir., 71 F. 60; Boyd v. Mutual Fire Ass'n, 116 Wis. 155, 90 N.W. 1086, 94 N.W. 171, 61 L.R.A. 918, 96 Am. St.Rep. 948; 2 Pomeroy's Eq.Jur., 5th Ed., § 419 a, note. Until the relation is clearly repudiated, the possession of the trustee is presumed to be the possession of the cestuis que trust. Hayden v. Thompson, supra; Felsenheld v. Block Bros. Tobacco Co., 119 W.Va. 167, 192 S.E. 545, 123 A. L.R. 347; 17 R.C.L. 708. But mere implied trusts are in an entirely different category. They are not within the exclusive jurisdiction of a Court of Equity, and the statute of limitations is applicable, and may be pleaded accordingly. Cooper v. Hill, 8 Cir., 94 F. 582; Jones Mining Co. v. Cardiff Min. & Mill. Co., 56 Utah 449, 191 P. 426; Landis v. Saxton, 105 Mo. 486, 16 S.W. 912. This case is within that rule.

[8] [9] [10] It appears from the allegations of the bill that H. M. Byllesby and Company was a stockholder in the Vicksburg Bridge & Terminal Company, and promoted its organization. It, also, appears that it controlled the actions of a majority of the officers and agents of the Bridge Company, when the transactions, complained of, occurred. Byllesby and Company was in the position of a fiduciary, but it does not follow that it was a trustee of an express trust. The officers and directors of a corporation are fiduciaries (Jones Mining Co. v. Cardiff Min. & Mill. Co., supra; Cooper v. Hill, supra; 1 Bogert on Trusts and Trustees, § 16, p. 59; Pomeroy's Eq.Jur., 5th Ed., § 1089; see, also, Guth v. Loft, Inc., 23 Del.Ch. 255, 5 A.2d 503); but they are not real trustees. Id. They do not hold the legal title to the corporate property. Id. They occupy a position of extreme trust and confidence toward all interested parties, and exercise great powers in managing corporate affairs, but they are not trustees of an express trust in the true sense of that term. Id. The fact that the Vicksburg Bridge & Terminal Company was insolvent since its very organization does not change that rule. Boyd v. Mutual Fire Ass'n, supra; Hayden v. Thompson, supra; Winston v. Gordon, 115 Va. 899, 80 S.E. 756; Lexington & O. R. Co. v. Bridges, 7 B.Mon., Ky., 556, 46 Am.Dec. 528. The so-called trust fund theory is not involved, and need not be considered.

[11] [12] [13] [14] Statutes of limitations are intended to prevent the enforcement of stale demands, and are based on reasons of sound policy; they are statutes of repose, intended to exact diligence. Carey, Adm'r v. Morris, 5 Har. 299; Boston v. Bradley's Ex'r, 4 Har. 524. As a general rule, courts will not read into them conditions or exceptions that do not appear; and usually no considerations of mere inconvenience or hardship will control their apparent meaning. Lewis v. Pawnee Bill's Wild West Co., 6 Pennewill 316, 66 A. 471, 16 Ann. Cas. 903; 34 Am.Jur. 150, 151; 17 R.C.L. 829. The Supreme Court recently emphasized that general rule of statutory construction. Federal United Corp. v. Havender, Del.Sup., 11 A.2d 331. But it seems that the statute does not apply when the alleged fraudulent acts are concealed from the plaintiff; in such cases, it is said that its application is suspended until his rights are discovered, or could have been discovered by the exercise of reasonable diligence. Lieberman v. Wilmington First Nat. Bank, 2 Pennewill 416, 45 A. 901, 48 L.R.A. 514, 82 Am.St.Rep. 414. The theory seems to be that it would be inequitable and unjust to permit the defendant to profit by his own fraud. 17 R.C.L. 854, 855; 34 Amer.Jur. 152. The same rule has been applied in the Law Courts of this State. Trainer v. Deemer, 5 W.W.Harr. 396, 35 Del. 396, 166 A. 657. The complainants seek to extend that rule, and to imply other exceptions on the ground of alleged necessity. They point out that it appears from the allegations of the bill that the suit was started shortly after the Bankruptcy Court had authorized it. They claim that, prior to that order, they, as trustees, had no authority to file the bill, and that the ***805** application of the statute must have been intended to be suspended accordingly. Hutchinson v. Hutchinson, 92 Kan. 518, 141 P. 589, 32 L.R.A., N.S., 1165. But the facts alleged do not bring the case within any exception appearing in the statute. Chapt. 146, Rev.Code 1935. Nor can any such exception be implied on the ground of alleged necessity. 1 Wood on Limitations 17; 34 Amer.Jur. 155. The complainants concede that when the bill was filed the alleged fraud had been known for more than three years. As trustees, they were the mere agents of the Bankruptcy Court, and it could have directed the prosecution of the claim of the insolvent estate within the prescribed statutory time; there was no lack of power to assert any alleged rights.

Cases like Hanger v. Abbott, 6 Wall. 532, 18 L.Ed. 939 and United States v. Wiley, 11 Wall. 508, 20 L.Ed. 211, involve very different facts, and need not be considered. The real scope and meaning of the statute is the question, and the condition or exception, relied on by the complainants, cannot be read into it.

[15] [16] [17] [18] [19] Nor is the running of the statute of limitations suspended by the provisions of the Federal Bankruptcy Act. The bill alleges that, on January 30th, 1934, equity receivers were appointed for the Vicksburg Bridge & Terminal Company by the United States District Courts for the Western District of Louisiana and the Southern District of Mississippi, respectively. That company was subsequently adjudicated a bankrupt, on its voluntary petition, on February 12th, 1934, and the equity receivers became the receivers in bankruptcy. On November 21st, 1934, the various actions were consolidated; the regular bankruptcy proceedings were suspended, and reorganization proceedings, under 77B of that Act, 11 U.S.C.A. § 207, took effect. On the same day, the complainants were appointed trustees under the latter section of the Act, and are suing as such.

The old Section 11, sub. d of the Federal Bankruptcy Act was amended by the Chandler Act on June 22, 1938, and now consists of two subsections, 11, sub. d and 11, sub. e. 11 U.S.C.A. § 29, subs. d, e. Section 11, sub. d deals with suits against a receiver or trustee of a bankrupt estate, but Section 11, sub. e is the important one. It provides:

"A receiver or trustee may, within two years subsequent to the date of adjudication or within such further period of time as the Federal or State law may permit, institute proceedings in behalf of the estate upon any claim against which the period of limitation fixed by Federal or State law had not expired at the time of the filing of the petition in bankruptcy. ***"

Section 102 of the Bankruptcy Act of 1938, 11 U.S.C.A. § 502, further provides that the "date of adjudication" will be taken to be the same as the date of the approval of the debtor's petition.

By the express provisions of Section 11, sub. e, the right of the complainants, as trustees, to sue was, therefore, limited to two years from November 21st, 1934, or to such further period as might be permitted by State laws. As construed by the courts, the applicable statute permits suits to be brought within three years from the discovery of the fraud. Chapt. 146, Rev.Code 1935; Lieberman v. Wilmington First Nat. Bank, supra; Trainer v. Deemer, supra. That provision of our law was not complied with.

Moreover, the general language of Section 77B, sub. b of the Bankruptcy Act does not affect the meaning of the specific

language of Section 11, sub. e. Prior to June 22, 1938, Section 77B, sub. b provided:

"The running of all periods of time prescribed by any other provisions of this Act [title], and by all statutes of limitations, shall be suspended during the pendency of a proceeding under this section".

This language appears in that part of the section which deals with claims against the bankrupt debtor's estate; not to claims asserted on its behalf by the trustees. Its apparent purpose is to preserve the rights of creditors of the bankrupt, as they existed at the commencement of the proceedings, to give time for a proper consideration of the plan of reorganization, and to prevent any precipitate action by the creditors. Gilbert's Collier on Bankruptcy, 4th Ed., § 1542; see, also, Gerdes on Bankruptcy § 1151. The context of the statute is in accord with this conclusion, and our State statute of limitations is controlling. Nairn v. McCarthy, 7 Cir., 120 F.2d 910; Eiffert v. Pennsylvania Central Brewing Co., 141 Pa.Super. 543, 15 A.2d 723. It is unnecessary to consider the language of Section 77B, sub. b, as amended in 1938 by section 261 of the Chandler Act, 11 U.S.C.A. § 661.

The plea, based on the statute of limitations, is good in both form and substance, and the complainants' motion is denied.

An order will be entered accordingly.

All Citations

27 Del.Ch. 33, 29 A.2d 801

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Court of Chancery of Delaware.

Charles D. CANTERA, Pierce K. Crompton, Jr., Trustee of Irrevocable Trust F/B/O Cynthia R. Crompton, Dated August 2, 1983, Pierce K. Crompton, Jr., Trustee of Irrevocable Trust F/B/O Joy A. Crompton, Dated August 2, 1983, Pierce K. Crompton, Jr., Trustee of Irrevocable Trust F/B/O William Douglas Crompton, Dated August 2, 1983, Pierce K. Crompton, Jr., Trustee of Irrevocable Trust F/B/O Antoinette Pennington, Dated March 8, 1983, George F. Snyder, Trustee of Revocable Trust Dated December 2, 1988, George F. Snyder, Trustee of Irrevocable Trust F/B/O Jill Marie Snyder (Stevens), Dated March 8, 1983, George F. Snyder, Trustee of Irrevocable Trust F/B/O Antoinette Pennington, Dated March 8, 1983 and Greenville Retirement Community, L.P., a Delaware Limited Partnership, Plaintiffs,
MARRIOTT SENIOR LIVING SERVICES, INC., a Delaware corporation, Defendant.

No. 16498.
|
Feb. 18, 1999.

Attorneys and Law Firms

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MEMORANDUM OPINION

LAMB, Vice Chancellor.

I. INTRODUCTION

***1** Pending is plaintiffs' motion for partial summary judgment. By it, the plaintiffs seek an order validating their exercise of an option to redeem the defendant's interest in a limited partnership. I hold that the provisions of the partnership agreement at issue unambiguously permitted this redemption and, further hold that the plaintiffs are not precluded from obtaining the relief sought in this action by any of the affirmative defenses asserted. Thus, the motion will be granted and an order entered giving effect to the redemption at issue.

A. Facts

Plaintiff Greenville Retirement Community, L.P. (the "Partnership") is a Delaware limited partnership, with its principal place of business in Greenville, Delaware. The Partnership owns and operates the retirement life-care facility known as "Stonegates Condominium."

It is undisputed that, before May 26, 1998, the individual and trust plaintiffs had a combined ownership interest of 50 percent of the Partnership (being 100 percent of the limited partnership interest) and that defendant Marriott Senior Living Services, Inc. ("MSLS") was the general partner and the owner of the other 50 percent partnership interest. Defendant MSLS is a Delaware corporation, and a wholly owned subsidiary of Marriott International, Inc.

On May 26, 1998, the individual and trust plaintiffs, purporting to act in accordance with the terms of the Limited Partnership Agreement dated January 13, 1983 (the "Partnership Agreement"), caused the Partnership to redeem MSLS' general partnership interest and to appoint plaintiff Charles D. Cantera as the Partnership's successor general partner. MSLS refused to recognize the validity of these acts. This litigation ensued.

B. Background of the Partnership Agreement

The Partnership was formed in 1983 for the purpose of acquiring a parcel of real estate in Greenville, Delaware and then developing and operating a life care community thereon. The Partnership's original general partner was Greenville Retirement Community Development Corporation ("GRCD"), a wholly owned subsidiary of Forum Group, Inc. ("Forum"). Forum incorporated GRCD for the purpose of participating in the Partnership. The limited partners were plaintiffs Charles D. Cantera, George F. Snyder and Pierce K. Crompton, Jr.[1]

1. The Transfer Restrictions

Section 8.1 of the Partnership Agreement prohibits that "(except to the extent otherswise provided therein) any assignment, tranfer or other disposition of any intrest in the Partnership. Section 8.2 ("Permitted Exceptins") provides,

> (d) The restrictions imposed by Section 8.1 shall not apply to the transfer of an interest, with the right to become a partner,
>
> (i) in the case of GRCD, to a corporation which with GRCD is a member of a controlled group of corporations within the meaning of Internal Revenue Code section 1563(a), or
>
> ***2** (ii) in the case of Cantera, Crompton or Snyder, to a trust of which the transferor is the sole trustee.
>
> However, if GRCD and its transferee cease to be members of a controlled group as hereinabove defined or an individual transferor ceases to be the sole trustee of his transferee trust, then in either such case the interest so transferred shall be subject to redemption at the option of the Partnership in accordance with Section 8.3.

The last sentence of this subsection, subjecting every transferred interest to the possibility of redemption in certain circumstances, lies at the heart of the dispute in this case. I will refer to it as the "However Clause."

2. The Redemption Provisions

The mechanics for redemption of a Partner's Partnership interest are set forth in § 8.3, and provide as follows:

> 8.3 *Redemption of Interests.* The Partnership shall have the right, at its option, to redeem the interest of
>
> (i) a transferee of a Partner as provided in Section 8.2(d)...
>
> *provided,* that such option may not be exercised if the optionor has received within the preceding sixty days a bona fide offer to purchase the interest, Section 8.2 of this Agreement defining the rights of the parties in such case. The exercise of such option shall require the unanimous vote of the Partners, the Partner whose interest is the subject of the option not voting. If the option is exercised, the purchase price of the interest shall be determined in accordance with Exhibit C and shall be paid in cash at closing, which shall occur within ninety days following the vote of the Partners, time being of the essence."

C. Transfers of the General Partnership Interest

GRCD's rights as general partner and the ownership of the general partnership interest have gone through a series of transfers or other changes over time. These are as follows:

- On April 15, 1986, GRCD transferred its partnership interest to Forum, its parent. Six years later, GRCD merged with and into Forum. Because Forum was the surviving entity in the merger, this transaction brought about no change in the ownership of that partnership interest or in the identity of the general partner. It did have the effect of vesting in Forum, by operation of Section 259 of the Delaware General Corporation Law ("DGCL"), whatever contract rights GRCD had in the Partnership Agreement.

- On March 25, 1996, MSLS, through a wholly owned subsidiary, acquired all of the outstanding shares of common stock of Forum as the result of a tender offer and a second-step merger in which Forum was the surviving corporation. Forum retained its general partner interest in the Partnership.

- On or about June 20, 1997, Forum assigned its partnership interest in the Partnership to its parent, MSLS. The following day, June 21, 1997, MSLS sold the outstanding common stock of Forum to Host Marriott Corporation ("Host Marriott"). MSLS and Host Marriott are related entities but are not members of the same controlled group of corporations within the meaning of Internal Revenue Code § 1563(a).

D. The Partnership Redeems MSLS' Interest

***3** Plaintiffs state that they learned of the dissociation between the ownership of Forum and the ownership of the general partnership interest caused by the transactions in June 1997, and thus of the claimed right to redeem MSLS'

general partnership interest, after receiving Partnership tax returns and financial statements in April 1998. On May 26, 1998, upon the unanimous vote of all of the partners other than MSLS, the Partnership purportedly exercised its option to redeem the general partnership interest of MSLS, as the transferee of Forum. At the same time, the partners other than MSLS unanimously elected plaintiff Charles D. Cantera to serve as the general partner of the Partnership. On May 26, 1998, plaintiffs wrote to MSLS, informing it of these actions.

MSLS responded, by letter dated May 27, 1998, that it would review the relevant facts and circumstances regarding the exercise of the option to redeem its interest in the Partnership, and would give its "considered response" within ten days. By letter dated June 5, 1998, MSLS wrote, stating that it did not agree that its interests had been redeemed, and that "[w]e disagree with your assertions, interpretation of the partnership agreement, and the conclusions you have drawn." MSLS added: "The vote of the limited partners on May 26 is invalid and did not result in any change to the relationships between the parties."

By letter dated July 27, 1998, the Partnership sent formal notice that the closing on the redemption of MSLS' partnership interest would occur on August 11, 1998. By letter dated August 4, 1998, MSLS acknowledged that plaintiffs offered to tender the redemption amount (as calculated by them), but stated that it would not accept a redemption of its interest, and that it would not attend the closing.

II. DISCUSSION

A. Standard for Summary Judgment

Summary judgment is properly employed for the enforcement of unambiguous contracts. *SBC Interactive, Inc. v. Corporate Media Partners,* Del.Supr., 714 A.2d 758, 761 (1998) (affirming Court of Chancery's award of summary judgment in favor of certain partners seeking to enforce arbitration provisions of partnership agreement); *Theater Acquisitions, L.P. v. Reading Co.,* Del. Ch., C.A. No. 15742, Chandler, C., slip op. at 5 (Apr. 23, 1998) ("[W]here there is a contractual dispute and the contract is unambiguous, the Court will resolve the dispute on summary judgment."); *Wright, Miller & Kane, Federal Practice and Procedure,* § 2730.1, at 63-65 (1998) [hereinafter *Wright*] ("Indeed, when the contract is unambiguous on its face, the operation of the parol evidence rule will preclude the introduction of outside evidence to dispute its terms and summary judgment is particularly appropriate.").

Summary judgment is the proper framework for enforcing unambiguous contracts because there is no need to resolve material disputes of fact. Rather a determination of whether a contract is ambiguous is a question for the court to resolve as a matter of law. *Pellaton v. The Bank of New York,* Del.Supr., 592 A.2d 473, 478 (1991) *Reardon v. Exchange Furniture Store, Inc.,* Del.Supr., 188 A. 704, 707 (1936). Furthermore, it is also well settled that Delaware courts apply rules of contract interpretation to limited partnership agreements. *See e.g., Star Cellular Telephone Co. v. Baton Rouge CGSA, Inc.,* Del. Ch., C.A. No. 12507, Jacobs, V.C., slip op. at 8 (July 30, 1993) (court must analyze limited partnership provision "in light of applicable contract principles"), *aff'd,* Del.Supr., 647 A.2d 382 (1994).[2]

B. Standards for Construction of the Contract

***4** As this Court recently noted, the starting point of contract construction is to determine whether a provision is ambiguous, *i.e .,* that it is "reasonably subject to more than one interpretation." *Supermex Trading Co. v. Strategic Solutions Group, Inc.,* Del. Ch., C.A. No. 16183, Lamb, V.C., slip op. at 7 (May 1, 1998). Toward that end, contract language "is not rendered ambiguous simply because the parties in litigation differ concerning its meaning." *City Investing Co. Liquidating Trust v. Continental Cas. Co.,* Del.Supr., 624 A.2d 1191, 1198 (1993); *Rhone-Poulenc Basic Chems. Co. v. American Motorists Ins. Co.,* Del.Supr., 616 A .2d 1192, 1196 (1992). Nor is it rendered ambiguous simply because the parties "do not agree upon its proper construction." *Rhone-Poulenc,* Del.Supr., 616 A.2d at 1196; *accord City Investing,* Del.Supr., 624 A.2d at 1198. *See Wright,* § 2730.1, at 65 ("The mere assertion that ambiguity or divergent intent exists will not prevent summary judgment from being entered.").

A contract is ambiguous "only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings." *Rhone-Poulenc,* Del.Supr., 616 A.2d at 1196; *see also SI Mgmt. L.P. v. Wininger,* Del.Supr., 707 A.2d 37, 42 (1998) (same); *MHM/LLC, Inc. v. Horizon Mental Health Mgmt, Inc.,* Del. Ch., C.A. No. 14465, V.C. Steele, slip op. at 6 (Oct. 3, 1996) ("To be ambiguous, the provision must be capable of being read reasonably to support the different provisions."), *aff'd,* Del.Supr., 694 A.2d 844 (1997).

Delaware courts adhere to the "objective" theory of contracts, *i.e.,* a contract's "construction should be that which would be understood by an objective reasonable third party." *Supermex,* Del. Ch., slip op. at 7 (quoting *Demetree v. Commonwealth Trust Co .,* Del.Ch., C.A. No. 14354, Allen, C., slip op. 7 (Aug. 27, 1996)). Thus, as the Court stated in *Demetree,*

> Where the parties have entered into an unambiguous integrated written contract, the contract[']s construction should be that which would be understood by an objective reasonable third party.... [I]nquiry into the subjective unexpressed intent or understanding of the individual parties [to the contract] is neither necessary nor appropriate where words of the contract are sufficiently clear to prevent reasonable persons from disagreeing as to their meaning.

Del.Ch., C.A. No. 14354, slip op. 7-8. *See also Eagle Indus., Inc. v. DeVilbiss Health Care, Inc.,* Del.Supr., 702 A.2d 1228, 1232 (1997) ("Contract terms themselves will be controlling when they establish the parties' common meaning so that a reasonable person in the position of either party would have no expectations inconsistent with the contract language.").

Delaware courts apply principles of contract interpretation to limited partnership agreements and, thus, have frequently declined to examine extrinsic evidence when interpreting limited partnership agreements. *See, e.g., James River-Pennington, Inc. v. CRSS Capital, Inc.,* Del. Ch., C.A. No. 13870, Steele, V.C., slip op. at 11 (Mar. 6, 1995) (refusing to rely upon an "antecedent oral agreement" to interpret a "clear and unambiguous" 78-word "Call provision" in limited partnership agreement that established one limited partner's right to purchase another limited partner's interests in the partnership); *Davenport Group MG, L.P. v. Strategic Inv. Partners, Inc.,* Del. Ch., 685 A.2d 715, 719 (1996) (refusing to rely on extrinsic evidence to interpret provisions of limited partnership agreement that set forth managerial obligations of general partner), *aff'd,* Del.Supr., 687 A.2d 194 (1996); *Cincinnati SMSA Ltd. Partnership v. Cincinnati Bell Cellular Sys. Co.,* Del. Ch., C.A. No. 15388, Chandler, C., slip op. at 7 (Aug. 13, 1997) (holding definition of "cellular service" in limited partnership agreement not ambiguous where such service was defined by FCC regulation), *aff'd,* Del.Supr., 708 A.2d 989, 990 (1998); *Desert Equities Inc. v. Morgan Stanley Leveraged Equity Fund II, L .P.,* Del. Ch., C.A. No. 12449, Chandler, V.C., slip op. at 4 (July 28, 1992), *rev'd on other grounds,* Del.Supr. 624 A.2d 1199 (1993) (finding provision in limited partnership agreement vesting general partner with power to exclude a limited partner from participating in an investment to be "clear and unambiguous").

C. Is the Partnership Agreement Ambiguous?

***5** The scope of disagreement about the proper interpretation of the Partnership Agreement is quite limited. The parties agree with each of the following statements:

- The 1986 transfer of GRCD's partnership interest to Forum was specifically permitted by the language of § 8.2(d), and no right of redemption thereafter arose under the However Clause with respect to this transfer because GRCD and Forum remained members of the same controlled group of corporations.

- As a result of the 1992 merger, Forum succeeded to GRCD's rights under the Partnership Agreement, including the right to transfer the general partnership interest in accordance with § 8.2(d). In Forum's hands, that power took on new life because Forum held the partnership interest on which the power could operate.[3]

- The anti-transfer restrictions in the Partnership Agreement did not prevent MSLS from acquiring the stock of Forum, as those provisions do not address issues relating to the control of Forum.

- Finally, Forum had the right to transfer the general partnership interest to MSLS when it did because at the time of the transfer MSLS was "a corporation which with [Forum] [wa]s a member of a controlled group of corporations."

What divides the parties is whether the However Clause was triggered by the June 1997 sale of Forum to Host Marriott. Ultimately, MSLS' position depends on its argument that the 1992 merger "exhausted" the However Clause, rendering that clause inapplicable to Forum's June 1997 transfer of the general partner interest to MSLS. MSLS argues that "[a]s a result of this merger, GRCD and its 'transferee,' Forum, became one and the same entity. Thereafter ... they were forever members of a common control group such that the However Clause could have no further effect." Thus, MSLS contends, while an effect of the 1992 merger was to empower Forum to make a second transfer of the general partnership interest a further effect of that merger was to free Forum to exercise that power without regard to the limitation found in the However Clause.

Plaintiffs respond that it is nonsensical to interpret the 1992 merger as having both breathed life into the power to transfer and exhausted or extinguished the related limitation. They

argue further that all of the terms of § 8.2(d) of the Partnership Agreement must be read as a whole, that the power to transfer and the However Clause were written to operate together, and that there is no basis in law or the language of the contract to read them independently of each other.

The following chart may be helpful in understanding the parties' conflicting positions on this issue. It shows, in Column 1, the original language of § 8.2(d) and, in Columns 2 and 3, respectively, the plaintiffs' and the defendant's reading of the effect of the 1992 merger, and the operation of § 259 of the DGCL, on the language of that section.

Chart A

Column 1	Column 2	Column 3
The Language of § 8.2(d) Without Modification to Reflect the Merger of GRCD with and into Forum	Plaintiffs' Reading of § 8.2(d) to Give Effect to the Merger of GRCD with and into Forum	Defendant's Reading of § 8.2(d) to Give Effect to the Merger of GRCD with and into Forum
§ 8.2(d). The restrictions imposed by Section 8.1 shall not apply to the transfer of an interest, with the right to become a partner,	§ 8.2(d). The restrictions imposed by Section 8.1 shall not apply to the transfer of an interest, with the right to become a partner,	§ 8.2(d). The restrictions imposed by Section 8.1 shall not apply to the transfer of an interest, with the right to become a partner,
(i) in the case of GRCD, to a corporation which with GRCD is a member of a controlled group of corporations within the meaning of Internal Revenue Code section 1563(a), or	(i) in the case of Forum, to a corporation which with Forum is a member of a controlled group of corporations within the meaning of Internal Revenue Code section 1563(a), or	(i) in the case of Forum, to a corporation which with Forum is a member of a controlled group of corporations within the meaning of Internal Revenue Code section 1563(a), or
(ii) in the case of Cantera, Crompton or Snyder, to a trust of which the transferor is the sole trustee.	(ii) in the case of Cantera, Crompton or Snyder, to a trust of which the transferor is the sole trustee.	(ii) in the case of Cantera, Crompton or Snyder, to a trust of which the transferor is the sole trustee.
However, if GRCD and its transferee cease to be members of a controlled group as hereinabove	However, if Forum and its transferee cease to be members of a controlled group as hereinabove	However, if [Forum and Forum cease to be members of a controlled group as hereinabove defined or]

defined or an individual transferor ceases to be the sole trustee of his transferee trust, then in either such case the interest so transferred shall be subject to redemption at the option of the Partnership in accordance with Section 8.3.	defined or an individual transferor ceases to be the sole trustee of his transferee trust, then in either such case the interest so transferred shall be subject to redemption at the option of the Partnership in accordance with Section 8.3.	an individual transferor ceases to be the sole trustee of his transferee trust, then in either such case the interest so transferred shall be subject to redemption at the option of the Partnership in accordance with Section 8.3.

***6** In the third column, the operative language of the However Clause is bracketed to reflect the ultimate point of MSLS' argument, *i.e.,* that the However Clause was permanently satisfied and exhausted as a result of the 1992 merger.

I conclude that the However Clause is not "reasonably or fairly susceptible" of the reading advocated by MSLS. Most importantly, I read § 8.2(d) to manifest the parties' clear intention to permit a transfer of an interest in the partnership only in the circumstances described in subparts (i) and (ii) of § 8.2(d) and then only for so long as the conditions described in the However Clause do not come into being. It would do injury to this intention to construe the effect of the 1992 merger as having both revived the power to transfer and exhausted the concomitant limitation of that power. *See Desert Equities,* Del.Ch., C.A. No. 12449, slip op. at 5 (holding that limited partnership agreement must be construed as a whole and effect given to all of its provisions); *Katell v. Morgan Stanley Group, Inc.,* Del.Ch., C.A. No. 12343, Chandler, V.C., mem. op. at 9 (June 8, 1993) (interpretation of partnership agreement rejected because it did not give effect to all parts of the contract); *E.I. du Pont de Nemours & Co. v. Shell Oil Co.,* Del.Supr., 498 A.2d 1108, 1113 (1985) ("In upholding the intention of the parties, a court must construe the agreement as a whole, giving effect to all provisions therein.").

For this reason, I reject MSLS' argument that the 1992 merger exhausted the However Clause for all time. Certainly, an effect of that merger was to satisfy permanently the However Clause with regard to the 1986 transfer from GRCD to Forum. But it lacks common sense to argue that the satisfaction of the However Clause with respect to one transfer rendered it inapplicable to any subsequent permitted exercise of that power by Forum. Nothing in the language employed by the parties impels me to such an incongruous result.

Rather, the However Clause is most easily and sensibly read as having sufficient vitality to apply both to the 1986 transfer by GRCD to Forum and to the 1997 transfer by Forum to MSLS. Thus, as plaintiffs argue, the only effect of the 1992 merger on the language of the However Clause was to substitute "Forum" for "GRCD." The balance of the language, remained unaffected by the 1992 merger, as illustrated in Column 2 of Chart A, above. This is the result suggested by the straightforward operation of § 259. The further change in language suggested by MSLS (*i.e.,* substituting "Forum" for "transferee" to render the clause meaningless) is neither required by that section of the DGCL nor consistent with the clear intention of the parties. That Forum was the "transferee" of the earlier transfer neither requires nor provides logical support for the substitution of the word "Forum" in the text of § 8.2(d) for the word "transferee". Indeed, the very fact that this suggested substitution would result in the nullification of the However Clause is sufficient reason to reject it.

***7** Because I find no ambiguity in the construction or interpretation of the language of § 8.2(d) of the Partnership Agreement, I have no occasion to consider such matters of extrinsic evidence on which MSLS relies in support of its rejected interpretation. *Eagle Indus .,* Del.Supr., 702 A.2d at 1232 ("If a contract is unambiguous, extrinsic evidence may not be used to interpret the intent of the parties, to vary the terms of the contract or to create ambiguity.").

D. MSLS' Affirmative Defenses

MSLS argues that the redemption of its interest is "barred by the doctrines of laches, waiver and estoppel." For the following reasons, I conclude that none of these doctrines has any bearing in the circumstances of this case.

1. Laches

The defense of laches is predicated on the unfairness that can occur when a person with knowledge of an equitable cause of action delays in bringing his claim, causing the defendant detrimentally to rely on plaintiff's inaction. *See generally Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.,* Del.Ch., 714 A.2d 96, 104-105 (1998), and the cases and authorities cited therein. Here, the delay about which MSLS complains was not in filing the lawsuit but in exercising the contractual option to redeem. The question whether the plaintiffs delayed too long in exercising their contract rights must be answered by reference to the contract, not to equitable notions of laches.

The Partnership Agreement does not specify a time period within which the option to redeem found in § 8.3, once it comes into being, must be exercised. MSLS points to the following language of § 8.3 (emphasis added) to argue that the May 26, 1998 exercise was too late:

> If the option is exercised, the purchase price of the interest shall be determined in accordance with Exhibit C and shall be paid in cash at closing, which shall occur within ninety days following the vote of the Partners, *time being of the essence.*

The provision of "time being of the essence" in this clause does nothing more than insure the prompt payment of the purchase price once the option is exercised. It plainly does not regulate the time in which the decision whether or not to exercise the option to redeem must be taken.

MSLS has cited no authority suggesting that, in the absence of a more restrictive provision in the contract, plaintiffs' delay of less than one year rendered ineffective the action taken by them to redeem MSLS' general partnership interest. By analogy, the generally applicable statute of limitations governing contract actions in Delaware is three years. *See* 10 *Del. C.* § 8106. In the circumstances, I cannot find that the passage of eleven months from the sale of Forum until the exercise of the option was so substantial as to give rise to a laches defense to this action seeking to enforce that exercise.

2. Waiver

Waiver is an intentional relinquishment of a known right. *Pepsi-Cola Bottling Co. of Asbury Park v. Pepsico., Inc.,* Del.Supr., 297 A.2d 28, 32-33 (1972). Although discovery is complete, there is no evidence in the record to establish either that the plaintiffs knew before April 1998 that the option to redeem had arisen or that they intentionally relinquished their right to exercise that option. Indeed, MSLS is reduced to arguing that plaintiffs knew "of the events giving rise to" the option to redeem (but not the legal consequence of those events) and "as manifested by their silence, plaintiffs intentionally failed to exercise that right for over a year." Proof of an intentional relinquishment of a known right requires much more.

3. Acquiescence

***8** MSLS' claim of acquiescence suffers from the same infirmity as its claim of waiver. As described in *Donald J. Wolfe, Jr. & Michael A. Pittinger, Corporate and Commercial Practice in the Delaware Court of Chancery,* § 11-3, at 760:

> Acquiescence arises when a party complaining of an act (1) has full knowledge of his rights and all material facts and (2) remains inactive for a considerable period of time, or freely gives recognition to the act, or conducts himself in a manner inconsistent with any subsequent repudiation of the act, thereby leading the other party to believe that the act has been approved.

There is no direct proof in the record that plaintiffs had "full knowledge of their rights" or of "all material facts" until shortly before they exercised the option in May 1998. Nor is there evidence from which a trier of fact could infer such knowledge. Thus, the 11-month period of inaction from June 1997 until May 1998 is legally irrelevant. Nevertheless, other than this period of inaction, MSLS can point to nothing supporting any of the ultimate conclusions that the plaintiffs "freely [gave] recognition to" the June 1997 transactions, "conduct[ed] [themselves] in a manner inconsistent with any subsequent" exercise of the option to redeem, or even led MSLS "to believe that the [June 1997 transactions] ha[d] been approved." In the circumstances, MSLS has not shown plaintiffs' acquiescence in MSLS' unilateral decision to dissociate ownership of Forum from ownership of the general partnership interest.

III. CONCLUSION

For all the foregoing reasons, plaintiffs' motion for partial summary judgment will be granted for the reasons and to

the extent described herein.[4] Plaintiffs' counsel are directed promptly to submit an appropriate order, on notice if not agreed as to form.

All Citations

Not Reported in A.2d, 1999 WL 118823

Footnotes

1 On or about September 27, 1983, the Partnership filed a First Amendment to the Certificate of Limited Partnership with the Secretary of State, reflecting the fact that limited partners Crompton and Snyder had assigned their interests (or portions thereof) in the partnership, with the right to become a limited partner, to the trust plaintiffs.

2 In the case of a contract dispute, once a party demonstrates that the language of the contract at issue is clear and unambiguous, the burden shifts to the non-moving party to prove that there are still issues of fact remaining that would otherwise preclude entry of summary judgment. *Hoechst Celanese Corp. v. National Union Fire Insur. Co. of Pittsburgh,* Del.Super., C.A. No. 89C-SE-35, Gebelin, J., slip op. at 3 (July 27, 1994), *rev'd sub. nom. on other grounds, Hoechst Celanese Corp. v. Certain Underwriters at Lloyd's, London,* Del.Supr., 656 A.2d 1094 (1995); *see Moore v. Sizemore,* Del.Supr., 405 A.2d 679, 680-81 (1979) (once the moving party has shown that there are no genuine issues of material fact for trial, the burden shifts to the non-moving party to show that there are material issues of fact).

3 The parties agree that the language of § 8.2(d) restricted to GRCD the right to transfer the general partnership interest and that the 1986 transfer of the general partnership did not convey that power to Forum. Thus, immediately before the 1992 merger, GRCD's contract right was of no present consequence, as GRCD did not own the interest on which the power could operate, and Forum, the owner of the interest, did not hold the power to transfer.

4 At the suggestion of counsel that it would not be necessary to do so, this opinion has not addressed issues relating to the calculation of the purchase price for MSLS' interest. The parties and. their counsel should confer in an effort to reach a resolution of any such issues remaining and advise the Court of the outcome of their efforts.

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2012 WL 6840625
Only the Westlaw citation is currently available.

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Superior Court of Delaware,
New Castle County.

CORNELL GLASGOW, LLC, et al., Plaintiffs,

v.

LA GRANGE PROPERTIES, LLC, et al., Defendants.

C.A. No. N11C–05–016–JRS CCLD.
|
C.A. No. N11C–07–160–JRS CCLD.
|
Submitted: Oct. 26, 2012.
|
Decided: Dec. 7, 2012.

Decision After Trial. **Verdict for Plaintiffs.**

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MEMORANDUM OPINION

SLIGHTS, J.

I.

***1** In September of 2009, two parties partnered to develop a residential neighborhood from a largely undeveloped tract of land in Newark, Delaware. At first glance, the pairing appeared to be the perfect matching of talents and resources. The arrangement was simple: one partner, the owner of the land, was to provide improved lots upon which the builder, the other partner, would construct homes and then market and sell them to third parties. To govern this new relationship, the parties drafted and signed a detailed Development Agreement (the "Agreement"). In so doing, they selected the very language that has both fueled and confounded this litigation for nearly two years.

The parties anticipated they would share in the profits the construction project was sure to deliver, but soon found themselves in the same predicament many residential developers have encountered over the past several years as the housing market slowed and the pace of home sales lagged behind projections. The parties then began a series of exchanges in which they expressed their dissatisfaction with each other's performance that escalated from e-mails and meetings to full-blown litigation before the Court of Chancery and the Superior Court. The Court now seeks to address the parties' numerous disputes and provide a final resolution of the legal aspects of the controversy that is in accord with the parties' expectations as expressed in the project's controlling documents.

The plaintiffs/counterclaim defendants are the builder and affiliated entities, Cornell Glasgow, LLC ("Cornell Glasgow") and Cornell Homes, LLC ("Cornell Homes") (collectively "Cornell"). The defendants/counterclaim plaintiffs are the landowners, La Grange Communities, LLC and La Grange Properties, LLC (collectively, "La Grange"), and the founding members of La Grange, Steven J. Nichols ("Nichols") and Lowell McCoy ("McCoy") (all collectively "defendants"). The parties have asserted claims of breach of contract against each other under the Agreement and seek compensatory damages. In addition, Cornell alleges that the defendants and an additional defendant, Bruce C. Johnson ("Johnson"), wrongfully conveyed a model home built and furnished by Cornell without adequately compensating Cornell.

After a five day bench trial and post-trial submissions by the parties, the Court is satisfied that La Grange breached the Agreement by wrongfully withholding certain payments from Cornell and by ousting Cornell from the project. Cornell was excused from providing La Grange with notice of an opportunity to cure the breach because any such notice would have been futile. For its part, La Grange failed to provide Cornell notice and an opportunity to cure any breach of the Agreement Cornell may have committed and, consequently, La Grange is precluded from prosecuting breach of contract claims against Cornell as a matter of law. Moreover, even if La Grange was somehow excused from the Agreement's notice

and cure provision, it has not proven its breach claims by a preponderance of the evidence. Cornell is entitled to damages for breach of the Agreement in the amount of $1,966,745.00. Cornell has also proven that La Grange is liable for breach of contract and breach of the covenant of good faith and fair dealing arising from the wrongful conveyance of Lot 206 with model house ("Lot 206"), and is entitled to damages on those claims in the amount of $192,281. Finally, Cornell is entitled to costs and prejudgment and post judgment interest.

II.

A. The Parties

***2** Cornell Homes is a Pennsylvania limited liability company. Cornell Glasgow is a Delaware limited liability company formed for the special purpose of partnering with the defendants to develop the La Grange Community (the "Development"). La Grange Communities, LLC is a special purpose entity formed by La Grange Properties, LLC for the same purpose (the venture to develop the Development shall be referred to as the "Project"). Both La Grange entities are Delaware limited liability companies. Nichols and McCoy are founding members of La Grange. McCoy is also a former member of the Board of Directors at NBRS Financial Bank ("NBRS"), a bank that provided some of the funding for the Project. Johnson, the son-in-law of McCoy, purchased Lot 206 from La Grange and is purportedly the current record owner of the property.

B. The Development Agreement

La Grange Communities, LLC purchased the land on which the Development is situated in 2005 for $14,250,000, financed with a Land Note from Wilmington Trust Company at an initial interest rate of 7.5%.[1] La Grange took out additional loans from institutional lenders, including Wilmington Trust and NBRS, as well as loans from individuals, most backed by personal guarantees from Nichols and McCoy, in order to improve the land and organize the new business endeavor.[2] After acquiring the necessary funds, La Grange began interviewing builders with whom it could partner to develop the land into a residential community.[3]

In March of 2009, Cornell and La Grange began to hammer out an arrangement and eventually documented the salient points in an e-mail from Cornell to La Grange dated March 31, 2009.[4] In a series of bullet points, Cornell expressed several goals and expectations the parties intended to be memorialized in the contract that would govern the arrangement.[5] Of particular relevance here, the e-mail emphasized that the contract must include a "notice and cure" provision and also that "... Cornell [was expected] to perform on timeliness of construction (not necessarily perform with regard to sales pace because profits are as important to pace in a lot of ways and pace is a wildcard in this economy)."[6] As made evident throughout the trial, the parties were focused on pace and profitability, with profitability being the most critical element of the endeavor.[7]

On September 23, 2009, Cornell and La Grange executed the Agreement pursuant to which La Grange granted Cornell the exclusive right to build, market and sell 185 of 227 residences within the Development.[8] These residences were to take the form of town homes, duplexes, and single-family homes.[9] The Agreement set forth the responsibilities of each party in connection with the Project,[10] and was signed on behalf of Cornell by Gregory Lingo ("Lingo"), the founder and manager of Cornell, and by Nichols on behalf of La Grange.[11]

Pursuant to the Agreement, La Grange was to complete all necessary site improvements within the Development in order to provide Cornell with lots on which to construct the residences.[12] Cornell would then design, construct, market, and sell the residences to third parties.[13] The compensation and profit sharing structure of the Agreement was relatively straight forward. At closing, Cornell would receive a management fee of $10,000 for the sale each town home, $11,000 for each duplex, and $12,000 for each single-family home.[14] In addition, the parties agreed that they would share profits but only after the Project reached a threshold of profitability.[15] The parties ultimately agreed that, at such time as profits exceeded $2,237,892, any additional profits would be split between the parties with 20% paid to Cornell and 80% paid to La Grange.[16] La Grange further agreed to reimburse Cornell for costs and expenses related to marketing, sales, architecture, and construction.[17] In this regard, the Agreement called for Cornell to supply an invoice to La Grange on the fifth day of each month thereby prompting La Grange to issue payment within three "working days" of receipt of funding from the financial institution funding the construction.[18]

***3** Cornell was charged with maintaining accurate books of account for the Project such that both Cornell and La Grange would have access to this financial information on a rolling basis by the fifteenth day of each month.[19] The data would reflect monthly profit and loss statements as well as job costing and would be tracked and organized by the financial software Quickbooks©.[20]

Consistent with the parties' pre-Agreement discussions, the Agreement contained a "time is of the essence" provision[21] and also addressed timing issues within Exhibit A to the Agreement, a so-called "Sales Projection Schedule."[22] This schedule set forth a "projected" time schedule for the sale of the various types of residences within the Development.

The Agreement also identified activities that constituted defaults under the Agreement and outlined the process by which a party could claim an Event of Default.[23] Pursuant to the Agreement, an Event of Default would be recognized only when the aggrieved party provided the defaulting party with written notice identifying the default and demanding that it be remedied within thirty days.[24] At trial, Lingo testified that this notice and cure provision was important to Cornell because Cornell knew that if a problem arose in its performance it likely could cure the problem with adequate notice, by moving personnel and resources from other projects to the Development.[25]

An additional caveat within the Agreement was that each party was to obtain financing to fund its obligations under the Agreement no later than November 1, 2009.[26] La Grange was to secure $3,000,000 to satisfy an outstanding loan with NBRS for the acquisition of the property, as well as $1,890,000 to fund reimbursement of Cornell's costs.[27] Cornell was to secure $2,000,000 for a revolving line of credit that would fund its construction of the residences.[28]

C. The Amendment to the Development Agreement

As stated, the Agreement set November 1, 2009 as the deadline by which the parties were to meet their respective financing obligations.[29] Cornell obtained financing; La Grange did not.[30] Due to federally-imposed lending limits and La Grange's substantial outstanding debt, NBRS would not loan additional funds to La Grange.[31] Consequently, in December of 2009, Cornell and La Grange negotiated an Amendment to the Agreement (the "Amendment") pursuant to which Cornell agreed to pay off some of La Grange's existing debt and thereby free up La Grange to procure additional financing to pay for improvements of the Development's lots as required by the Agreement.[32] In exchange, La Grange granted to Cornell the exclusive right to market, sell and construct all 227 lots in the Development (not just the initial 185 lots) and delivered into escrow the deeds to twenty (20) lots.[33] The deeds were to be released to third party purchasers at closing or to Cornell upon La Grange's default of the Agreement or the Amendment.[34] The purpose of holding these deeds in escrow was to provide Cornell with assurance that lots it improved with its resources would not be sold before it had been reimbursed its costs and paid its management fee.[35] The parties executed an Escrow Agreement to finalize these terms.[36]

D. The Parties' Business Relationship Deteriorates

***4** Upon entering into the Agreement, La Grange began to develop lots and install infrastructure within the Development while Cornell began to construct, market and sell homes to third parties. In June of 2010, Cornell's sales of town homes and duplexes were ahead of the sales projections the parties had included as Exhibit A to the Agreement.[37] Even Nichols acknowledged Cornell's ability to sell these two products stating, "I think the duplexes were fairly well received. They went—they were probably, I am going to say, eight, nine, ten ahead of that schedule at that time...."[38] Sales of single family homes, however, lagged behind projections. As Lingo conceded, "[o]ur sales of the single family homes were slower in general than the rest of the products."[39] Despite the slower sales pace of single family homes, the Project was $250,000 ahead of projected profitability as of September 2010.[40]

In September 2010, Cornell noted that La Grange had failed to reimburse certain costs as required under the Agreement and expressed its concerns to La Grange.[41] In response, La Grange asserted that it required additional accounting information and access to financial records in order to evaluate and process Cornell's invoices.[42] And so began an almost ritualistic exchange of e-mails in which La Grange would request specific details or clarifications regarding costing and other accounting details and Cornell would respond with responsive information and demands for payment.[43] Despite this seemingly open (albeit circular) dialogue, the reimbursement and accounting issues persisted

throughout the following months.[44] By early 2011, the relationship between Cornell and La Grange had soured.[45] On January 5, 2011, Nichols sent an e-mail to Lingo raising five concerns with respect to Cornell's activities at the Development:[46] (1) Cornell's sales of homes for prices below the minimum agreed upon price;[47] (2) incentives in relation to Cornell's relationship with Pike Creek Mortgage Services, Inc. ("Pike Creek");[48] (3) the ongoing accounting issues;[49] (4) unapproved soft costs;[50] and (5) a $70,000 architectural issue related to the construction of three homes.[51] Lingo responded by email on January 6, 2011, and indicated that Cornell wanted to address La Grange's concerns and was still interested in maintaining a long term relationship with La Grange.[52]

The parties met later in the day on January 6, 2011, and discussed several solutions to La Grange's concerns.[53] For instance, Cornell suggested that the parties hire an independent accountant to assess the accounting issues in dispute.[54] E-mail exchanges and meetings between La Grange and Cornell regarding La Grange's concerns continued through mid-January.[55]

On January 15, 2011, Lingo forwarded to Nichols an internal Cornell e-mail in which McSorley relayed his account of a meeting between McSorley and La Grange personnel, including an employee named Michelle Pinder.[56] At the conclusion of this email, McSorley states, "As a company, we can be more profitable focusing our efforts elsewhere. [ ] Michelle stated [La Grange] can be more profitable with another builder, which I believe is the best option at this point."[57]

***5** On February 4, 2011, apparently in response to learning of Cornell's internal discussions about terminating the relationship, Nichols sent an e-mail to Lingo in which Nichols states that he had discussed the matter with McCoy and both agreed that La Grange and Cornell "should go there [sic] separate ways."[58] E-mails between the parties continued throughout the day.[59] At 4:26 p.m ., Nichols sent an email to Lingo in which he states, "I think at this point it would be best for you to let the Cornell personnel know that after today, they do not need to report to Lagrange [sic]."[60] Also on February 4, 2011, Robert Penza, Esquire, counsel for La Grange, sent a letter to Lingo in which he expressed La Grange's desire "to initiate a dialogue to frame the current outstanding issues so that the parties can attempt to terminate the Development Agreement on mutually acceptable terms."[61] Lingo responded that Cornell was not averse to a mutual termination of the Agreement, but was reluctant to begin the process without further consideration of the consequences.[62]

In the following week, the relationship between the parties broke down completely. Unbeknownst to Cornell, La Grange began to take steps to continue the Project without Cornell. It solicited bids from: C. O'Brien Architects, Inc. for new house plans, Sign–A–Rama for new signage, and Richard Martelo for a new bond and liability insurance.[63] La Grange also sought out and obtained an entirely new business plan for the Project from Mason Run Builders, LLC, a company owned by Drew McCoy, the son of Defendant, Lowell McCoy.[64]

At 2:49 p.m. on February 11, 2011, Marc Kaplin, Esquire, an attorney representing Cornell, faxed and e-mailed a Notice of Default to La Grange and its attorney, Mr. Penza.[65] The default notice was predicated on La Grange's refusal to reimburse Cornell for costs and expenses under the Agreement.[66] As discussed below, Mr. Nichols' conduct on the evening of February 11, 2011, suggests he received the notice of default that evening and immediately reacted.[67]

E. La Grange Ousts Cornell From The Development

Cornell's last day on the Project was February 11, 2011. As described by Krista DeVoll ("DeVoll"), a Cornell sales representative, in the early evening of February 11, Nichols entered the Cornell sales office at the Development and, in a business-like tone, informed DeVoll that she and her fellow Cornell employees were to leave the Development immediately and not return.[68] She was further informed that if she did return she would be escorted from the premises.[69] She left that evening with the clear understanding that she was no longer welcome on the Project.[70] DeVoll contacted Lingo to relay what had transpired and was directed by Lingo that she and a co-worker were to gather Cornell's property within the office and remove it.[71]

Nichols disagreed with DeVoll's account of the events of February 11. According to Nichols, he observed DeVoll informing prospective customers that there were no available properties for sale at the Development.[72] Only upon hearing

this false representation to a prospective home buyer did he inform DeVoll that if Cornell did not intend to sell homes, she and her fellow Cornell sales agents need not return to the Project.[73] Nichols testified that he intended to call Lingo to speak about the matter, but did not do so.[74]

***6** After hearing the competing versions of the events of February 11, the Court finds DeVoll's account to be most credible. Nichols likely received Cornell's notice of default earlier that evening and reacted precipitously by dismissing Cornell's sales agents from the Project with instructions never to return. This thoughtless reaction, never retracted by La Grange, now serves as the foundation upon which Cornell's breach claims have been constructed.

F. Lot 206

As discussed above, pursuant to the Amendment, La Grange delivered into escrow the deeds to twenty (20) lots to be released to purchasers upon the sale of each lot or to Cornell upon La Grange's default of the Agreement.[75] The deed to Lot 206 was one of the twenty held in escrow.[76] Cornell constructed a model home on Lot 206 to be used to market residences in the Development.[77] At trial, Cornell produced an expert who testified that Cornell had invested more than $457,000 to construct and furnish the Model, with NBRS financing approximately $274,000 of the total amount.[78] Based on the Amendment, La Grange was to pay the monthly interest payments on Cornell's NBRS loan.[79]

In April 2011, Cornell provided a second notice of default to La Grange in which it reiterated the defaults it had identified in February 2011, and added as a default La Grange's ouster of Cornell from the Development.[80] Pursuant to the Escrow Agreement, Cornell directed the Escrow Agent to release the deed to Lot 206 to Cornell as a result of La Grange's default.[81] La Grange contested the release of the deed and the Escrow Agent continued to hold the deed in escrow.[82] Unbeknownst to Cornell, on May 18, 2011, La Grange, through counsel, drafted a new deed by which La Grange Communities, LLC transferred Lot 206 to Bruce C. Johnson for $430,000.[83]

Lot 206, with improvements, had been appraised by Fox Appraisal Services, LLC on April 28, 2011, at $436,000.[84] Johnson acquired the property with a $280,000 loan and a $150,000 second mortgage which was purportedly a "set-off" from La Grange for money that Johnson had previously loaned to McCoy.[85] The parties on both sides of the transaction had substantial difficulty explaining its bases and structure, lending credence to Cornell's suspicions regarding the *bona fides* of the deal. Johnson testified that he loaned $500,000 to McCoy as a personal loan, while McCoy testified that Johnson loaned the money to La Grange.[86] And then, there was the mysterious $10,000 check that someone brought to the settlement on Lot 206. No one on either side of the transaction could definitively explain its origin or purpose.[87]

According to McCoy, the sale of Lot 206 occurred because interest payments to NBRS in connection with Lot 206 were three (3) months in arrears and the funds from the sale to Johnson were necessary to bring the loan current.[88] Johnson testified that he purchased Lot 206 as an investment on McCoy's recommendation, but further testified that he never engaged in any negotiations regarding the purchase price of the property.[89] Moreover, he visited the property one time and never secured keys to the home.[90] Since acquiring the property, Johnson has made several attempts to sell Lot 206 and the premises are currently occupied by prospective purchasers.[91]

G. Procedural History

***7** After Cornell's exclusion from the property on February 11, 2011, Cornell filed a complaint against La Grange in the Delaware Court of Chancery on February 18, 2011, seeking mandatory injunctive relief and specific performance of the Agreement.[92] Cornell sought interim relief in the form of a temporary restraining order and, following briefing and argument, was granted such relief on March 8, 2011.[93] After expedited discovery revealed that the defendants likely did not have the resources to perform the Agreement, Cornell filed a motion to transfer the case to the Complex Commercial Litigation Division of the Superior Court so that it could seek monetary damages against the defendants. The motion was granted by Chancellor William B. Chandler, III on April 4, 2011.[94] Chancellor Chandler wrote, "... the equitable remedy of specific performance is unrealistic in this case. La Grange does not have enough funds on its construction line of credit to satisfy costs associated with discharging its obligations of delivering the fully improved lots to Cornell."[95]

Also in April 2011, the parties exchanged additional notices of default. Both notices listed various defaults but neither addressed the requisite thirty (30) day opportunity to cure.[96]

On April 13, 2011, Cornell sent a letter to La Grange entitled, in part, "Further Notice of Continuing Default" in which it reiterated La Grange's failure to reimburse Cornell for costs and expenses and also addressed Cornell's wrongful "eviction" from the Development.[97] La Grange responded on April 15, 2011, with a Notice of Default which listed La Grange's view of Cornell's alleged defaults under the Agreement.[98] Again, no mention was made of an opportunity to cure the alleged defaults.[99]

Cornell filed two separate complaints in this Court. This first addressed its claims arising from the defendants' alleged breaches of the Agreement and Amendment (with related tort claims); the second addressed Cornell's claims arising from the allegedly wrongful conveyance of Lot 206.[100] The cases were consolidated for trial with the agreement of the parties.

As the litigation progressed, both parties pressed certain equitable claims (e.g. rescission and piercing the corporate veil) and, at various times, requested this judge to seek *pro tem* appointment as a Vice Chancellor so that these claims could be litigated along side the law claims. The Court declined. Rather, the Court severed the equity claims and stayed them pending resolution of the law claims.[101]

III.

A. Cornell's Claims and La Grange's Defenses

Cornell contends that La Grange discontinued reimbursement of soft costs as of September 2010 in breach of the Agreement.[102] Cornell further contends that La Grange's removal of Cornell from the project was in breach of La Grange's contractual obligation to provide Cornell with free and unrestricted access to the Development. According to Cornell, La Grange failed to provide Cornell with the contractually-required notice of default and opportunity to cure prior to the ouster. As a result of this breach of the Agreement, Cornell contends that it has lost its entitlement to management fees. Accordingly, it seeks compensatory damages in the total amount of $1,966,745 for: (1) unreimbursed costs and expenses; and (2) lost management fees.[103]

***8** Cornell's remaining three claims stem from the Lot 206 dispute. Cornell contends that La Grange's sale of Lot 206 to Johnson was not an arm's length transaction nor did it result in a sale that returned a fair market price for the property.[104] Cornell next contends that, despite the parties' dispute over ownership of Lot 206, which should have prevented the deed from leaving escrow, the defendants' conduct in obtaining a replacement deed for Lot 206 and then transferring the property to Johnson violated the implied covenant of good faith and fair dealing with respect to the Agreement and the Amendment.[105] Lastly, Cornell contends that La Grange, Nichols and/or McCoy received proceeds from the sale and Johnson received the fully furnished model home without suffering any financial detriment and, as a result, all defendants including Johnson were unjustly enriched.[106]

La Grange has responded to Cornell's claims with defenses they contend excuse any alleged wrongdoing on their part. In response to Cornell's claim that La Grange's ouster constituted a breach justifying an award of lost management fees, La Grange argues that it was Cornell who first breached the Agreement.[107] La Grange maintains that Cornell agreed to sell homes on a set schedule and, due to its inability to maintain the pace set for single family homes, Cornell breached a firm obligation under the Agreement.[108] Cornell's sale of homes for less than required by the Agreement, says La Grange, constitutes a further breach. La Grange refers to these breaches as material breaches and, as such, argues it is not liable to Cornell for management fees on sales closing after February 11, 2011.[109] La Grange also addresses Cornell's claim regarding the failure to reimburse soft costs. La Grange asserts that it initially paid the invoices presented by Cornell, but in September of 2010 began questioning certain expenses .[110] La Grange maintains that Cornell was unable satisfactorily to answer La Grange's inquiries making payment unnecessary.[111] Moreover, La Grange alleges that Cornell's accounting failures constituted a breach of the Agreement.

In response to Cornell's Lot 206 claims, La Grange asserts that it had a right to Lot 206 and the corresponding deed held in escrow. La Grange contends that Cornell could take possession of any of the twenty lots held in escrow if La Grange defaulted under the Agreement only if the default occurred for any reason other than Cornell's failure to comply with the terms of the Agreement.[112] According to La Grange, Cornell's claim that La Grange was in default so as to justify release of the Lot 206 deed to Cornell was predicated on La Grange's failure to reimburse Cornell. Because its default was

a result of Cornell's antecedent default, La Grange argues that its failure to reimburse does not constitute a default justifying the release of the Lot 206 deed to Cornell.[113]

B. La Grange's Counterclaims and Cornell's Defenses

***9** La Grange contends that Cornell allowed for excessive, unauthorized sales incentives and sold residences below the base prices called for in the Agreement without La Grange's consent.[114] As a result of these actions, La Grange seeks breach damages in the amount of $827,144.95.[115]

Cornell counters by stating that La Grange cannot assert a breach claim because it did not comply with the clear and unambiguous notice and cure provision set forth in the Agreement.[116] Cornell stresses that even if La Grange's failure to comply with the notice and cure provision was excused, La Grange has not met its burden of proving breach as to its base price and incentive claims.[117] According to Cornell, it never sold homes below the agreed upon base price and La Grange has not proven the contrary by a preponderance of the evidence.[118] As to the unauthorized incentives, Cornell maintains that this allegation is based on a misplaced understanding of the contract terms in that La Grange confuses the value of the incentive with the actual cost.[119] In response to specific allegations of impropriety concerning Pike Creek, Cornell points to the language of the Agreement in justifying its incentive arrangement with Pike Creek asserting that this relationship was not a deviation from the terms of the Agreement.[120]

IV.

The Court begins with the fundamental observation that Cornell bears the burden of proving its claims and La Grange bears the burden of proving its counterclaims by a preponderance of the evidence. In this regard, the Court must be mindful that if the evidence presented by the parties during trial is inconsistent, and the opposing weight of the evidence is evenly balanced, then "the party seeking to present a preponderance of the evidence has failed to meet its burden."[121] As fact-finder, the Court followed the direction that we regularly give to our juries when assessing the evidence and the credibility of witness testimony:

> I must judge the believability of each witness and determine the weight to be given to all trial testimony. I considered each witness's means of knowledge; strength of memory and opportunity for observation; the reasonableness or unreasonableness of the testimony; the motives actuating the witness; the fact, if it was a fact, the testimony was contradicted; any bias, prejudice or interest, manner of demeanor upon the witness stand; and all other facts and circumstances shown by the evidence which affect the believability of the testimony. After finding some testimony conflicting by reason of inconsistencies, I have reconciled the testimony, as reasonably as possible, so as to make one harmonious story of it all. To the extent I could not do this, I gave credit to that portion of testimony which, in my judgment, was most worthy of credit and disregarded any portion of the testimony which, in my judgment, was unworthy of credit.[122]

V.

As the Court listened to the evidence at trial, two major themes emerged to characterize the parties' dispute. These themes now serve as the backdrop for the Court's legal analysis in this case.

***10** First, the Court recognizes that a contract, at its core, is a memorialization of the expectations of the contracting parties. In the present case, the Court is satisfied that the parties entered into the Agreement with the overarching expectation of profitability. This conclusion, apparently undisputed, is supported by the language of the Agreement as well as the testimony elicited at trial from both Cornell's witnesses and La Grange's witnesses. Unfortunately, as the relationship soured, La Grange, in particular, lost sight of this expectation and allowed its frustration with discreet aspects of the relationship to cause it to dismantle a productive and profitable business partnership with Cornell.

Second, when parties enter into a commercial relationship with expectations of success, they define their relationship with express contractual terms that are meant to protect their expectations and provide remedies when the expectations are not met. Here, the parties elected to include within the Agreement a detailed notice and cure provision. Now that the parties find themselves embroiled in litigation, they seek to invoke the contractual protections they bargained-for at the outset of their relationship in support of their respective claims of breach. Yet when the relationship began to fail,

both parties were quite willing to ignore the notice and cure provision they had bargained-for in happier times.

For its part, Cornell says that La Grange did not reimburse its costs and expenses. According to Cornell, this, along with La Grange's ouster of Cornell from the project, constituted breaches of the Agreement. La Grange points to a laundry list of failures to support its breach claim, including Cornell's flawed accounting practices, Cornell's inability to maintain the projected sales pace for single family homes, Cornell's alleged sales of homes below the base price, and Cornell's offer of unauthorized incentives. Remarkably, however, neither La Grange nor Cornell ever exchanged timely notice of the alleged breaches or provided an opportunity to cure. As discussed below, what saves Cornell's failure to abide by the Agreement, but not La Grange's, is Cornell's commitment to try to make the relationship work. Cornell stayed engaged in the relationship; La Grange gave up on it prematurely and in material breach of the Agreement, rendering any "notice and cure" futile.

A. Interpretation of the Contractual Provisions at Issue

Before the Court can determine if either or both parties breached the Agreement, it must first interpret the provisions of the contract to determine the parties' respective obligations. In so doing, the Court must be guided by Delaware's parol evidence rule.[123] "When two parties have made a contract and have expressed it in a writing to which they have both assented as to the complete and accurate integration of that contract, evidence ... of antecedent understandings and negotiations will not be admitted for the purpose of varying or contradicting the writing."[124] The Court must be mindful, however, that a disagreement between the parties as to the meaning of the contract's provisions or terms does not render the document ambiguous.[125] "Rather, a contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings."[126]

***11** The Court will interpret the contract's terms according to the meaning that would be ascribed to them by a reasonable third party.[127] Where the Court finds that the contract clearly and unambiguously reflects the parties' intent, the Court's interpretation of the contract must be confined to the document's "four corners."[128] Otherwise, if there is ambiguity, the Court may consider extrinsic evidence of the parties' intent.[129]

While the parties have invoked several provisions of the Agreement to make their respective breach of contract claims, two provisions in particular memorialize broad obligations that govern all aspects of the parties' contractual relationship. Specifically, the parties agreed that "time [was] of the essence" in the performance of the Agreement and that each was obliged to provide to the other a "notice of default" and "opportunity to cure" before pursuing remedies for breach in court. The parties have argued that these provisions of the Agreement are clear and unambiguous but, not surprisingly, they have offered different interpretations of the provisions' meaning. They also both have submitted extrinsic evidence to aid in the interpretation of the provisions should the Court find them to be ambiguous.

1. Time Is of the Essence

The Agreement states in relevant part, "Time is of the essence as to all matters to be performed by the parties under this Agreement."[130] The Court finds this provision to be clear and unambiguous. A time is of the essence provision has distinct legal significance. In his seminal treatise on contracts, Professor Williston explains:

> When it is said that time is of the essence, the proper meaning of the phrase is that the performance by one party at or within the time specified in the contract is essential in order to enable that party to require performance from the other party. It does not simply mean delay will give rise to a right of action against that party, although the breach of any promise in a contract, including one dealing with the time of performance, will have that effect. Nor does that phrase merely mean that performance on time is a material matter, but rather, that it is so material that exact compliance with the terms of the contract in this respect is essential to the right to require counter-performance.[131]

It is, of course, true that, "[a]n express statement in a contract that 'time is of the essence' is not conclusive, and other provisions may be so inconsistent therewith as to lead to the conclusion that time is not essential."[132] Nevertheless, a clear and unambiguous "time is of the essence" provision cannot simply be ignored. The Court must presume that the parties included the provision for a reason.[133] Standing alone, a time is of the essence provision is too broad to be the basis of an actionable breach claim; but the provision coupled with a proven deviation from a firm contractual time deadline will support a breach claim.[134] Unfortunately for La Grange, it

has attempted to link the Agreement's time is of the essence provision to a projection, not a deadline.[135]

***12** Exhibit A to the Agreement is a table entitled "Sales Projection Schedule." The table sets forth each of the three original residence styles—town homes, single family homes, and duplexes—and sets forth a corresponding projection of how many of that style residence will be sold in each quarter.[136] The parties have offered differing interpretations of the term "projection." Cornell argues that "projection" connotes an aspiration or target, while La Grange contends that Exhibit A reflects hard sales deadlines. In Delaware, courts routinely refer to dictionaries to discern a contractual term's ordinary meaning.[137] Merriam–Webster's dictionary defines "projection," in relevant part, as "an estimate of future possibilities based on a current trend."[138] Consistent with the term's ordinary meaning, the Court of Chancery has held that "a projection is, at best, a good faith estimate of how a company might perform in the future; it is by no means a warranty that can be blindly relied upon."[139] The Agreement was negotiated at arm's length and the parties chose to characterize the sales targets in Exhibit A as a "projection" not a "deadline."[140] The Court will not rewrite Exhibit A under the guise of interpreting it.[141] Cornell's interpretation of Exhibit A is the more reasonable interpretation and will be applied here.

Even assuming, *arguendo,* the Court found Exhibit A to be ambiguous and, therefore, considered extrinsic evidence to interpret it, the result would be unchanged. Cornell presented persuasive evidence that when, in the past, it has committed to a particular sales pace, it has memorialized that commitment with clear and unambiguous terms in so-called "Lot Purchase Agreements."[142] A standard Lot Purchase Agreement states, in relevant part:

> Purchaser shall purchase a minimum of seventeen (17) Lots contained on one (1) Building Pad (the "Initial Purchase") within ten (10) days after receipt by purchaser of written notice from Seller that the Conditions Precedent to Settlement have been met for fifty one (51) Lots (the "Completion Notice"). After the Initial Purchase, Purchaser shall purchase a minimum of one (1) Building Pad (including all Lots located therein or thereon) per quarter during each of the first three (3) quarters, no Building Pads in the fourth (4th) quarter, and thereafter not less than three (3) Building Pads per every four (4) quarters.[143]

The Lot Purchase Agreement's hard deadlines stand in stark contrast to the "projections" set forth in Exhibit A. Moreover, Lingo persuasively explained why Cornell would never have committed to hard sales deadlines in the midst of one of the worst housing markets in recent memory.[144] The Court is satisfied that the persuasive extrinsic evidence reveals that the Exhibit A "Sales Projection Schedule," even when read in light of the Agreement's time is of the essence provision, set forth aspirational projections, *not* deadlines the violation of which would constitute a default under the Agreement.

2. The Notice and Cure Provision

***13** The Agreement's "notice and cure" provision provides:

> The occurrence of one or more of the following, along with written notice thereof to the defaulting party identifying such default and demanding its remedy within thirty (30) days of such notice, shall constitute an "Event of Default," unless such occurrence is remedied within any applicable grace or cure period.

As clearly stated, the provision requires the party claiming a default to deliver to the defaulting party a written notice identifying the default and allowing a thirty (30) day opportunity to cure. The provision is clear and unambiguous.

a. Noncompliance With Notice and Cure

Courts in our State and beyond have recognized that contractual notice and cure provisions cannot be ignored no matter how urgently parties may seek to do so when prosecuting breach claims in litigation.[145] Of these decisions, *U.S. Bank National Ass'n* provides the most direct admonition to litigants that they may not intentionally overlook or attempt to provide *ex post* explanations for failing to abide by clear and unambiguous contractual notice and cure provisions.[146] As will be discussed in more detail below, neither party *sub judice* saw fit to comply with the Agreement's notice and cure provision after their relationship broke down.

Cornell provided La Grange with two notices of default, both of which failed to comply with the notice and cure provision. Cornell's first notice of default was dated February 11, 2011, and addressed La Grange's failure to reimburse Cornell for soft costs in breach of the Agreement.[147] While the notice clearly identified the alleged default, Cornell failed to offer the requisite opportunity to cure. As noted above, Cornell

filed suit in the Court of Chancery on February 18, 2011, a mere seven days after providing the notice of default. In the absence of justification for noncompliance, Cornell's failure to offer La Grange an opportunity to cure its alleged defaults extinguishes any claim of breach it might later pursue.[148]

La Grange likewise has failed to comply with the notice and cure provision of the Agreement.[149] Indeed, La Grange's purported notice of default, dated April 15, 2011, identifies Cornell's alleged defaults but does not allow for the requisite opportunity to cure as the parties were already well underway in litigation. Accordingly, absent some cognizable justification for its noncompliance, La Grange may not pursue its breach claims against Cornell in litigation.

b. Futility Excuses Cornell's Noncompliance But Not La Grange

The contractual obligation to provide pre-suit notice and opportunity to cure may be excused where such notice would be futile in achieving its intended purpose.[150] Our Courts generally have recognized that "[t]he law does not require a futile act."[151] That said, the parties have not informed the Court, nor is the Court otherwise aware, of any Delaware precedent that clarifies the standard for futility against which noncompliance with a contractual notice and cure provision should be measured. Accordingly, the Court has looked elsewhere and has found the holding in *In re Best Payphones, Inc.* to be instructive.[152] There, the court held that a court may find compliance with a notice and cure provision is futile only when the defaulting party expressly and unequivocally repudiates the contract or where the actions of the defaulting party have rendered future performance of the contract by the non-defaulting party impractical or impossible.[153] A repudiation must be positive and unequivocal.[154] This guidance jibes well with similar analytical themes found within Delaware's ample repudiation jurisprudence.[155]

***14** It would be difficult to illustrate the concept of repudiation with more colorful detail than Nichols provided the evening of February 11, 2011, when he ousted Cornell from the project. Nichols told Cornell sales agents to leave the project and not come back. If any Cornell representative tried to return, Nichols made it clear that La Grange would have them escorted from the property.[156] Nichols' rash decision to kick Cornell off the project rendered Cornell's future performance—in the form of construction, marketing and sales of new homes—not merely impractical but impossible. Denying access to the Development and threatening physical removal was a clear and unequivocal assertion that La Grange would neither allow Cornell to continue to perform nor itself continue to perform under the Agreement. Cornell's obligation to comply with the Agreement's notice and cure provision is excused by futility.

For its part, La Grange urges the Court to rely on *Reserves* to excuse its failure to provide notice and an opportunity to cure.[157] In *Reserves,* the court noted that "the parties and/or their representatives met on more than one occasion to discuss the status of the infrastructure" and further found that the record in that case showed "that written notice of a default on the infrastructure would not have led to agreement or compromise."[158] Unfortunately, it is not clear from this discussion the nature and extent to which the parties in *Reserves* attempted to resolve their issues.[159] Further, in the present case, the record does not support a finding that the parties were so fundamentally at odds as to render a compromise on at least some if not all of La Grange's issues impossible.[160]

Cornell specifically requested that the notice and cure provision be included in the Agreement because it wanted an opportunity to fix its defaults before the parties walked away from their partnership and pursued litigation.[161] La Grange deprived Cornell of this opportunity. To read *Reserves,* as La Grange does, to sanction a claim of futility whenever a notice and cure provision does not fit within a party's strategic business plan would be tantamount to endorsing an exception that swallows the rule.[162] And it would frustrate the legitimate expectations of contracting parties. Nothing Cornell did in the course of the parties' relationship evidenced a repudiation of the Agreement. Nor did Cornell's alleged failure in performance render La Grange's performance impractical or impossible. Accordingly, the Court finds that La Grange's failure to provide Cornell with notice and the opportunity to cure was not justified by futility.

B. Cornell's Claims for Relief

1. The Breach of Contract Claims

Cornell's claim for breach of the Agreement and Amendment is comprised of two parts, each constituting a separate breach: (1) La Grange's failure to reimburse Cornell's soft costs dating back to September of 2010; and (2) Cornell's inability to

obtain the benefit of the bargain due to La Grange's actions on February 11, 2011. Under Delaware law, the elements of a breach of contract claim are: (1) a contractual obligation; (2) a breach of that obligation; and (3) resulting damages.[163]

a. Failure To Reimburse Costs and Expenses

***15** With respect to Cornell's first breach claim involving La Grange's alleged failure to reimburse costs and expenses, there appears to be little dispute that La Grange failed to meet its contractual obligations. Pursuant to the Agreement, La Grange was obligated to reimburse Cornell for such soft costs relating to marketing, architecture and construction.[164] Yet La Grange failed to reimburse Cornell for soft costs dating back to September of 2010.[165]

At trial, Nichols testified that La Grange stopped reimbursing Cornell for soft costs because Cornell failed to provide the requisite accounting to justify reimbursement.[166] The explanation is not persuasive. The evidence reveals that Cornell gave La Grange unfettered access to its costing data in the form of complete Quickbooks© files.[167] As McSorley explained, this data provided all that La Grange needed to know about job costing.[168] Moreover, as noted, La Grange never provided Cornell with a notice of default relating to these accounting issues, thus raising serious doubt as to whether these issues were the actual reason La Grange was withholding reimbursement. Cornell's purported failure to meet La Grange's accounting standards did not constitute a breach that would excuse La Grange's failure to reimburse Cornell. Cornell has proven breach and is entitled to damages.

b. The Ouster and Resulting Breach

Pursuant to the Agreement, La Grange was required to provide Cornell with unrestricted access to the Development.[169] On February 11, 2011, La Grange ousted Cornell from the Project. This breach of the Agreement, in turn, rendered Cornell unable to perform services that would have yielded management fees from the future sales of homes. As a result of La Grange's breach, therefore, Cornell was damaged. La Grange argues that Cornell is not entitled to management fees on houses that it never built or sold. In this regard, La Grange contends that its ouster of Cornell from the project was justified because Cornell had materially breached the contract by failing to maintain the sales pace for single family homes set forth in the projections contained in Exhibit A to the Agreement. Relying upon *Hifn, Inc.,*[170] La Grange maintains that, in light of the Agreement's time is of the essence provision, Cornell's failure to adhere to the "Sales Projection Schedule" constituted a material breach which excused La Grange's continued performance and justified the ouster. The Court already has rejected this argument as contrary to the Agreement's clear and unambiguous terms. As discussed below, it is also contrary to the evidence adduced at trial.

La Grange maintains that it bargained for the time is of the essence provision in relation to the sales projection schedule for the purposes of timely satisfying repayment demands from its lenders[171] and also to ensure that La Grange would be able to recoup the funds it had invested in infrastructure for the Development.[172] This explanation makes perfect sense. What does not make sense, however, is La Grange's implicit suggestion that either of these interests was ever in jeopardy during the course of the parties' relationship. La Grange presented no evidence that it was in default of its loan obligations prior to the ouster. Indeed, Cornell was servicing portions of La Grange's debt.[173] Nor did La Grange present evidence that it was not able to improve lots or install infrastructure in the Development as a consequence of Cornell's inability to sell single family homes at the pace projected in Exhibit A.

***16** While perhaps not fully mindful of its mandates, the Court is satisfied that Cornell complied with the Agreement's time is of the essence provision and its Exhibit A. In this regard, the Court reiterates its finding that Exhibit A did not impose sales deadlines upon Cornell. Nevertheless, Cornell was obliged to perform its work—construction, marketing and sales of new homes—with dispatch. Although it is clear that the sales of single family homes in the Development lagged behind the projections,[174] it is also clear that Cornell's performance under the Agreement was yielding profits to the parties in excess of those projected at the outset of their relationship.[175] The profitability of the project reflects Cornell's hard work and dedication to the project, is consistent with the overarching goal of the project as reflected in the Agreement, and is in keeping with the Agreement's time is of the essence requirement. There was no breach of this provision that would excuse La Grange's ouster of Cornell from the project. Cornell is entitled to damages.

2. The Lot 206 Claims

a. Breach of Contract

Cornell asserts that La Grange breached the Agreement, Amendment, and the Escrow Agreement by: (a) selling Lot 206 with the fully furnished Model Home to Johnson when the deed to the property should have been held in escrow; and (b) failing to use the proceeds from the sale to pay amounts owed Cornell.[176] As mentioned above, under Delaware law, the elements of a breach of contract claim are: (1) a contractual obligation; (2) a breach of that obligation; and (3) resulting damages.[177]

Cornell has premised this claim, specifically, and its entire complaint, generally, upon the factual predicate that La Grange Properties, LLC and La Grange Communities, LLC violated an obligation that the parties were not to disturb the deed to Lot 206 held in escrow. Cornell has not identified a contractual provision that expressly imposes this obligation, and the Court has found no such obligation in the operative agreements.[178] Having said this, the Court has found no provision of the operative agreements that would permit this conduct either. To the extent La Grange's conduct in drawing a new deed for Lot 206 and then transferring that property to Johnson is actionable, therefore, the cause of action lies outside of the contracts entered into by and between Cornell and La Grange. Cornell has failed to prove this aspect of its breach of contract claim.

Cornell has, however, proven that La Grange breached the operative agreements by failing to reimburse Cornell its costs in connection with the improvements it constructed on Lot 206. Specifically, the Agreement required La Grange "to reimburse Cornell for all expenses paid by Cornell for the construction [of homes within the Development]."[179] In addition, the Amendment required La Grange to make "interest and/or principal payments" on a loan from NBRS related to Lot 206.[180] It did not do so in breach of the Amendment.[181] Accordingly, Cornell is entitled to breach damages on these claims.

b. Breach of the Covenant of Good Faith and Fair Dealing

***17** Cornell alleges that La Grange's conduct in drawing a new deed and then transferring Lot 206 to Johnson in the midst of its dispute with Cornell over the title to the property constituted a breach of the covenant of good faith and fair dealing. "The covenant [of good faith and fair dealing] is 'best understood as a way of implying terms in the agreement,' whether employed to analyze unanticipated developments or to fill gaps in the contract's provisions."[182] Stated differently, the covenant provides "a way of 'honoring the reasonable expectations created by the autonomous expressions of the contracting parties."[183] Under Delaware law, the covenant "attaches to every contract."[184]

After carefully reviewing the evidence, the Court is satisfied that the parties expected that deeds to designated properties within the Development, including Lot 206, would be held in escrow by an escrow agent. Upon noting La Grange's defaults under the Agreement, and pursuant to the Amendment, Cornell demanded that the escrow agent release to it the deed to Lot 206. La Grange disagreed. Rather than facilitate or, at least, await a resolution of that dispute, La Grange secretly had a new deed drawn and sold Lot 206 out from under escrow, in violation of the parties' expectations as expressed in the operative agreements.[185] This conduct was "arbitrary and unreasonable" and it had "the effect of preventing [Cornell] from receiving the 'fruits' of the bargain."[186] La Grange is liable, therefore, for violating the covenant of good faith and fair dealing.

c. Fraudulent Conveyance (6 *Del. C.* § 1301, *et seq.*)

The Court turns to Cornell's statutory claim for fraudulent conveyance. Our fraudulent conveyance statute provides a framework, including defined terms, which a claimant must satisfy to obtain relief. It is telling to the Court that, with a significant record at its disposal, Cornell has given only cursory attention to this claim in its post-trial submission.[187] Despite a record spanning five (5) days of trial testimony and approximately sixty (60) trial exhibits, Cornell does not attempt to satisfy any definition or identify any statutory pathway upon which the Court could ground relief on this claim. For its part, La Grange takes pains to assert that Cornell has not met its burden of proving that the sale of Lot 206 rises to the level of fraud.[188]

Under these circumstances, the Court will not attempt to construct the pathway to relief on Cornell's behalf. Accordingly, as the statutory requirements for fraudulent conveyance have not been established by a preponderance of the evidence against any of the defendants, the Court finds in favor of all defendants on this claim.[189]

d. Unjust Enrichment

The Court next considers Cornell's claim of unjust enrichment. "The elements of a claim of unjust enrichment are '(1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and the impoverishment, (4) the absence of justification, and (5) the absence of a remedy provided by law.' "[190] To the extent the claim is directed to La Grange, it fails as a matter of law. "It is a well-settled principal of Delaware law that a party cannot recover under a theory of unjust enrichment if a contract governs the relationship between the contesting parties that gives rise to the unjust enrichment claim."[191] As determined above, several contracts govern the relationship between Cornell and La Grange with respect to Lot 206. No claim for unjust enrichment against La Grange lies here.

***18** Cornell also seeks recovery from Johnson on a theory of unjust enrichment on the ground that he "received a fully furnished model home ... without spending a dime."[192] It is not at all clear that this contention is supported by the record evidence, particularly given that closing documents for the Lot 206 transaction reveal that Johnson did, in fact, "spend a dime" (several in fact) for the property.[193] Even assuming *arguendo* that Cornell's claim was factually accurate, it is, nevertheless, legally flawed. As our Court of Chancery recently held:

> As an extension of that principle [no unjust enrichment when a valid contract] exists, this Court also has held that 'unjust enrichment cannot be used to circumvent basic contract principles [recognizing] that a person *not a party to [a] contract* cannot be held liable to it.' Delaware courts consistently have held that 'where a contract exists no person can be sued for breach of contract who has not contracted either in person or by an agent, and ... that the doctrine of unjust enrichment cannot be used to circumvent this principle merely by substituting one person or debtor for another.' 'The rationale for this rule is that the inability of a party to a contract to fulfill an obligation thereunder cannot serve as basis to conclude that other entities, *who are not party to the contract,* are liable for that obligation.'[194]

Cornell has alleged that La Grange's conduct with respect to Lot 206 constituted a breach of the parties' contracts. The Court has found that allegation to be supported by the preponderance of the evidence and has found La Grange in breach. Cornell cannot now seek to circumvent the operative agreements by invoking the equitable doctrine of unjust enrichment against Johnson simply because Johnson was not a party to its contracts with La Grange. Cornell has its remedy at law and that must suffice.[195]

To the extent Cornell is still pressing an unjust enrichment claim against Nichols and McCoy in their individual capacities (not argued in its post trial brief), the claim fails because the contract with La Grange governs the controversy.[196] If Cornell seeks to reach Nichols and McCoy through the La Grange entities, that claim would effectively require the Court to pierce the corporate veil(s), a remedy this Court lacks the subject matter jurisdiction to provide.[197]

The Court finds in favor of all defendants on Cornell's unjust enrichment claim.

C. La Grange's Counterclaims

1. Sales Incentives and Pike Creek Mortgage Incentives

The Court already has determined that La Grange did not comply with the notice and cure provision of the Agreement and that this noncompliance was not excused by futility. While this determination is fatal to La Grange's breach of contract counterclaims, the Court will entertain them on the merits in any event for the sake of completeness. As discussed below, the Court is satisfied that La Grange has failed to meet its burden of proving its counterclaims by a preponderance of the evidence.

***19** La Grange contends that Cornell was required by the Agreement to seek La Grange's written approval when deviating from the agreed upon sales incentives and base prices for the various types of residences sold in the Development.[198] According to La Grange, Cornell did not comply with this provision when it offered unauthorized sales incentives to home buyers. The evidence says otherwise.

As McSorley explained at length, the incentives Cornell offered to buyers never exceeded those permitted by the Agreement.[199] In this regard, it is important to focus on the actual cost of the incentives to the seller, not the value of the incentives to the buyer. Lingo reconciled the value versus cost confusion by using the example of an incentive for a finished basement. Lingo explained that a finished basement cost $3,000 to build, but when the sale was documented the finished basement was reflected as a $10,000 to $12,000 charge to the customer.[200] Mr. Lingo further stated, "[w]e were consistently under but we were being told you gave

the customer $12,000, which was never the—agreement was the cost of the incentive, not how much we mark it up so the customer saw value."[201] The Court agrees with this interpretation of Cornell's obligation. Cornell did not short change La Grange on sales incentives.

La Grange took umbrage with Cornell offering incentives to home buyers who secured mortgage financing through Pike Creek, Cornell's preferred lender.[202] In this regard, the evidence revealed that Cornell displayed Pike Creek's marketing information in its sales office and Cornell's sales representatives would recommend Pike Creek as a credible mortgage company.[203] If a purchaser selected Pike Creek as its lender, then they would receive as an "incentive" a "discount against the purchase price [of the home]" or cash back at settlement.[204] In exchange, Cornell received a quarterly marketing fee from Pike Creek in the amount of $60,000.[205]

Cornell, through McSorley, was adamant that the relationship between Cornell and Pike Creek Mortgage was well-known to La Grange from the inception of the Agreement and throughout the Project.[206] McSorley testified that Pike Creek's preferred lender status was clearly set forth in Cornell's Purchase Agreement (Exhibit C to the Agreement).[207] Moreover, a La Grange employee, Mary Ann WaskoSmith,[208] who worked directly with Cornell from the outset of the Project, was well aware of Pike Creek's involvement with the Project.[209] McSorley testified convincingly that the arrangement between Cornell and Pike Creek was not detrimental to La Grange, but rather had a "net positive effect ."[210] And, as Lingo explained, the average sales price for homes sold with the Pike Creek incentive was $16,000 higher than homes sold without the incentive.[211] Based on the foregoing, the Court is satisfied that the Pike Creek incentive not only did not breach the Agreement, it was entirely consistent with the Agreement.

2. Lagging Sales Pace for Single Family Homes

***20** The Court has addressed this claim in the context of La Grange's argument that it was excused from performance by virtue of Cornell's failure to meet sales projections. For the same reasons that argument fails, La Grange cannot mount a counterclaim against Cornell for a breach that never occurred.

3. The Alleged Accounting Failures

La Grange has failed to prove a breach of the Agreement based upon Cornell's alleged failure to provide the requisite level of accounting under the Agreement. As discussed above, Cornell made clear that La Grange's requests for information were met with commitments to provide complete access to Cornell's internal accounting system.[212] Cornell not only agreed to meet with La Grange to discuss these issues, but at times reformatted previously accessible information at La Grange's request.[213] There was no breach here.

D. Cornell's Damages

Having determined that Cornell has proven its claims for breach of the Agreement, and certain claims regarding the wrongful conveyance of Lot 206, the Court must now turn to a determination of Cornell's damages. Cornell seeks recovery of its unreimbursed costs relating to the Project, the present value of lost future management services fees under the Agreement,[214] damages relating to the improper sale of Lot 206 and interest and court costs. In support of its damages claims, Cornell presented the expert testimony of David A. Anderson (Certified Public Accountant, Certified Fraud Examiner) ("Anderson").[215] LaGrange raised an eleventh-hour challenge to the admissibility of Anderson's testimony as unreliable and seeks its exclusion from the record.[216]

1. The *Daubert* Challenge

Delaware Rule of Evidence 702 provides:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.[217]

In interpreting D.R.E. 702, our Supreme Court has adopted the United States Supreme Court's holding in *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* where the court held that an expert's opinion must be based upon proper factual foundation and sound methodology meaningfully applied to the facts at issue in order to be admissible at trial.[218] In keeping with *Daubert,* the trial judge must act as the

"gatekeeper" to determine whether a proffered expert's testimony meets the requisites for admissibility.[219] The trial judge has "broad latitude" while performing this function to decide whether the proffered expert testimony is sufficiently reliable and relevant.[220] The party offering the testimony bears the burden of establishing both prongs of this analysis, *i.e.,* relevancy and reliability, by a preponderance of the evidence.[221]

***21** "If an expert bases an opinion on an erroneous factual foundation, the inaccurate premises invalidate the conclusion even if the expert's methods are generally valid."[222] Stated differently, "where an expert opinion is 'fundamentally unsupported by the facts of the case,' it should be excluded on 'the ground that it will be of no assistance to the fact finder in deciding the case.' "[223]

In this instance, Anderson projected the amount of management fees associated with each housing segment that Cornell was to build at the Development.[224] Not surprisingly, in order to calculate expectancy damages which, by their nature, relate to as yet unrealized benefits of the bargain, Anderson necessarily made assumptions regarding the future conduct of the parties as if La Grange had not breached their agreement.[225] Anderson assumes, *inter alia,* that the parties would amend Exhibit A (which does not, on its face, contemplate the additional "weak link homes" that Cornell subsequently gained the rights to build, market and sell) and projected time frames for building, marketing and selling the town homes (including the additional weak link variety) and duplexes based upon their actual, historical pace.[226] La Grange does not take issue with this assumption, and for good reason. Nichols agreed at trial that Exhibit A did not accurately reflect the parties' arrangement after they entered into the Amendment.[227]

Anderson then makes the two assumptions that have garnered protest from La Grange: (1) that the parties would have amended Exhibit A to allow for an extension of time to sell the single family homes; and (2) that the parties would have agreed to alter the price and/or design of the single family homes to increase their sales pace.[228] Anderson calculated the amounts of projected management fees of each housing segment and reduced that amount to present value to opine that Cornell sustained expectancy damages in the amount of $2,159,000.[229]

La Grange cites *Perry* in support of its contention that Anderson's testimony is inadmissible.[230] There, the Supreme Court affirmed the Superior Court's finding that the testimony of the plaintiff's medical expert was inadmissible upon concluding that he demonstrated a "complete lack of knowledge of the most fundamental relevant facts."[231] Specifically, the court determined that the expert was unaware of the plaintiff's prior medical history of injuries that were similar if not identical to those the expert had opined were proximately caused by the accident at issue.[232] Accordingly, the court concluded that the expert's opinion as to causation was "without an accurate factual predicate" and, therefore, inadmissible under *Daubert* and D.R.E. 702.[233]

Unlike the medical expert in *Perry,* Anderson did not demonstrate a fundamental misunderstanding of the facts upon which his opinions were based. To the contrary, Anderson knew full well of the parties' disagreement regarding whether Exhibit A reflected projections or deadlines.[234] He also knew that sales of single family homes had lagged behind projections.[235] He was asked to assume that Exhibit A did not reflect contractual deadlines and, therefore, that Cornell had not breached the Agreement by not keeping pace with the projected sales of single family homes. These assumptions, as it turns out, comport with the Court's findings after trial. Moreover, they do not reflect ignorance of key facts that undermine the reliability of the conclusions.[236] Rather, they reflect a reasonable assumption that the parties would have worked together, but for La Grange's breach, to continue on a path towards profitability for the Project. La Grange, through counsel, was able to test Anderson's assumptions through "vigorous cross examination."[237] *Daubert* is concerned with the reliability of the expert's methodology, not the accuracy of his ultimate conclusions.[238] Anderson's testimony is admissible because his methodology was reliable. La Grange's challenge will be considered when assessing the weight to be given to Anderson's testimony.[239]

2. Cornell Has Proven Its Damages

***22** Having determined that Anderson's testimony is admissible, the Court next considers whether Cornell has satisfied its burden of proving damages by a preponderance of the evidence.[240] A proper damages award for breach of contract is an amount sufficient to restore Cornell to the position it would have enjoyed but for the breach.[241]

In summary, Anderson rendered the following opinions as to the amounts of Cornell's damages should La Grange be found liable in this litigation:

- Construction and loan costs for Lot 206 owed in an amount of $192,281;[242]
- Sales, marketing, administrative and related Project costs owed in an amount of $250,631;[243] and
- Present value of lost management services fees owed in an amount of $1,716,114.[244]

La Grange elected to challenge Cornell's damages presentation by cross-examination, which focused upon the assumptions made by Anderson relating to his projected loss of management services fees derived from future sales, rather than by presenting a competing damages expert. Despite its efforts, however, the Court has found Mr. Anderson's testimony to be both credible and persuasive.

a. Construction and loan costs for Lot 206

In reaching his opinion, Anderson received and reviewed a summary of construction lots and expenses relating to Lot 206 provided by Cornell. He then verified the legitimacy of that information by reconciling each line item and its corresponding numbers with underlying vendor invoices, checks, bank statements and other evidence to ensure that the amounts were expenditures actually incurred by Cornell in connection with Lot 206 or the model home.[245] Anderson found that $457,878.64 was supported by documentation.[246] Anderson included within his calculations a charge by NBRS to Cornell ($8,402.72) relating to the loan Cornell secured in connection with the Amendment and escrowing of the Lot 206 deed.[247] Anderson totaled these amounts ($466,281.36) and then subtracted construction draws from NBRS ($274,000) that resulted in an amount of $192,000.[248] With due consideration given to cross-examination by La Grange, the Court is persuaded that Anderson's approach and opinion as to Lot 206 damages is reasonable and supported by the preponderance of the evidence.

b. Sales, marketing, administrative and other costs

Anderson undertook a similar approach in determining the amount of sales, marketing and other costs that Cornell sought to be reimbursed by La Grange. Specifically, Anderson evaluated expenses that included salaries and costs of sales personnel, advertising, collateral materials, promotion and other expenses related to the objective of selling homes within the Development.[249] Although Cornell initially sought more in reimbursements, Anderson was able to verify, by way of reconciliation with supporting documentation, an amount of $300,340.[250] Anderson next adjusted this figure to account for $49,709 that Cornell owed to Nichols Nursery, which resulted in the amount of $250,631.[251] Notwithstanding cross-examination, the Court is persuaded that Anderson's approach and opinion as to this component of Cornell's damages presentation is also reasonable and, again, supported by the preponderance of the evidence.

c. Lost management services fees (present value)

***23** In determining the lost management services fees, Anderson made assumptions about the parties anticipated co-operation in furthering the goal of profitability for the Project.[252] In reaching his conclusion, Anderson determined a gross figure for each housing segment, then discounted the total of those numbers to present value. With respect to town homes, specifically, Anderson determined that lost management fees totaled $960,000.[253] He reached that number by using a conservative time frame in which to close the sale (approximately 210 days) and projecting a future sales pace based upon actual sales history prior to February 11, 2011.[254] Anderson implemented the Least Squares approach in analyzing the statistical trend of actual sales within his calculations.[255] To ensure the reliability of his projections, and reduce reliance upon the potentially subjective input of Cornell, he contrasted his projected sales pace with other Cornell residential developments with comparable unit types and prices in a nearby locale.[256] Anderson then multiplied 96 (the number of town homes that had not closed as of February 11, 2011) by $10,000 (the management services fee prescribed by the Agreement) to reach $960,000. Anderson employed a similar method to derive $330,000 in management fees for duplexes,[257] as well as $600,000 in management fees for the expected sales of single family homes.[258] Lastly, Anderson discounted each of these amounts by a rate of 5.5%[259] to achieve present value for each segment,[260] which he totaled to be $1,716,000 (rounded).[261]

Despite significant cross-examination regarding Anderson's assumptions, and La Grange's position at trial that it would not have agreed to extend the timeframe for future sales (especially for single family homes),[262] the Court is persuaded that Anderson's testimony and opinion as to the present value of lost management services fees is reasonable. The assumptions are consistent with the parties' expectations of profitability for the Project, as reflected by the preponderance of the evidence, and the methodology was conservative and reliable.

d. Costs and interest

In addition to the damages supported by Anderson's testimony, Cornell has requested costs, as well as prejudgment and postjudgment interest.[263] Without citing any authority, La Grange contends that Cornell is not entitled to recover costs relating to the filing of the Complaints in the Court of Chancery because they were dismissed. La Grange further contends that the costs of Ms. DeVoll's deposition transcript are not "within the meaning of [Superior Court] Rule 54(g)" because La Grange accommodated Cornell's request that Ms. DeVoll not testify in person to alleviate her inconvenience.[264] Finally, La Grange contends that Cornell is not entitled to prejudgment interest because La Grange had "no means available to determine that amount which [it] had to tender in order to prevent interest from accruing."[265]

***24** As a general rule, "costs shall be allowed as of course to the prevailing party upon application to the Court within ten (10) days of the entry of final judgment, unless the Court otherwise directs."[266] "Under case law ... our courts have defined costs as those 'expenses necessarily incurred in the assertion of [a] right in court,' such as court filing fees, fees associated with service of process or costs covered by statute."[267] Fees paid to court reporters for depositions, however, "shall not be taxable costs unless introduced into evidence."[268]

Courts in our state have found that "[c]osts are allowances in the nature of incidental damages awarded by law to reimburse the prevailing party for expenses *necessarily* incurred in the assertion of [ ] rights in court."[269] The complaints that Cornell filed in the Court of Chancery were not necessarily incurred in the assertion of the rights that Cornell asserts before this Court. Accordingly, that aspect of Cornell's request for costs is denied. With respect to the deposition costs of DeVoll, La Grange could have conditioned its assent to its admission into the record upon Cornell's foregoing of associated costs. It did not. Cornell incurred the costs associated with ordering a copy of the deposition transcript despite DeVoll being called to deposition by La Grange. Accordingly, as Cornell admitted DeVoll's deposition into the record *sub judice,* Cornell is allowed to recover these costs.

Prejudgment interest is routinely awarded to successful litigants .[270] The Court is not persuaded that *Coca-cola Bottling Co. of Elizabethtown, Inc.* stands for the proposition proffered by La Grange, that is, that Cornell was obliged to specify the amount which La Grange needed to pay so that La Grange could avoid an assessment of prejudgment interest.[271] La Grange was fully capable of calculating Cornell's likely expectancy damages (lost management fees clearly defined in the Agreement) at the time it kicked Cornell off the Project. Accordingly, the Court awards Cornell prejudgment interest, as well as post judgment interest, at the legal rate.[272]

VII.

For the foregoing reasons, the Court has found in favor of Cornell and awards damages in the amount of $1,966,745 in Civil Action No. N11C–05–016–JRS [CCLD] against La Grange Communities, LLC and La Grange Properties, LLC and $192,281 in Civil Action No. N11C–07–160–JRS [CCLD] against La Grange Communities, LLC and La Grange Properties, LLC. Further, costs are awarded in the amount of $8,309 and prejudgment and post judgment interest are awarded at the legal rate.

IT IS SO ORDERED.

All Citations

Not Reported in A.3d, 2012 WL 6840625

Footnotes

1 The parties submitted joint exhibits at trial which shall be referred to as "JX——." Trial testimony shall be referred to by "Date, Trans., Page: Line." *See* JX 31; 9/28/12 Trans. 49:14–20.

2 JX 31, 54, 55. 9/27/12 Trans. 9:4–12.

3 9/26/12 Trans. 103:19–23

4 JX 3A.

5 *Id.*

6 *Id.*

7 *See e.g.* 9/24/12 Trans. 9:15–16 (asserting that going into the Agreement it was clear to the parties that maximizing profitability was "absolutely critical"); 9/24/12 Trans. 18:14–15 (stating that Exhibit A to the Agreement was never amended because pace was not nearly as important as profitability); 9/24/12 Trans. 54:6–7(referring to maximizing profitability as a mutual goal of the parties).

8 JX 4, The Development Agreement. There is some confusion in the record as to which entities are party to the agreement. *See e .g.* (1) JX 4 at introductory recital; (2) JX 4 at signature block; (3) JX 6 at ¶ 18, Amendment to Development Agreement. The parties appear to have cleared up this confusion in the Pre–Trial Stipulation where they state: "La Grange Properties, La Grange Communities and Cornell Glasgow are parties to the Development Agreement and Amendment to the Development Agreement." Pretrial Stip., Facts Admitted Without Proof (1).

9 JX 4.

10 *Id.*

11 *Id.*

12 *Id.* at ¶¶ 3B and 3C.

13 *Id.* at ¶¶ 2B–D.

14 *Id.* at ¶ 5D.

15 9/24/12 Trans. 47:15–16.

16 JX 4 at ¶ 5E.

17 *Id.* at ¶¶ 5A–C.

18 *Id.* at ¶ 5G.

19 *Id.* at ¶ 2H.

20 *Id.*

21 *Id.* at ¶ 19. ("TIME. Time is of the essence as to all matters to be performed by the parties under this Agreement."). As discussed below, the parties disagree as to the significance and meaning of this provision.

22 *Id.* at Ex. A.

23 *Id.* at ¶ 6.

24 *Id.*

25 9/24/12 Trans. 117:20–23 thru 118:1–2.

26 JX 4 at ¶ 1A.

27 *Id.*

28 *Id.*

29 *Id.*

30 9/24/12 Trans. 17:1–4.

31 *See* 9/26/12 Trans. 107:6–9.

32 *See* JX 6.

33 *Id.* at ¶¶ 1, 2, 17, 20, Ex. L.

34 *Id.* at ¶ 2. At the closing on the sale of a residence, the sale proceeds were used to pay the principal of Cornell's loan, plus any accrued interest and other unreimbursed costs and expenses incurred by Cornell in connection with the residence. *Id.*

35 9/24/12 Trans. 24:1–7 (McSorley testified at trial as to the purpose of the Escrow arrangement stating, "we did not want to be in [a] position that [we] improved a lot, but we don't own them. All of a sudden that lot would be able to be sold to someone else.").

36 JX 6, Ex. L.

37 9/28/12 Trans. 91:14–19.

38 *Id.*

39 9/24/12 Trans. 55:2–3.

40 9/24/12 Trans. 20:16–19.

41 9/25/12 Trans. 27:10; 9/28/12 Trans. 69:8–16.

42 9/24/12 Trans. 135:4–18.

43 *See e.g.* JX 14 (e-mail from La Grange to Cornell seeking spreadsheets of expenses and requesting that Cornell re-class expense items, followed by a response from Cornell that they have re-classed the expenses and attached the requested spreadsheets to the e-mail); JX 16 (e-mail from La Grange to Cornell requesting invoices related to nine different expense items with a response from Cornell stating they "are willing to pull anything you need."); JX 17 (e-mailed offer from Cornell to sit down with La Grange to go through a few examples on the QuickBooks© software).

44 JX 10, 19.

45 JX 19, 20.

46 JX 19.

47 Nichols addressed four specific lots allegedly sold below the base price: 49, 55, 62, and 139. *See* JX 18 (Nichols questioned McSorley about a base house on Lot 62 sold for $209,990, to which McSorley responded that the base price for the unit was $227,990 with a final sales price of $240,174).

48 Nichols alleged incentives were given in excess of $4,000 to buyers who agreed to use Pike Creek due to a relationship between Cornell and Pike Creek Mortgage.

49 Nichols specifically questioned funds taken from settlement for construction expenses as compared to budgets of the base houses and options of Lots 49, 55, 62, and 139.

50 The fourth concern deals with $74,898 that La Grange asserts were not approved.

51 The $70,000 architectural issue dealt with columns constructed on three different residences which ultimately had to be shortened due to an alleged error in Cornell's plans.

52 JX 19.

53 *See id.* (La Grange Community Meeting notes dated January 6, 2011).

54 *Id.*

55 *See* JX 20.

56 *Id.*

57 *Id.*

58 JX 23.

59 JX 24A (e-mail chain consisting of four e-mails).

60 *Id.*

61 JX 24.

62 *See Id.*

63 JX 26, 28, 29.

64 *See* JX 21.

65 JX 27.

66 *Id.*

67 The testimony was not clear with respect to when La Grange received the notice. Initially, Nichols testified he received the notice some time on February 12. Upon cross-examination, however, Nichols testified that he was unsure when he received the document and may have received it Friday evening (2/11/11). 9/28/12 Trans. 36:23 thru 37:1–10, 79:1–13. The timing is relevant as it relates to the sequence of events on the evening of February 11 leading to Cornell's ouster from the Development.

68 Deposition Transcript of Krista DeVoll, C.A. 6202–CC, 3/25/11 Trans. 25–28. In lieu of in-person testimony, the Court admitted DeVoll's transcript into the record.

69 *Id.*

70 *Id.*

71 *Id.*

72 9/28/12 Trans. 37:20–21.

73 *See* 9/28/12 Trans. 38:3–7.

74 9/28/12 Trans. 40:20–23.

75 JX 6, Ex. L.

76 *Id.*

77 9/24/12 Trans. 24:21–23.

78 *See* JX 51.

79 JX 6.

80 JX 34.

81 JX 38.

82 JX 38, 39, 40.

83 *See* JX 42.

84 JX 37.

85 JX 41; 9/27/12 Trans. 132:7–15.

86 9/27/12 Trans 68:9–15, 112:12–18.

87 *See* JX 41; 9/25/12 Trans. 146–147; 9/27/12 Trans. 123:1–10 (unsatisfactorily explaining the origin of the $10,000 check).

88 9/27/12 Trans. 75:22–23 thru 76:1–2.

89 *See* 9/27/12 Trans. 120:4–9.

90 9/27/12 Trans. 121:1–9.

91 *See* JX 43, 44, 45.

92 *Cornell Glasgow, LLC v. La Grange Properties, LLC,* C.A. No. 6202–CC (filed February 18, 2011).

93 La Grange was temporarily enjoined from selling or marketing homes in the Development. C.A. No. 6202–CC (Tr. ID 36353314).

94 *Cornell Glasgow, LLC v. La Grange Properties, LLC, et al.,* 2011 WL 1451840 (Del. Ch. April 4, 2011).

95 *Id.* at *1.

96 JX 34, 36.

97 JX 34.

98 JX 36.

99 *Id.*

100 C.A. No. N11C–05–016 JRS [CCLD]; C.A. No. N11C–07–160 JRS [CCLD].

101 Tr. ID 48802291. The parties stipulated that Plaintiffs' equitable claims in the Action ending '160–(I) fraudulent conveyance (for equitable relief); (II) fraudulent conveyance (for equitable relief); (III) constructive trust; (VIII) ejectment; and (IX) rescission—would be deferred for future adjudication if necessary. The parties further stipulated that defendants' motion to amend their Answer and Counterclaims to assert claims for (IV) *alter ego* /agency liability and (V) disgorgement would also be deferred for future adjudication if necessary.

102 Cornell maintains that La Grange has admitted that soft costs remain outstanding dating back to September of 2010. Plaintiffs' Opening Brief ("Pfs.Op.Br.") at 22.

103 *Id.* at 23.

104 *Id.* at 26.

105 *Id.*

106 *Id.* at 27.

107 Defendants' Answering Brief ("Dfs.Ans.Br.") at 11.

108 *Id.*

109 *Id.*

110 Defendants' Opening Brief ("Dfs.Op.Br.") at 4.

111 *See id.*

112 Dfs. Ans. Br. at 6.

113 *Id.* at 7.

114 Dfs. Op. Br. at 19.

115 *Id.* at 19–20. La Grange arrives at $827,144.95 by adding together $689,144.95 in excessive incentives, $68,000 resulting from houses sold below the base price, and the $70,000 architectural issue addressed above. *See* JX 62.

116 Plaintiffs' Answering Brief ("Pfs.Ans.Br.") at 9.

117 *Id.* at 10.

118 *Id.*

119 *Id.* at 11.

120 *Id.* at 19.

121 *Eskridge v. Voshell,* 593 A.2d 589 (Del.1991) (ORDER), (citing *Guthridge v. Pen–Mod, Inc.,* 239 A.2d 709, 713 (Del.Super .1967)).

122 *Dionisi v. DeCampli,* 1995 WL 398536, *1 (Del. Ch. June 28, 1995).

123 *See Pellaton v. Bank of NY,* 592 A.2d 473, 478 (Del.1991) ("if [an] instrument is clear and unambiguous on its face, neither this Court nor the trial court may consider parol evidence 'to interpret it or search for the parties' intent[ions]' ") (citing *Hibbert v. Hollywood Park, Inc.,* 457 A.2d 339, 343 (Del.1983)).

124 26. CORBIN ON CONTRACTS § 573 (1960).

125 *See Rhone–Poulenac Basic Chem. Co. v. American Motorists Ins. Co.,* 616 A.2d 1192, 1196 (Del.1992)("A contract is not rendered ambiguous simply because the parties do not agree upon its proper construction.").

126 *Id.*

127 *Comrie v. Enterasys Networks, Inc.,* 837 A.2d 1, 13 (Del. Ch.2003).

128 *See O'Brien v. Progressive Northern, Ins. Co.,* 785 A.2d 281, 288–89 (Del.2001).

129 *Id.*

130 JX 4 at ¶ 19.

131 15 WILLISTON ON CONTRACTS § 46:2 (4th 2000).

132 *Rocky Mountain Gold Mines v. Gold, Silver & Tungsten,* 93 P.2d 973, 983 (Colo.1939).

133 *See Estate of Osborn v. Kemp,* 991 A.2d 1153, 1159 (Del.2010) ("We will read a contract as a whole and we will give each provision and term effect, so as not to render any part of the contract mere surplusage.") (citation omitted).

134 Williston, *supra* § 46:2.

135 In so finding, the Court does not render the Agreement's time is of the essence provision surplusage. *See Estate of Osborn,* 991 A.2d at 1159. There remain deadlines in the Agreement that are modified by this provision. For example, a firm deadline is established at ¶ 1A. of the Agreement, which states "Financing commitments from financial institutions providing for (i) and (ii) of this Section A must be in place by no later than November 1, 2009 ." In fact, a failure to meet this deadline prompted the parties to amend the entire Agreement by way of the December 2009 Amendment.

136 JX 4, Ex. A.

137 *See e.g. Lorillard Tobacco Co. v. Am. Legacy Fund,* 903 A.2d 728, 738 (Del.2006) ("Delaware courts look to dictionaries for assistance in determining the plain meaning of terms which are not defined in a contract."); *Martin Marietta Materials, Inc. v. Vulcan Materials Co.,* 2012 WL 5257252 at *34–35 (Del. Ch. May 4, 2012) (referring to Webster's Dictionary to define several undefined terms within a confidentiality agreement).

138 http://www.meriam-webster.com/dictionary/projection

139 *In re Oracle Corp.,* 867 A.2d 904, 940–41 (Del. Ch.2004), *aff'd sub nom., In re Oracle Corp. Derivative Litig.,* 872 A.2d 960 (Del.2005).

140 *Cf. Stroud–Hopler, Inc. v. Farm Harvesting Co., Inc.,* 2005 WL 3693342 at *4–5 (N.J.Super.A.D. January 23, 2006) (interpreting exhibit that indicates specific dates to complete work, to be unambiguous and, when read in conjunction with a time is of the essence provision, to be the equivalent of deadlines where agreement provides that "strict adherence to project scheduling is a must" and "[n]o extension of time beyond date stipulated in proposal will be allowed on account of [ ] causes which could have been avoided by exercise of reasonable foresight....").

141 *Union Fire Ins. Co. of Pittsburgh, P.A. v. Pan American Energy, LLC,* 2003 WL 1432419 at *4 (Del. Ch. March 19, 2003)("The courts may not by construction add or excise terms, nor distort the meaning of those used and thereby make a new contract for the parties under the guise of interpreting the writing.").

142 JX 32 A.

143 *Id.* at ¶ 3(a).

144 9/24/12 Trans. 8:22–23.

145 *See e.g., U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C.,* 2004 WL 1699057 (Del. Ch. July 29, 2004) (rejecting argument that mere filing of complaint by non-breaching party would satisfy contractual notice and cure provision); *Harper v. Del. Valley Broadcasters,* 743 F.Supp. 1076, 1083–84 (D.Del 1990)(enforcing notice and cure provision to bar certain breach of contract claims), *aff'd,* 932 F.2d 959 (3d Cir.1991); *Kerns v. United States,* 2012 WL 5877479 (E.D.Va. Nov. 20, 2012)(dismissing claims arising from a Deed of Trust because the plaintiff failed to comply with the notice and cure provision contained within the document); *Point Productions A.G. v. Sony Music Entm't, Inc.,* 2000 WL 1006236 (S.D.N.Y. July 20, 2000) (granting a motion for summary judgment where party did not comply with notice and cure provision of contract and failed to prove excuse by futility); *Argo Corp. v. Greater N.Y. Mut. Ins. Co.,*

827 N.E.2d 762, 764 (N .Y.Ct.App.2005)(affirming order dismissing breach claims for failure to comply with contract's notice and cure provision).

146 *See U.S. Bank Nat'l Ass'n,* 2004 WL 1699057 at *6, n. 24 ("Therefore, this court adheres to the well-reasoned decisions [...] holding that a pre-suit notice provision in a contract should be given meaning, as it evidences the clear intent of the parties to require written notice of default before [a party] may pursue litigation.").

147 JX 27.

148 *U.S. Bank Nat'l Ass'n,* 2004 WL 1699057 at *3 (Del. Ch. July 29, 2004) ("Very simply, the filing of [the complaint] does not afford the receiving party the opportunity to cure its defaults in a non-litigious manner."). Cornell's second attempt at compliance—the April 13, 2011 notice of default—also missed the mark. The parties were engaged in litigation by that time and the subject matter of the second notice was clearly implicated by Cornell's complaint. *See* JX 34.

149 In response to Cornell's motion for summary judgment, La Grange argued that it substantially complied with the notice and cure provision. The Court, relying on *Gildor v. Optical Solutions, Inc.,* 2006 WL 4782348 (Del. Ch. May 11, 2006), held that where literal compliance was possible substantial compliance was not a substitute. (Tr. ID 46520066).

150 *Reserves Dev., LLC v. R.T. Properties, LLC,* 2011 WL 4639817 (Del.Super.Sept.22, 2011).

151 *Id.* at *7.

152 *Best Payphones, Inc. v. Manhattan Telec. Corp. (In re Best Payphones, Inc.),* 432 B.R. 46 (S.D.N.Y.2010). The Court has already relied upon *Best Payphones, Inc.* in connection with pretrial rulings with regard to the notice and cure provision. (Tr. ID 46556734).

153 *Id.* at *54 (citing *Bausch & Lomb Inc. v. Bressler,* 977 F.2d 720, 728 (2d Cir.1992) (recognizing that a failure to provide notice and an opportunity to cure may be excused where "the repudiating party expressly disavowed any further duties under the contract at issue, in effect declaring the contract at an end."); *About.com, Inc. v. TargetFirst, Inc.,* 2003 WL 942134 at *4 (S.D.N.Y. March 10, 2003) (noting that to excuse performance of the obligation to provide notice and opportunity to cure "[t]he announcement of intention not to perform by the repudiating party must be 'positive and unequivocal.' ") (internal citations omitted)).

154 *Id.*

155 *See e.g. Frontier Oil Corp. v. Holly Corp.,* 2005 WL 1039027, at *27 (Del. Ch. Apr. 29, 2005) ("An '*unequivocal* statement by a promisor that he will not perform his promise' is the essential underpinning for a repudiation claim.") (quoting *Carteret Bancorp, Inc. v. The Home Group, Inc.,* 1988 WL 3010 at *5 (Del. Ch. June 13, 1988) (emphasis supplied)).

156 DeVoll, 3/25/11 Trans. 25–28.

157 *Reserves,* 2011 WL 4639817 at *7 (Del.Super.Sept.22, 2011).

158 *Id.*

159 The phrase "more than one occasion" could signify two meetings or two hundred meetings. *Id.*

160 As McSorley explained, Cornell was attempting to address La Grange's concerns regarding the accounting issues by providing increased and more meaningful access to Cornell's costing data and better explanations of the breakdown of home sales prices prior to closing. 9/24/12 Trans. 135:4–22 (testifying that each of Cornell's requests for reimbursement were met with question from La Grange that were then answered by Cornell); 9/25/12 Trans. 78, 84 (addressing e-mail requests from La Grange for accounting information and Cornell's willingness and ability to provide the requested information). In addition, Lingo persuasively explained that Cornell could have stepped up the sales pace, if needed to respond to a notice of default from La Grange, by dedicating resources and directing customers from other Cornell projects to the Project. 9/24/12 Trans. 118:1–11 (testifying that at three other communities Cornell had been able to sell houses at a rapid rate when pressured to meet an objective by increasing staff and advertising).

161 9/24/12 Trans.117:20–23 thru 118:1–2.

162 *See Purnell v. State,* 979 A.2d 1102, 1107 (Del.2009) (noting that exceptions—in this case to the hearsay rule—should not be construed to allow the "exception to swallow the [ ] rule."); *Henry v. Nanticoke Surg. Assoc., P.A.,* 931 A.2d 460, 464 (Del.Super.2007) (same).

163 *H–M Wexford, LLC v. Encorp, Inc.,* 832 A.2d 129, 144 (Del. Ch.2003).

164 JX 4 at ¶¶ 5A–C.

165 *See* 9/24/12 Trans. 134:17–23–135:1–22. McSorley testified that for the first nine months of the business relationship, Cornell submitted invoices related to incurred soft costs and received reimbursement from La Grange without issue. Beginning in September of 2010, Cornell's invoices were consistently met with a series of questions as to expenses and requests for financial information instead of payment. The requested information was provided by Cornell but La Grange did not remit payment. *Id.*

166 9/28/12 Trans. 69:12–21.

167 JX 11, 16.

168 9/25/12 Trans. 72:16–21. When questioned by opposing counsel as to trial exhibits which reflected production of requested accounting information, McSorley noted JX 11 and JX 16 addressed La Grange's ability to access the information generated by Quickbooks©.

169 JX 4 at ¶ 3A.

170 *Hifn, Inc. v. Intel Corp.,* 2007 WL 2801393 at *9 (Del. Ch. May 2, 2007), ("When time is of the essence in a contract, a failure to perform by the time stated is a material breach of the contract that will discharge the non-breaching party's obligation to perform its side of the agreement.")

171 9/26/12 Trans 112–114. La Grange asserts that it was expected to make periodic loan repayments on its loans and that the lending institutions needed assurances as to where this money would come from. La Grange maintains that Exhibit A to the Agreement, along with the time is of the essence provision, would be the type of documentation its lenders would want to see to ensure La Grange would have the funds to make timely payments on its loans. Nichols testified that its lenders would not have allowed La Grange to enter into an arrangement without a firm obligation as to time of performance because otherwise such an arrangement could last indefinitely without any performance generating profits. *Id.*

172 *See* 9/26/12 Trans. 117:17–20, 119:2–9.

173 9/24/12 Trans. 20:16–17.

174 9/24/12 Trans. 52: 11–18; 54:22–23 thru 55:1–3 (addressing the slower pace of single family homes with some dispute as to whether the slow sales were the result of a depressed housing market or Cornell's efforts).

175 9/24/12 Trans. 20:16–19 (asserting that the project was $250,000 more profitable than anticipated in September of 2010).

176 Pfs. Op. Br. at 25–26.

177 *H–M Wexford, LLC,* 832 A.2d at 144.

178 Within the factual allegations of the Complaint in N11C–07–160, which Cornell incorporates by reference into the subject breach of contract count, Cornell refers to ¶ 17 of the Amendment, which provides that La Grange will, *inter alia,* "deliver into escrow with the [escrow agent]" the deed to Lot 206. *See* Complaint, ¶ 24. Cornell has not alleged that La Grange failed to do so. *See* Complaint, ¶ 25.

179 JX 4 at ¶ 5C.

180 JX 6 at ¶ 2.

181 9/27/12 Trans. 57:10–15.

182 *Dunlap v. State Farm Fire & Cas. Co.,* 878 A.2d 434, 441 (Del.2005) (citation omitted).

183 *E.I. DuPunt de Nemours & Co. v. Pressman,* 679 A.2d 436, 443 (Del.1996) (citation omitted).

184 *Dunlap,* 878 A.2d at 442.

185 JX 6 at ¶ 17, Ex. L at ¶ 3.

186 *Dunlap,* 878 A.2d at 447.

187 Indeed, Cornell refers to this claim but once in a single footnote. Pfs. Op. Br. at 27, n. 12.

188 La Grange argues that Cornell has failed to show that La Grange received something other than "a reasonably equivalent value" for the property. (*See* Dfs. Op. Br. at 17–18) (styled under argument that Cornell's claims were not proven against Johnson). This argument is in addition to La Grange's statutory "good faith" defense. Dfs. Op. Br. at 18.

189 The scope of review of this claim, in accordance with the parties' stipulation (Tr. ID 46802291), is limited to consideration of available legal remedies under 6 *Del. C.* § 1307(b).

190 *Seibold v. Camulos Partners LP,* 2012 WL 4076182 at *1 n. 106 (Del. Ch. Sept. 17, 2012) (citing *Nemec v. Shrader,* 991 A.2d 1120, 1130 (Del.2010)).

191 *Vichi v. Koninklijke Philips Electronics N.V.,* 2012 WL 5949204 at *22 (Del. Ch. Nov. 28, 2012) (citations omitted).

192 Pfs. Op. Br. at 27.

193 JX 41.

194 *Vichi,* 2012 WL 5949204 at *21 (Del. Ch. Nov. 28, 2012) (citing *WSFS v. Chillibilly's, Inc.,* 2005 WL 730060 (Del.Super. March 30, 2005) (citations and internal quotation marks omitted) (emphasis in original)).

195 *Seibold,* 2012 WL 4076182 at *1 (Del. Ch. Sept. 17, 2012) (dismissing plaintiff's unjust enrichment claim upon noting that plaintiff had an available legal remedy on its tort claim, observing that "[u]njust enrichment is in essence a gap-filling remedy, which can be sought in the absence of a remedy provided by law.") (citation and internal quotation marks omitted).

196 *Vichi,* 2012 WL 5949204 at *21 (Del. Ch. Nov. 28, 2012).

197 *See Sonne v. Sacks,* 314 A.2d 194, 197 (Del.1973).

198 JX 4 at ¶ 2C. The Agreement states in relevant part, "To enable Cornell to enter into the Contracts on behalf of La Grange, Cornell and La Grange shall agree, in advance, to the minimum sales prices and terms reasonably acceptable to La Grange (the "Default Terms") as set forth in Exhibit "E." Any Contract that incorporates a sales price and terms no less favorable to La Grange than the Default Terms and is executed by Cornell shall be deemed acceptable to La Grange. If the terms of any Contract differ from the Default Terms, Cornell shall request the consent of La Grange."*Id.*

199 9/25/12 Trans. 41–43.

200 9/24/12 Trans. 87:4–11.

201 9/24/ 12 Trans. 87:11–16.

202 Dfs. Op. Br. at 8.

203 9/25/12 Trans. 30:5–13.

204 JX 4, Ex. C at ¶ 10(b).

205 JX 9.

206 9/25/12 Trans. 30–31.

207 JX 4, Ex. C at ¶ 10(b). "Purchaser Discount. Purchaser has been notified that Seller has a business relationship with Pike Creek Mortgage Services, Inc. (PMC a/k/a "Preferred Lender"). Purchaser has also been notified that Purchaser is under no obligation to utilize PMC and that Purchaser has the right to obtain mortgage financing from any lender that Purchaser so chooses. As an incentive to encourage Purchaser to utilize PMC for mortgage financing, and to the extent permitted under applicable law, Seller is willing to provide Purchaser with either a discount against the purchase price set forth in Paragraph 3 hereof ("Non–Cash Discount") or provide Purchaser with a discount against cash due at Settlement, including financing and other Closing Costs (Cash–Discount), or some combination thereof (collectively, the "Incentives").

208 9/24/12 Trans. 19:5–6, 29:7–10. Nichols asked Cornell to hire Mrs. Wasko–Smith to oversee the project and she functioned as a liaison on the Project who was instructed from the beginning to share Cornell information directly with La Grange. 9/25/12 Trans. 44: 22–23, 45: 1–7.

209 9/25/12 Trans. 30–31.

210 9/25/12 Trans. 31:2–7.

211 9/24/12 Trans. 107:19–23, 108:1–4. *See also* 9/24/12 Trans. 79: 22–23 thru 80: 1 (Lingo testifies that "part of [Cornell's] development responsibilities in section 2E [of the Agreement] was that we were responsible for helping customers get mortgages. That was really one of the critical components to this project that made it successful.").

212 *See* JX 11; 9/24/12 Trans. 45:13–15, 45:21–23 thru 46:1–2.

213 9/24/12 Trans. 135:5–23 thru 136:1–7.

214 *Duncan v. Theratx, Inc.,* 775 A.2d 1019, 1022 (Del.2001) ("The 'standard remedy' in Delaware, as elsewhere, 'for breach of contract is based upon the reasonable expectations of the parties *ex ante.*' ") (citing Restatement (Second) of Contracts § 347 cmt. a).

215 At trial, La Grange did not object nor otherwise contest through *voir dire* the qualifications or competency of Anderson in his proffered field of expertise.

216 As La Grange raised its *Daubert* challenge in a letter to the Court three days before the start of trial, the Court allowed Anderson to testify and reserved decision on La Grange's application to exclude his testimony.

217 D.R.E. 702.

218 *See Perry v. Berkley,* 996 A.2d 1262, 1267 (Del.2010)(citing *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579 (1993); *M.G. Bancorporation v. Le Beau,* 737 A.2d 513, 521 (Del.1999)).

219 *Perry,* 996 A.2d at 1267 (citations omitted).

220 *Id.* (citations omitted)

221 *Jones v. Astrazeneca, LP,* 2010 WL 1267114 at *6 (Del.Super. March 31, 2010) (citing *Minner v. Am. Mortgage & Guar. Co.,* 791 A.2d 826, 843 (Del. Ch.2000)).

222 *Perry,* 996 A.2d at 1268–9 (citing David H. Kaye, David E. Bernstein and Jennifer L. Mnookin, *The New Wigmore: Expert Evidence* § 3.1 (2004)).

223 *Id.* at 1269 (citing 2 James W. Moore et al., *Moore's Federal Rules Pamphlet* § 702.6 at 565 (2010) (citations omitted)).

224 JX 51.

225 On multiple instances during his testimony, as well as in his report, Anderson explained that he based his assumptions upon the parties' shared desire to maximize profits. *See e.g.* 9/26/12 Trans. 13:9–15, 16:6–13, 17:6–12, 22:9–13. *See* Restatement (Second) of Contracts, § 347 cmt. a (1981) (noting the future and conditional nature of expectation damages when "awarding [the injured party] a sum of money that will, to the extent possible, put [that party] in as good a position as [the injured party] *would* have been in *had the contract been performed.*")(emphasis supplied).

226 9/26/12 Trans. 21–23, 34–37 (applying Least Squares Trend Analysis). JX 51 (same). Of note, La Grange does not object to the projected sales paces of town homes and duplexes. Dfs. Ans. Br. at 13–15.

227 9/28/12 Trans. 148:15–23 thru 149:1.

228 *See* Dfs. Ans. Br. at 13–15. 9/26/12 Trans. 14–15, 39–40. JX 51.

229 9/26/12 Trans. 51:8–13. JX 51 (using rounded figures for ease of explanation).

230 *See Perry,* 996 A.2d at 1268. La Grange challenges Anderson's assumptions as being "entirely counterfactual and extra-contractual." La Grange does not dispute the reliability of. Anderson's principles and methods nor the reliability of his application, rather it is the content of Anderson's assumptions that prompts La Grange's objection. Dfs. Ans. Br. at 13–15.

231 *Perry,* 996 A.2d at 1271.

232 *Id.*

233 *Id.*

234 JX 51.

235 9/26/12 Trans. 80:18–21. JX 51.

236 *See Util. Trailer Sales of Kansas City, Inc. v. MAC Trailer Mfg., Inc.,* 267 F.R.D. 368, 372 (D.Kan.2010) (rejecting Daubert challenge to damages expert's opinion on grounds that assumptions were flawed upon concluding "whether ultimately correct or not, Mr. Hill's assumptions are reasoned and based on facts, not pure speculation.").

237 *Daubert,* 509 U.S. at 595–96 (holding that "[v]igorous cross examination, presentation of contrary evidence, and careful instruction on the burden of proof are the traditional and appropriate means of attacking shaky but admissible evidence."). *See also Beard Research, Inc. v. Kates,* 8 A.3d 573, 593 (Del. Ch.2010) (noting that "there is less of a basis to use *Daubert* to exclude testimony entirely in a bench trial because the judge can consider any shortcomings in the expert's testimony that are drawn out through cross-examination.") (citation omitted).

238 *See State v. McMullen,* 900 A.2d 103, 114 (Del.Super.2006) ("Proponents do not need to demonstrate to the judge by a preponderance of the evidence that the assessments of their experts are correct, they only have to demonstrate by a preponderance of the evidence that their opinions are reliable.") (citations omitted).

239 *Perry,* 996 A.2d at 1269 (citing *Minn. Supply Co. v. Raymond Corp.,* 472 F.3d 524, 544 (8th Cir.2006) ("[a]s a general rule, the factual basis of an expert opinion goes to the credibility of the testimony, not the admissibility, and it is up to the opposing party to examine the factual basis of the opinion upon cross-examination."); *Margolies v. McCleary, Inc.,* 447 F.3d 1115, 1120–1121 (8th Cir.2006) (finding expert's opinion on estimated damages was both reliable and relevant and thus admissible in breach of contract case; defendant's challenges to factual basis of that opinion properly went to weight of evidence, not its admissibility)).

240 *See Frontier Oil Corp. v. Holly Corp.,* 2005 WL 1039027 (Del. Ch. Apr. 29, 2005) *judgment entered sub nom. Frontier Oil Corp. v. Holly Corp.,* 2005 WL 5794558 (Del. Ch. May 23, 2005); *Pharmathene, Inc. v. SIGA Technologies, Inc.,* 2011 WL 4390726 at *31 (Del. Ch. Sep. 22, 2011).

241 *Titan Investment Fund II, LP v. Freedom Mort. Corp.,* 2012 WL 1415461 at *10 (Del.Super. March 27, 2012) (citing *Genecor Int'l, Inc. v. Novo Nordisk A/S,* 766 A.2d 8, 11 (Del.2000)).

242 JX 51, Ex. 1B.

243 JX 51, Ex. 2.

244 JX 51, Ex. 8.

245 *See* 9/25/12 Trans. 172:4–22. This investigation is memorialized in JX 51, Ex. 1A.

246 9/25/12 Trans. 173:3–6.

247 9/25/12 Trans. 173:19–23 thru 174:1–4.

248 JX 51, Ex. 1B.

249 9/26/12 Trans. 175:17–20.

250 9/26/12 Trans. 176:9–23 thru 177:1–4.

251 JX 51, Ex. 2.

252 These assumptions include that La Grange would continue to provide Cornell with developed land (9/26/12 Trans. 11:2–21) and La Grange would not have ousted Cornell from the property (9/26/12 Trans. 12:2–19). Additionally, Anderson made assumptions that the parties would extend the time frame in which to sell the entirety of the residences. *See generally* 9/26/12 Trans. 12–17. La Grange focused its cross-examination efforts, however, upon the assumptions which were the subject of its *Daubert* objection discussed above.

253 9/26/12 Trans. at 18:1–6.

254 9/26/12 Trans. 19:11–23 thru 20:1–18. *See generally* 9/26/12 Trans. 26–27 and JX 51, Ex. 4 (indicating actual sales through February 11, 2011 exceeding Exhibit A to Agreement).

255 9/26/12 Trans. at 27:3–9. The results of that analysis are reflected in JX 51, Ex. 4.

256 9/26/12 Trans. 28–29, 43–44. JX 51, Ex. 5A.

257 9/26/12 Trans. 33:7–12. 30 (duplexes to be sold) multiplied by $11,000 (fees per Agreement).

258 9/26/12 Trans. 40:1–12. 12 (single-family homes to be sold) multiplied by $12,000 (fees per Agreement).

259 This is a more conservative (higher) rate than the five-year U.S. treasury bond rate as of February 11, 2011 (2.38%). 9/26/12 Trans. 47:5–23 thru 48:1–18. The result of a higher rate in calculating present value is, of course, a lesser present value. 9/26/12 Trans. 48:13–21.

260 Present value of town homes ($849,458), duplexes ($308,789) and single-family homes ($536,656). JX 51, Ex. 8.

261 9/26/12 Trans. 51:3–4. JX 51, Ex. 8.

262 *See* 9/26/12 Trans. 108–121.

263 Cornell seeks costs associated with the following: (a) filing of four complaints against the defendants, including two complaints filed in the Court of Chancery “that directly led to the two pending cases”; (b) DeVoll's deposition transcript;

and (c) Anderson's expert witness trial testimony. Pfs. Op. Br. at 28, Ex. B (affidavit in support of costs by David A. Felice, Esquire). In the absence of another rate identified in the contract, says Cornell, it also seeks pre-judgment and post-judgment interest at the default legal rate prescribed by 6 *Del. C.* § 2301(a). Pfs. Op. Br. at 28.

264 Dfs. Ans. Br. at 19.

265 Dfs. Ans. Br. at 19–20 (citing *Coca–Cola Bottling Co. of Elizabethtown, Inc. v. The Coca–Cola Co.,* 769 F.Supp. 599, 633 (D . Del.1991), *aff'd in part and rev'd in part on other grounds,* 988 F.2d 385 (3d Cir.), *cert. denied,* 510 U.S. 908 (1993)).

266 Super. Ct. Civ. R. 54(d).

267 *FGC Holdings Ltd. v. Teltronics, Inc.,* 2007 WL 241384 (Del. Ch. Jan. 22, 2007) (citations omitted)(interpreting Court of Chancery analogue, Ct. Ch. Rule 54(d)).

268 Super. Ct. Civ. Rule 54(f).

269 *Donovan v. Delaware Water and Air Res. Comm'n,* 358 A.2d 717, 723 (Del.1976) (citing *Peyton v. William C. Peyton Corp.,* 8 A.2d 89 (Del.1939)(emphasis added)).

270 *See Citadel Hldg. Corp. v. Roven,* 603 A.2d 818, 826 (Del.1992)("In Delaware, prejudgment interest is awarded as a matter of right.")

271 *See Coca–Cola Bottling Co. of Elizabethtown, Inc.,* 769 F.Supp. at 633.

272 6 *Del. C.* § 2301(a).

6

566 A.2d 8
Court of Chancery of Delaware, Kent County.

Beverly C. CRAVERO, formerly
Beverly C. Holleger, Plaintiff,
v.
Donald W. HOLLEGER and
Saundra Lee Holleger, Defendants.

Civ. A. No. 951–K
|
Submitted: June 3, 1989.
|
Decided: July 18, 1989.

Synopsis

Former wife brought action against subsequently deceased former husband and husband's widow, seeking to effectuate property settlement agreement entered into between herself and husband. On defendants' motion for summary judgment, the Chancery Court, Kent County, Chandler, Vice-Chancellor, held that: (1) agreement between former wife and husband did not create express trust; (2) material issue of fact existed as to whether contractual provision requiring husband to devise interest in property to former wife survived completion of payments under another provision requiring payments to be made for "the ex-wife's interest"; (3) recording act was not applicable to agreement between former wife and husband; and (4) former wife was not equitably estopped from bringing action.

Motion denied.

West Headnotes (18)

[1] **Divorce** Tenancies

Upon divorce, property held by entireties is converted by operation of law to property held as tenants in common.

3 Cases that cite this headnote

[2] **Trusts** Form and Contents

No particular words or form are required to create express trust; all that is required is that parties intend that relationship which equity would describe as trust exist.

2 Cases that cite this headnote

[3] **Trusts** Nature and essentials of trusts

It is intent of settler as expressed in agreement itself which is controlling as to whether express trust has been created.

2 Cases that cite this headnote

[4] **Trusts** Nature and essentials of trusts

In determining whether express trust exists, it is immaterial whether parties knew they were creating trust.

[5] **Trusts** Transactions Creating or Operating as Trusts in General

Property settlement agreement between former wife and husband did not evidence intent on part of wife to create trust with respect to certain real property but, rather, gave wife only personal contract rights; under agreement, husband, rather than wife, was to enjoy beneficial ownership of property, subject only to charge of $550 per month, and there was no requirement that husband distribute profits from property to wife or that he reinvest or add profits to corpus.

1 Case that cites this headnote

[6] **Trusts** Agreements to Hold or Convey to Use of Another

"Trust" exists when one person holds title to property for benefit of another.

[7] **Trusts** Presumptions and burden of proof

In light of agreement between former wife and husband which clearly established that no trust concerning real property was created and absent evidence to contrary, burden of proof rule established in case law, concerning

requirements for establishing express trust to contradict presumption of grantee's absolute ownership of real property, was not applicable.

[8] **Executors and Administrators** Questions for jury

Summary Judgment Wills, trusts, and estates

Material issue of fact as to whether provision of property settlement agreement between former wife and husband requiring husband to "devise by will" to wife one-half interest in certain property was interdependent with another provision requiring husband to make payments for "the ex-Wife's interest" in property precluded summary judgment in favor of husband's estate and husband's widow, as to wife's claim of interest in property under former provision, on ground that payments under latter provision had been completed.

[9] **Divorce** Real estate and interests therein

In light of implied covenant of good faith, former husband's sale of property to his current wife for $180,000, which was far below fair market value, and distribution of $90,000 to his former wife did not satisfy terms of divorce property settlement agreement between former wife and husband which allowed husband to sell property for sum not less than $180,000, with one half of proceeds to go to ex-wife and, accordingly, "sale" did not preclude former wife's recovery under another provision of agreement requiring husband to "devise by will" to her one half interest in property; agreement did not provide that husband could "cash out" any obligations under contract by paying former wife $90,000.

1 Case that cites this headnote

[10] **Real Property Conveyances** Duress

Former husband's behavior in harassing former wife and threatening to retain their children in effort to induce her to execute deed to property did not rise to type of immediate threat of harm which would render deed voidable on ground of duress.

[11] **Real Property Conveyances** Merger of Other Agreements

Under "doctrine of merger in deed," on execution and delivery of deed, contract obligations of both parties arising from agreement to sell property are said to "merge" with deed, and its terms become controlling.

1 Case that cites this headnote

[12] **Real Property Conveyances** Circumstances preventing merger

Doctrine of merger in deed will not defeat clearly evidenced intent by parties that contractual provisions of sales agreement survive.

3 Cases that cite this headnote

[13] **Covenants** Special warranty

Special warranty deeds create only rebuttable presumption that grantor intended to convey all rights in property to grantee. 25 Del.C. § 121.

[14] **Trusts** Husband and wife

Former wife's execution of special warranty deed conveying certain property to subsequently deceased former husband did not preclude wife from seeking to have constructive trust imposed upon legal interest of husband's widow to effectuate terms of agreement which required husband to "devise by will" to former wife one-half interest in property. 25 Del.C. § 121.

[15] **Marriage and Cohabitation** Construction, operation, performance, and breach

Marriage and Cohabitation Validity and enforceability

Recording act providing that "[a] deed concerning lands or tenements shall have priority from the time that it is recorded * * * " was not

applicable to contract provision binding husband to devise to former wife one-half interest in certain property and, accordingly, fact that deeds pursuant to which husband's widow took title to property were recorded prior to former wife's recording of contract did not bar former wife from receiving equitable remedies based on contract to which she was otherwise entitled. 25 Del.C. § 153.

[16] **Wills** Actions for breach

Former wife's cause of action under contract requiring husband to "devise by will" to her a one-half interest in certain property did not accrue for purposes of doctrine of laches until husband's death.

[17] **Estoppel** Relying and acting on representations

Former wife's executing deed conveying property to subsequently deceased former husband did not equitably estop wife from bringing action against husband's estate and husband's widow to recover on agreement between former wife and husband requiring husband to "devise by will" to former wife one-half interest in property, absent evidence that widow, to whom husband deeded property, relied on deed executed by former wife or suffered any detriment as result of former wife's actions.

1 Case that cites this headnote

[18] **Trusts** Nature of constructive trust

In proper case, equity, to enforce contract to will, may impose constructive trust upon property even where property which was to have been willed has been transferred to third party before testator's death.

Attorneys and Law Firms

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Joshua M. Twilley and Charles W. Welch, III, of Twilley, Street and Braverman, Dover, for defendants.

OPINION

CHANDLER, Vice Chancellor.

This suit involves the equitable and legal title to approximately 27 acres of property located near Canterbury, Kent County and known as the Flying Dutchman Trailer Park (the "Flying Dutchman" or the "property"). Plaintiff Beverly C. Cravero, formerly Beverly C. Holleger ("ex-Wife"), is the former wife of a past owner and the developer of the property, Donald W. Holleger ("Husband"), now deceased. Husband's estate is one of the defendants in this action.[1] Defendant Saundra Lee Holleger ("Widow") was the wife of Donald W. Holleger at the time of his death. She is the current record owner of the property and the executrix of Husband's estate. In order to effectuate a property settlement agreement entered into between Husband and ex-Wife, ex-Wife asks this Court to impose a constructive trust in her favor on the property and a mandatory injunction requiring Widow to convey to her an undivided one-half interest in the Flying Dutchman (subject to certain charges and accountings), or award to her its fair market value.

The defendants have moved for summary judgment. This is my Opinion with respect to that motion.

I. *Background Facts*

Husband and ex-Wife were married in 1948 and divorced on February 16, 1973. During the marriage, Husband and ex-Wife acquired as tenants by the entireties the property now known as the Flying Dutchman. A small trailer park was located on ***11** part of the property at the time of purchase.[2] Husband and ex-Wife expanded and developed the property and trailer park during the marriage.

In contemplation of their divorce, ex-Wife and Husband entered into a property settlement agreement on December 20,

1972 (the "Agreement"). The Agreement was prepared by the lawyer for ex-Wife.

The Agreement divided the personal and real property of the marriage between Husband and ex-Wife. With respect to the Flying Dutchman, it provided as follows:

> "2.(A). The husband shall have all of the real and personal property comprising the Flying Dutchman Trailer Park located near Canterbury, Kent County, Delaware, consisting of approximately 27 acres with the improvements thereon erected subject to the terms and conditions hereinafter set forth.
>
> 1. The husband shall pay to the wife $550 per month on the first of each month commencing on the date of the execution hereof for a term of 20 years. So long as there are minor children of this marriage residing with the wife, $100 per month of the aforesaid sum of $550 per month shall be regarded as child support paid by the husband for each such minor child residing with the wife. The balance of said sum of $350 per month paid by the husband to the wife, shall be in payment to the wife of her interest in the Flying Dutchman Trailer Park. The aforesaid monthly sum of $550 shall be reviewed each year and shall be modified either upwards or downwards depending on the fluctuation up or down of the cost of living as determined by the Federal Government when compared to the cost of living as determined for calendar year 1972.
>
> 2. The husband shall have the right to sell the business and property known as the Flying Dutchman Trailer Park at any time for a sum not less than $180,000 in which case the wife shall receive one half of the net proceeds of such sale after deducting normal expense of this sale. In the event of a sale as permitted by this paragraph and upon payment to the wife of her share as herein provided, the husband shall be relieved of any further payments to the wife under the terms hereof, but not child support, and further payments made to the wife hereunder up to the time of said sale for her support ($350 per month) shall be deducted from the one half share provided for the wife herein.
>
> 3. In the event the Flying Dutchman Trailer Park is not sold as herein provided at the time of husband's death, the husband if he is not married at the time of his death, shall devise the Flying Dutchman Trailer Park to the wife; in the event the husband has remarried and remains remarried at the time of his death, the husband shall by will devise the Flying Dutchman Trailer Park as follows: one half to the wife herein subject to a charge, however, against said one half interest in the sum equivalent to the total number of monthly payments computed at the rate of $300 per month paid to the wife in accordance with subparagraph 1 hereof; and the remainder to his second wife."

On August 20, 1973, ex-Wife executed a special warranty deed (the "1973 deed") conveying the property comprising the Flying Dutchman to Husband. This deed was recorded on August 27, 1973. Sometime thereafter, Husband executed a mortgage on the Flying Dutchman property together with a bond, in favor of ex-Wife, for $132,000. Across the top of the document of mortgage was printed the following language: "Not to be recorded during the life of Donald W. Holleger".[3]

***12** On October 12, 1973, Husband and Widow were married. They remained married until Husband's death on August 2, 1987. Throughout the course of this marriage, Husband and Widow continued to expand and develop the Flying Dutchman as a trailer park.

On November 4, 1974, Husband and Widow executed a deed (the "1974 deed") conveying the property to themselves as tenants by the entireties. This deed was recorded on November 12, 1974.

In November of 1977, Husband and ex-Wife executed an untitled document "to verify payments on the property settlement agreement/second mortgage on the property known as the Flying Dutchman Mobile Home Park between Donald W. Holleger and Beverly Holleger Cravero." This document indicates that Husband had made timely payments under the Agreement through November of 1977, had paid a total of $34,100 to ex-Wife at that time and would as of December 5, 1977 "owe a balance of $97,900 to be paid at the rate of $550 per month, the last payment being September 5, 1992, at which time Beverly Holleger Cravero will have received a total of $132,000 and will be paid in full." Husband apparently continued to make timely payments under the Agreement until after the filing of this action.

In the early 1980's, Husband developed a cancer. In anticipation of his death, on March 23, 1984, Husband and Widow executed a deed (the "1984 deed") conveying the property to Widow as sole owner. No consideration was given in connection with the conveyance, which was made in an attempt to reduce the taxes which would become due at Husband's death. This conveyance was not recorded until March 23, 1987.

In 1987, Husband became gravely ill with cancer. On being informed that he had not long to live, ex-Wife, who had masked the "not to be recorded" language on the face of the mortgage which Husband had executed in her favor, had the mortgage recorded by her attorney. At this time, ex-Wife discovered the November 4, 1974 and March 23, 1984 conveyances of the property in favor of Widow. On April 6, 1987, ex-Wife had a copy of the Agreement recorded. She filed this lawsuit on the same day.

On April 30, 1987, Husband's deposition was taken in connection with this lawsuit. Later that day, he entered an agreement to convey all his interest in the property to Widow via a quit-claim deed. A deed effectuating this transaction was filed on May 4, 1987. The stated consideration for this conveyance, $180,000, was not the result of any negotiation or appraisal.

The purchase was financed by a loan from the First National Bank of Wyoming for $180,000. Of this sum, $86,026.01 was deposited in a joint checking account maintained by Husband and Widow. These funds were then paid back to the First National Bank of Wyoming to reduce the principal on the loan. $35,200 of the proceeds of the sale were sent by Husband to ex-Wife. After receiving this payment, ex-Wife satisfied the mortgage which she held on the property, but specifically reserved all claims which she had on the property based upon the Agreement.

On August 3, 1987, Husband died. In his will, he devised his entire estate to Widow, who was also named executrix.

Ex–Wife has introduced evidence that the fair market value of the property as of May 1, 1987, was $915,000.

II. *The Agreement as Trust*

[1] Ex–Wife argues that the Agreement creates a trust, with herself as the settlor and cestui que trust, Husband as the trustee and her undivided one-half interest in the property as the trust corpus.[4] ***13** Husband would thus be subject to all the fiduciary duties encumbent upon a trustee, and ex-Wife argues that, as a consequence, she is entitled to the relief which she seeks in this suit.

Defendants contend that the Agreement is not a trust, and that it gives ex-Wife only personal contractual rights. I agree.

[2] **[3]** **[4]** Nowhere in the Agreement are there express words of trust. This alone, however, is not fatal to ex-Wife's argument. No particular words or form are required in order to create an express trust. *Bodley v. Jones,* Del. Ch., 32 A.2d 436 (1943); *Walsh v. St. Joseph Home for the Aged,* Del.Ch., 303 A.2d 691 (1973). All that is required is that the parties intended that a relationship, which equity would describe as a trust, exist. "When a question arises as to whether or not an agreement creates a trust, the courts look objectively at the result to determine the matter.... The question in each instance is whether the kind of relationship known to the law as a trust has been created." *Fulweiler v. Spruance,* Del.Supr., 222 A.2d 555, 560 (1966). It is the intent of the settlor as expressed in the agreement itself which is controlling as to whether a trust has been created. *Hanson v. Wilmington Trust Co.,* Del.Ch., 119 A.2d 901 (1955), *aff'd,* Del.Supr., 128 A.2d 819 (1957). It is immaterial that the parties did not know that they were creating a trust. *Fulweiler v. Spruance, supra.* However, the Court is cognizant of the mischief which could be created with respect to the system of conveyance of real property in connection with the erroneous determination by the Court that express trusts have been created. As a result, it has been said that no trust is created by a transaction that is as consistent with another form of undertaking as with that of trust. *Bodley v. Jones, supra.*[5]

A). Express Terms of the Agreement.

[5] Ex–Wife here claims that the language of the Agreement is "clear, simple and unambiguous", demonstrating her intent to settle trust property upon Husband with beneficial enjoyment in herself. She points to the fact that Husband was given the right to sell the property "at anytime" for not less than $180,000, with one half of the net proceeds (less the monthly payments which had been made under § 2(A)(1)) to go to ex-Wife. She also points to the clause in the Agreement which requires Husband to devise the entire property to her should he be unmarried at the time of his death, and to devise one half of the property to her (less the monthly payments which had been made to her) should he be married at the time of his death.

[6] I am satisfied, however, that the Agreement, read as a whole, does not evidence intent on the part of the ex-Wife to create what is recognized in the law as a trust. A trust exists when one person holds title to property for the benefit of another. Trusts involve recognition of two types of ownership of property: 1) legal ownership, which in a trust is held by

the trustee, and 2) beneficial ownership, which in a trust is held by the cestui que trust. *Fulweiler v. Spruance, supra.* The Agreement at issue is an allocation of the property of the marriage, some to the wife, some to the husband. With respect to the Flying Dutchman, Husband is to "have all the property subject to the terms and conditions hereinafter set forth".

The first obligation of Husband upon which his "having" the property is conditioned, set out at § 2(A)(1) of the Agreement, is that he is to pay $550 per month ***14** for a term of 20 years. So long as there were minor children of the marriage residing with ex-Wife (there were two at the time of the divorce) $100 per month per child was to be considered as a child support payment. The balance, $350 per month, was to be "in payment to the wife of her interest in the Flying Dutchman." In another paragraph, this payment is said to be "for her support".

Under the Agreement, so long as Husband remained in possession of the Flying Dutchman (as long as he did not sell it during his lifetime), *he* was to enjoy the beneficial ownership of the property, subject only to the charge of $550 per month. $200 of the $550 payment was for support of the children and not related in any way to the property. The remaining $350, in payment of ex-Wife's "interest" in the Flying Dutchman, was in no way related to income from the property. In fact, the undisputed tax records regarding the property indicate that in the early years after the divorce the Flying Dutchman did not make a profit. In years when it did, however, there was no requirement under the Agreement that such funds should be distributed to ex-Wife as beneficiary or reinvested or added to the corpus. They were for Husband's enjoyment.

This settled monthly payment is not consistent with beneficial ownership remaining in ex-Wife. It *is* consistent, however, with compensation by Husband for ex-Wife's one-half undivided interest in the property.

I also find the sale provision § 2(A)(2) of the Agreement to be inconsistent with the creation of a trust. Husband was given the "right" to sell the property for any amount in excess of $180,000. While one half of this (net of the cost of the sale) was to go to ex-Wife, the amount of "support" payments, or payments "for her interest in the Flying Dutchman" were to be deducted from this amount. I also note that upon sale for more than $180,000, the Husband's obligation to make monthly payments was terminated.

Finally, the will provision contained in § 2(A)(3) seems inconsistent with an intention on the part of ex-Wife to have her one-half interest held in trust. I note that, in case Husband had not remarried at the time of his death, the Agreement called for the *entire* Flying Dutchman to be devised to ex-Wife. This is inconsistent with an intent to merely retain beneficial ownership of her one half interest. Once again, in the case where Husband died having remarried, payments made to ex-Wife under the Agreement were to be deducted from her one-half share.

As discussed below, the parties differ as to whether the Agreement is in the nature of a contract for deed for the transfer of fee simple absolute title to Husband, with the "sale" and "death" provisions of §§ 2(A)(2) and 2(A)(3) intended only to provide security for the payments due to ex-Wife during the 20–year term of the contract, or whether the sale and death portions of the Agreement were meant to be independent of the payments due under § 2(A)(1). Whichever is correct, the provisions with respect to the Flying Dutchman are part of the "promises and mutual undertakings" set forth as the consideration for the Agreement, that is, they constitute a contract between the parties which places enforceable personal responsibilities upon Husband. No intention to create a trust is manifested by the Agreement. *Compare Fulweiler v. Spruance, supra.*

B). The *Bodley v. Jones* Rule.

[7] In reaching this result, I have not applied, as defendants requested me to, the *Bodley v. Jones* rule to the Agreement. The rule in *Bodley v. Jones,* as discussed in the more recent Supreme Court case of *Levin v. Smith,* Del.Supr., 513 A.2d 1292 (1986), is one of burden of proof: "In order to contradict by written or spoken words or by conduct the presumption of a grantee's absolute ownership of real property conveyed to him by deed in fee simple absolute, one seeking to prove an express trust must demonstrate the intent to create such a trust 'by definite explicit and unequivocal words, or by circumstances so revealing and compelling as to manifest the intention with all reasonable certainty.' " *Levin v. Smith, supra* at 1297, *quoting* ***15** *Bodley v. Jones.* The rule was imposed in *Bodley* itself upon a purported document of trust found to be ambiguous and contradicted by the subsequent conduct of the putative settlor. *Levin v. Smith, supra,* concerned an oral trust overwhelming evidence for which was provided by the subsequent conduct of the settlors, trustee and beneficiary. The only evidence weighing against the existence of the trust in *Levin* was the bald testimony of the trustee that no trust had been intended, and the fact that the existence of a trust would

contradict the terms of a deed which purported to transfer the trust corpus to the trustee in fee simple absolute. The evidence at trial showed that this deed was a sham, however, in that the grantee did not relinquish possession of the property during his lifetime. The trial court, applying the *Bodley v. Jones* rule, held that the testimony as to lack of intent on the part of the trustee was sufficient to defeat a finding that a trust existed.

The Supreme Court reversed, holding that the *Bodley* rule had no application to that situation. Since the deed was a sham, there was no presumption of title for the *Bodley* rule to protect, and thus a mere preponderance of the evidence was sufficient to prove the existence of a trust.

It is unclear whether the *Bodley* rule would apply to the instant situation. As in *Levin v. Smith,* the deed purporting to grant fee simple absolute to Husband (the 1973 deed) appears to have been a sham. Ex–Wife's testimony indicates that it was not intended to give present exclusive ownership to Husband, but merely to allow him to borrow upon the property. There are subsequent transfers of the property here, however, including the 1974 deed to Widow by the entireties. There is no evidence that this transfer was a sham. Fortunately, I need not decide this question, because the burden of proof rule of *Bodley v. Jones* is not applicable here for other reasons.

In reaching a conclusion that no trust was created by the Agreement, I am *weighing* no factual evidence. The Agreement, ambiguous with respect to certain of its contract provisions, is clear in demonstrating, as a matter of law, that no trust was created. Therefore, the *Bodley* rule has no application here. Even if the Agreement were ambiguous as to trust, and, in the manner of *Bodley* and *Levin,* I was forced to examine evidence of the subsequent conduct of the parties, there is absolutely nothing in this conduct to indicate that a trust was intended or created. The purported trustee, Husband, never provided an accounting or did anything else to indicate that he was a fiduciary for the purported beneficiary, ex-Wife, other than to pay her the set monthly amounts due under the contractual provisions of the Agreement. Ex–Wife was content to accept these payments, without demanding distribution of profits, an accounting, or anything else which would tend to indicate her belief that a trust existed.

Since the Agreement is clear on its face with respect to the trust issue, and since no evidence to the contrary has been submitted, I am not presented with a situation where the weighing of factual evidence comes into play and I am spared the need to consider the application of the *Bodley v. Jones* rule.

C). *Fulweiler v. Spruance* Distinguished.

Plaintiff has cited no cases factually similar to this case which held that a trust was created. A superficially similar Delaware case exists which I think it is worthwhile to distinguish, however. In *Fulweiler v. Spruance, supra,* as in the instant case, a husband and wife entered into a property settlement agreement in contemplation of divorce. The agreement provided that certain property, in the form of shares of stock, was to be held by the husband, with dividends paid to his wife and children. At his death, the stock was to go to his children.

In that case, the Delaware Supreme Court found that a trust existed. "[Husband] has set aside certain securities and by stop transfer orders has made it impossible for him to deal with them as his own property. He has obliged himself to pass on the dividends received on these himself to pass on the dividends received on these ***16** securities to his former wife and children. He has obligated himself to provide by will the ultimate vesting of title to these in his children or their issue. In short, the agreement divests [Husband] of any beneficial interest in the corpus, represented by the securities separately held, and has transferred that interest to his wife and children. The fundamental elements of a trust relationship thus exist." 222 A.2d at 560.

While factually similar, *Fulweiler* is distinguishable from the instant case in one very important aspect. In *Fulweiler* the husband paid *all* benefits received from the securities forming the corpus of the trust to the beneficiaries. The property acquired through the securities other than as dividends (such as stock from stock splits) was to be added to the corpus. While he was responsible for passing along dividends, he had no obligation in connection with the securities to make fixed payments in excess of any dividends. In other words, as the *Fulweiler* Court found, beneficial interest in that case was transferred to the wife and children as beneficiaries. The husband was left with title but no enjoyment or use of that title. In contrast, Husband in the instant situation by the terms of the Agreement was not responsible to ex-Wife for the profits from the Flying Dutchman. He *was* responsible for fixed payments regardless of whether those payments could be made out of Flying Dutchman profits. Those payments were to have the effect of reducing any amounts of money or property interests due ex-Wife upon sale of the property or Husband's death. In other words, the beneficial ownership in *Fulweiler* was with the beneficiaries, the wife and children. In the instant case, beneficial ownership

was in the Husband, and this interest was transferred to him by ex-Wife in exchange for certain payments and other contractual obligations. Accordingly, the Agreement does not create a trust with respect to the Flying Dutchman.

III. *Defendants' Summary Judgment Arguments*

The fact that the Agreement did not make the ex-Wife beneficiary of a trust does not, of course, mean that it did not create contractual rights in her favor. Ex–Wife claimed in her initial complaint that Husband breached these contractual rights by the 1974 and 1984 conveyances to Widow in violation of § 2(A)(2) (the "sale" provision). In her amended complaint, ex-Wife realleges these breaches and adds an additional contention, that Husband breached the Agreement by not devising her the Flying Dutchman, in violation of § 2(A)(3). It is clear from an examination of the Agreement that only the allegation of § 2(A)(3)'s breach is properly before me.

By ex-Wife's own view of the Agreement, the universe of possibilities was divided by §§ 2(A)(2) and 2(A)(3) into two contingencies: that Husband would have at the time of his death sold the Flying Dutchman as provided in § 2(A)(2), or that he would not. I conclude later in this Opinion, for purposes of this motion, that no sale occurred as provided in § 2(A)(2). Therefore, under ex-Wife's view of the Agreement, § 2(A)(3) becomes operative, and the Agreement requires Husband to "by will devise" to ex-Wife a one-half interest in the Flying Dutchman. The 1974 and 1984 transfers of the property did not prevent such a devise. Husband, theoretically, was free to reacquire the property and devise as required in § 2(A)(3).

As of the time of his death, however, Husband had not reacquired legal title to the Flying Dutchman and made no attempt to devise it to ex-Wife. Thus, under ex-Wife's interpretation of the Agreement, Husband at his death was in breach.[6] The defendants claim that they are entitled to summary judgment with respect to ex-Wife's contractual claims because the undisputed facts demonstrate that: 1) Husband satisfied the requirements of the Agreement by completing the schedule of payments in compliance with § 2(A)(1); 2) Husband satisfied the requirements of the Agreement by selling the property in compliance with § 2(A)(2); 3) the 1973 warranty ***17** deed from ex-Wife to Husband, the 1974 deed from Husband to Husband and Widow as tenants by the entireties, and the 1984 warranty deed from Husband and Widow to Widow create equitable and legal title in Widow which this Court is precluded from disturbing; 4) the suit is barred by the doctrine of laches; and 5) the suit is barred by the doctrine of equitable estoppel. These arguments are considered *seriatim.*

A). The Agreement as a Contract for Deed.

[8] The defendants' first argument is that the Agreement, with respect to the Flying Dutchman, was in the nature of a mortgage or contract for deed. In defendants' version, the payments to be made under § 2(A)(1) for "the ex-Wife's interest" in the Flying Dutchman were in the nature of purchase money, to be paid over a 20–year period, for ex-Wife's entire undivided one-half interest in the property. In defendants' view, provisions 2(A)(2) and 2(A)(3) provided security to ex-Wife should Husband sell the property or die before completion of the string of payments due under § 2(A)(1). This view, say defendants, is supported by Husband's deposition testimony, the fact that the one-half interest to be conveyed to ex-Wife upon sale or death is to be reduced by payments made under § 2(A)(1), by the fact that payments under § 2(A)(1) are "for [ex-Wife's] interest" in the property, and by certain actions of ex-Wife and Husband after the Agreement was executed.

Ex–Wife argues that §§ 2(A)(1), (A)(2) and (A)(3), are, except where the Agreement expressly provides otherwise, separate. Under ex-Wife's view, the payments made under § 2(A)(1) were for her support, in a rough approximation of the income she would have received from her one-half share in the Flying Dutchman. The fact that § 2(A)(1) is concededly satisfied, has, in ex-Wife's view, no bearing on her contractual right to receive the property upon the death of the Husband under § 2(A)(3). Ex–Wife's deposition testimony indicates that this was the intention of the parties in executing the Agreement.

With respect to the interdependence of §§ 2(A)(1), 2(A)(2) and 2(A)(3), the Agreement is ambiguous.[7] Ex–Wife's interpretation is consonant with the Agreement's express terms. There is evidence in the record to support it. Therefore, for purposes of this motion, I cannot find that no dispute of fact exists over whether the intention of the parties executing this Agreement was that §§ 2(A)(2) and 2(A)(3) were only to provide security for payments due under § 2(A)(1), and that obligations under §§ 2(A)(2) and 2(A)(3) terminated upon satisfaction of the terms of § 2(A)(1). Husband has cited the venerable rule that in case of ambiguity an instrument is to be contrued against its drafter (here, ex-Wife). Though

this rule may be useful when the finder-of-fact weighs the evidence and makes a decision as to the intention of the parties in executing the Agreement, it is inapposite at the summary judgment stage. *See Continental Oil Co. v. Pauley Petroleum Inc.,* Del.Supr., 251 A.2d 824 (1969). Therefore, for purposes of this motion only, I conclude that the ex-Wife's version of the Agreement is correct and that the contractual requirements of § 2(A)(3), which required Husband to "devise by will"[8] to ex-Wife a one-half interest in the Flying Dutchman, survive the completion of payments under § 2(A)(1).[9]

***18** B). The Alleged Sale of the Property.

[9] The defendants next claim to be entitled to summary judgment because, they say, they have satisfied the Agreement by selling the property in conformity with § 2(A)(2). That section allowed Husband to sell the property "at any time" for a sum not less than $180,000. One half of the net proceeds of such sale were to go to ex-Wife, subject to a charge for any payments she had received under § 2(A)(1), computed at the rate of $350 per month.

In order to evaluate defendants' summary judgment argument, one must review the circumstances under which this sale took place. Shortly after learning of the 1974 transfer of the property from Husband to Husband and Widow by the entireties and the 1984 transfer to Widow in fee simple absolute, ex-Wife filed this action for equitable relief. Defendants answered, raising some of the defenses argued here. Discovery was commenced, and on April 30, 1987, Husband's deposition was taken. At that time it was his correct belief that his death was imminent. On the day of the deposition, as a prophylactic measure to preserve the property for Widow and to prevent ex-Wife from taking a share, Husband and Widow entered into an "agreement of sale". This sales agreement was rapidly consummated. Under its terms, Widow was to "pay" Husband $180,000. This amount was decided upon as a result of the provisions of § 1(B). It was not the result of any negotiation. The $180,000 was borrowed against the Flying Dutchman from the First National Bank of Wyoming, which appraised the value of the property in connection with the loan at approximately $600,000. Of the $180,000 borrowed, $35,200 was sent to ex-Wife. This was actually more than ex-Wife was entitled to under the provisions of § 2(A)(2) and was intended to satisfy the amount outstanding as payments under § 2(A)(1).

Of the balance, $86,026.01 was deposited in Husband and Widow's joint checking account, and was used to reduce the outstanding principal on the loan. The remainder was apparently returned directly to the bank to reduce other outstanding obligations with respect to the property. In return for this "payment", Husband quit-claimed any interest he had in the Flying Dutchman to Widow.

Defendants claim that this transaction satisfied the letter of § 2(A)(2). There is, however, an implied covenant of good faith appended to every contract made in the State of Delaware. "Every contract contains the implied condition that the parties will act in good faith and deal fairly with each other in its performance." *Voege v. American Sumatra Tobacco Corp.,* D.Del., 241 F.Supp. 369, 375 (1965). *See* Restatement of Law, 2d, *Contracts,* § 205 (1981). The Agreement could have, but did not, provide that Husband could "cash out" any obligations under the contract by paying the ex-Wife the sum of $90,000 (one half of $180,000) less amounts paid under § 2(A)(1). This is precisely what Husband's actions, if allowed to satisfy § 2(A)(2), will transmute that section into. Under defendants' view, had Husband decided to sell the property at its fair market value (there is evidence before me to indicate that this was $970,000 at the time of Husband's death) he could have "sold" the property for $180,000 to a strawman, satisfied the obligations of the Agreement by paying ex-Wife $90,000 less payments made under § 1(A), repurchased the property for $180,000 and then sold it for the far higher fair market amount. This is clearly not what was intended by the parties to the Agreement, however. In the normal course of things a sale for the highest possible price would have benefited both Husband and ex-Wife equally. It is clear that what the parties meant by a "right to sell" was that the Husband had the right to consummate an arm's length transaction for a sale of the property when he felt it was to his advantage to do so. The Agreement did not contemplate a sham transaction for far less than market value. This is borne out by ex-Wife's deposition ***19** testimony, in which she explains that, at the time of the Agreement, she and Husband felt that $180,000 was at or above fair market value for the Flying Dutchman. Given the intent of the parties, the express language of the Agreement and the implied covenant of good faith appended thereto, one can only conclude that the 1987 quit-claim "sale" of the property from Husband to Widow did not satisfy the terms of § 2(A)(2).

C). The 1973, 1974 and 1984 Deeds.

[10] Defendants next argue that the 1973, 1974 and 1984 deeds create sole equitable and legal title in the Widow. I shall first consider the 1973 deed.[10]

[11] **[12]** This special warranty deed from ex-Wife to Husband purports to convey a fee simple estate in the Flying Dutchman. First, with respect to this deed, I will consider the doctrine of merger in deed, which is applicable in Delaware. *Reed v. Hassell,* Del.Super., 340 A.2d 157 (1975). While the parties have not adverted to this doctrine, I think it merits some discussion. When an agreement to sell real property is executed between two parties, it creates certain contractual rights. Under the doctrine of merger in deed, on the execution and delivery of a deed, the contract obligations of both parties are said to "merge" with the deed, and its terms become controlling. Unquestionably, however, the doctrine will not defeat a clearly evidenced intent by the parties that the contractual provisions of the sales agreement would survive. *Reed v. Hassell, supra.* That is precisely the situation we have here. The Ex–Wife's uncontradicted deposition testimony indicates that this deed was given only for the purpose that Husband use it to secure loans to improve the property. Husband's deposition testimony and continued payments to ex-Wife under § 2(A)(1) make it clear that he intended that the Agreement would remain in force after execution and delivery of the deed. Therefore, the doctrine does not apply in this case.

[13] **[14]** Defendants next note that the 1973, 1974 and 1984 deeds were all special warranty deeds. 25 *Del.C.* § 121 provides that such deeds "shall be construed to pass and convey to the grantee therein and to his heirs and assigns the fee simple title or other the whole estate or interest which the grantor could lawfully convey in and to the property therein described." Defendants appear to argue that this section provides that a properly executed and acknowledged deed creates an irrebuttable presumption that the grantor intended to convey the largest estate possible, thus precluding this action for equitable relief in that it would defeat this presumed intent. This reasoning is flawed. First, special warranty deeds create only a rebuttable presumption that the grantor intended to convey all rights in the property to the grantee. *See Levin v. Smith, supra; Penieskice v. Short,* Del.Super., 194 A. 409 (1937). Second, the plaintiff in this action concedes that legal title is in Widow. She is not attacking that title, but is requesting that an equitable device, a constructive trust, be imposed upon the legal interest of Widow to effectuate the terms of the Agreement. This is not prevented by the operation of 25 *Del.C.* § 121.

Defendants make a more serious argument based on the deeds. In 1968 Delaware changed its former "period of grace" recording statute into a pure "race to the recorder's office" statute. ***20** *N & W Development Co. v. Carey,* Del. Ch., C.A. No. 6885, 1983 WL 17997, Hartnett, V.C. (1983). 25 *Del.C.* § 153 provides in its entirety:

> "*Priority of deed concerning lands or tenements.* A deed concerning lands or tenements shall have priority from the time that it is recorded in the proper office without respect to the time it was signed, sealed and delivered."

This somewhat draconian statute is intended to promote prompt recording of deeds and allow reliance by purchasers on record title. Defendants point out that the 1974 deed giving the Widow rights in the property as tenant by entireties and the 1984 deed conveying sole title to her were both recorded prior to ex-Wife's recording of the Agreement in 1987. Therefore, in order to effectuate the purpose of the recording statute, defendants argue that no equitable lien can be placed upon the property.

[15] A significant question remains as to whether Widow is entitled to the benefit of the recording statute.[11] I do not have to reach this issue, for the simple reason that the recording act refers to priority as among "deeds effecting lands or tenements" and the Agreement is *not* a deed.[12] The provision at issue here, § 2(A)(3) is, according to the ex-Wife's contentions, a contract provision binding Husband to devise to ex-Wife a one-half interest in the Flying Dutchman, subject to a charge based on the payments made under § 2(A)(1). The Agreement does not transfer an interest in land and does not cloud Widow's title to the property. The question is whether equity will impose a constructive trust upon that property to effectuate Husband's contractual commitments to ex-Wife. Since the Agreement is not a deed, 25 *Del.C.* § 153 does not apply, and the fact that the 1973, 1974 and 1984 deeds were recorded prior to the recording of the Agreement will not bar ex-Wife from receiving any equitable remedies based on the Agreement to which she is otherwise entitled.

D). Laches.

Defendants next argue that the equitable doctrine of laches bars ex-Wife's claim. Defendants contend that if ex-Wife has a cause of action, it accrued on November 12, 1974. This is the date of the recording of the deed from Husband to Husband and Widow as tenants by the entireties. Defendants' contention is that if ex-Wife had a valid contract requiring Husband to devise her the Flying Dutchman, this transfer of the survivorship interest to Widow was a breach of that contract. The intervening 13 years represent unreasonable

delay, say defendants, and they have been disadvantaged by this delay to the extent that Widow has put more effort into the property than she would have if she had known of ex-Wife's interest, and in that Husband has now died and cannot testify at trial.

[16] Without deciding whether a claim based on anticipatory breach was perfected by the 1974 deed, it is clear that a cause of action did not accrue under § 2(A)(3) until Husband's death in 1987. The claim is based on a contract to will. By its nature, this claim cannot have accrued until the death of the testator. *Snyder v. Baltimore Trust Co.,* Del.Super., 532 A.2d 624 (1986). *See Nardo v. Guido DeAscanis & Sons, Inc.,* Del.Super., 254 A.2d 254 (1969). The original complaint in this case was filed before Husband's death, and the amended complaint shortly thereafter. Even were I to accept defendants' improbable assertion that one who has a contractual claim involving a piece of property has the duty to check frequently for changes in ***21** the record title to that property, ex-Wife's suit was in place when her cause of action accrued at Husband's death, and therefore in no sense can she be said to have slept on her rights to the detriment of the defendants. Therefore, the doctrine of laches does not apply as a bar in this matter.

E). Equitable Estoppel.

[17] Finally, defendants argue that they are entitled to summary judgment in that this suit is barred by the doctrine of equitable estoppel. Defendants' claim is that in executing the 1973 deed, which purported to be a warranty deed granting fee simple absolute title to Husband, ex-Wife misled Widow to believe that Husband in fact owned a fee simple absolute, free of ex-Wife's contractual claims, in the Flying Dutchman. In reliance upon that conduct of ex-Wife, defendants claim Widow believed that the 1974 and 1984 deeds gave her, first, an interest in the property by the entireties and, second, fee simple absolute ownership to the property, free of any contractual claims of ex-Wife. Finally, defendants claim that Widow acted on this belief to her detriment, in that she put more time and effort into the property than she otherwise would have. This, say defendants, constitutes the equitable ground for an estoppel, *citing Wilson v. American Insurance Co.,* Del.Supr., 209 A.2d 902 (1965); *Gottlieb v. McKee,* Del. Ch., 107 A.2d 240 (1954).

"To establish an estoppel, it must appear that the party claiming the estoppel lacked knowledge and the means of knowledge of the truth of the facts in question, that he relied on the conduct of the party against whom the estoppel is claimed, and that he suffered a prejudicial change of position in consequence thereof." *Wilson v. American Insurance Co., supra.* The record does not support defendants' claim for an equitable estoppel. First, no evidence exists that Widow actually relied upon the 1973 deed as evidence of Husband's ownership. Nothing in the record so indicates, and it seems likely that upon receiving the gift of ownership by the entireties in 1974 or of fee simple absolute in 1984, Widow simply believed Husband's assertion that he owned the property, rather than conducting a title search. Even were I to assume the existence of reliance, I could not find that Widow relied to her detriment. There is evidence that Widow worked hard to maintain and improve the property after 1974. There is no evidence, however, to indicate that she worked harder than she would have if she had been aware of the provisions of the Agreement. The Flying Dutchman was Widow's family business and sole source of income. I cannot assume that she would have worked less hard if she had known of ex-Wife's potential claim. In fact, the evidence is that Widow was "working herself silly" on the property at the time of Husband's deposition, some time after the suit had been filed and Widow learned of ex-Wife's claim. Therefore, I cannot conclude on the record before me that Widow relied upon or suffered any detriment as a result of ex-Wife's actions, and equitable estoppel does not bar this action. *Wilson v. American Insurance Co., supra; Timmons v. Campbell,* Del. Ch., 111 A.2d 220 (1955).

IV. *Summary*

[18] The Agreement does not create an express trust with ex-Wife as the beneficiary. Given the evidence before me, I cannot, however, grant to defendants summary judgment with respect to ex-Wife's claim for the breach of a contract to will. In a proper case, equity, to enforce a contract to will, may impose a constructive trust upon property. *Snyder v. Baltimore Trust Co., supra; Equitable Trust Co. v. Hollingsworth,* 49 A.2d 325 (1946). This can be true even where the property which was to have been willed has been transferred to a third party before testator's death. *See Brewer v. Simpson,* 53 Cal.2d 567, 2 Cal.Rptr. 609, 349 P.2d 289 (1960); *Shackleford v. Edwards,* Mo.Supr., 278 S.W.2d 775 (1955). The parties have not placed the question before me, and I shall not here decide, whether the equities are present to impose such a trust in the instant case. I note in passing, however, that while Widow did not take her interest in the Flying Dutchman for value, there is no record evidence indicating that she was aware ***22** that ex-Wife had any claim against the Flying

Dutchman other than the monthly payments due under § 2(A)(1). Widow has lived and worked on the property for 16 years. Apparently, she now supports herself and the minor child of her marriage with Husband out of the proceeds she receives from the Flying Dutchman. Should ex-Wife prevail at trial with respect to her construction of the Agreement, in order to impose a constructive trust she must demonstrate that the equities would so require.

I also note that to the extent this case involved an equitable claim based on breach of fiduciary duty by a trustee, that claim is no more. What remains is a legal claim, breach of contract, for which an equitable remedy, imposition of a constructive trust, is sought. Defendants have not put before me the question whether an adequate remedy at law, in the form of suit for damages for breach of contract against Husband's estate, exists.

For the foregoing reasons, summary judgment is denied.

IT IS SO ORDERED.

All Citations

566 A.2d 8

Footnotes

1 This suit was initially brought against Donald W. Holleger during his lifetime.

2 The property was purchased in several parcels at different times during the marriage.

3 The bond and mortgage are dated October 2, 1972, that is, some two and a half months prior to the Agreement. The Husband in deposition testimony indicated that he believed that the bond and mortgage were executed on or about the stated date. Ex–Wife in deposition testimony maintained that the bond and mortgage were executed at her insistence and for her security in connection with and sometime after the August 20, 1973 deed by which she conveyed title to Husband. This being a motion for summary judgment I will not weigh these two conflicting pieces of evidence but will resolve the discrepancy in favor of the nonmoving party in order to determine whether that evidence supports a favorable conclusion to the nonmoving party. *Continental Oil Co. v. Pauley Petroleum, Inc.,* Del.Supr., 251 A.2d 824 (1969).

4 At the time the Agreement was entered into, Husband and ex-Wife were tenants by the entireties. Thus, both Husband and ex-Wife "owned" the entire property "per tout et non per my." That is, by the legal fiction that is at the heart of tenancy by the entireties, the marital unit (and not the Husband and ex-Wife individually) was possessed of the complete fee in the property. *Huber v. Penn Mut. Fire Ins. Co.,* Del.Super., 33 A.2d 729 (1943); *Heitz v. Sayers,* Del.Super., 121 A. 225 (1923). The Agreement was made in contemplation of divorce, however. In Delaware, upon divorce, property held by the entireties is converted by operation of law to property held as tenants in common. *See Mitchell v. Wilmington Trust Co.,* Del.Super., 449 A.2d 1055 (1982), *aff'd,* Del.Supr., 461 A.2d 696. Thus the ownership by the marital unit is eliminated and the ownership of the two individuals is "reduced" from ownership of the entire parcel (in connection with similar ownership rights of the other party to the marital unit) to undivided one-half interests in the property.

5 *See* the discussion of *Bodley v. Jones, infra,* pages 14–15.

6 Since under ex-Wife's view of the Agreement Husband was in breach of § 2(A)(3) at his death, I need not consider the problem as to whether the 1974 and 1984 transfers represented an actionable anticipatory breach of the Agreement.

7 Both sides in this lawsuit have described the Agreement as "clear and unambiguous". Both sides, however, have also developed an extensive evidentiary record and have argued it to me as evidence that their interpretation of the Agreement is correct. Both sides have ignored the parol evidence rule as a bar to the admission of extrinsic evidence. *See Husband (P.J.O.) v. Wife (L.O.),* Del.Supr., 418 A.2d 994 (1980); *Scott–Douglas Corp. v. Greyhound Corp.,* Del.Super., 304 A.2d 309 (1973). The Agreement, to be charitable, is poorly drafted and, with respect to the contractual obligations imposed by § 2(A), is ambiguous.

8 A phrase not unlike "murder by death".

9 The Husband completed payment of the $195,000 due under § 1(A) several years before the time called for in the Agreement, delivering a lump sum final payment to ex-Wife in connection with the "sale" by quit-claim deed to Widow in

1987. Ex–Wife has not argued to me that there was a contractual failure to comply with § 1(A) due to this accelerated payment. It appears that Husband has satisfied all conditions imposed upon him by that section.

10 Ex–Wife complains of the conditions under which the 1973 deed was obtained from her by Husband. The circumstances of which she complains are that Husband and his lawyer called her frequently at her home and place of business in Florida requesting that she make such a deed. This annoyed her. In addition, on one occasion while the children of the marriage were visiting their father in Delaware he telephoned ex-Wife in Florida and told her that if she did not execute the deed he would not send the children home. After this harassment and threat to retain the children, ex-Wife said she obtained her attorney's advice and executed a deed in favor of Husband.

To the extent that this argument of ex-Wife constitutes an assertion that the 1973 deed is voidable due to duress I conclude that the behavior stated does not rise to the type of immediate threat of harm which constitutes duress. *See* 26 C.J.S. *Deeds* § 61 (1956).

11 This is because it is clear from the record that the Widow was not a purchaser for value. The Delaware recording statute as it existed prior to 1968 contained an express requirement that those entitled to its benefits be purchasers for value. This requirement appears to have been eliminated in the current version of the statute. Other states with “race” recording statutes (albeit not identical to Delaware's) impose a “purchaser for value” requirement upon those seeking the protection of the statute, however. *See* N.C.Gen.Stat. § 47–18(a) (1984); La.Rev.Stat. An. § 9:2721 (1965).

12 Black's Law Dictionary provides: Deed: A conveyance of realty, a writing signed by the grantor, whereby title to realty *is transferred* from one to another. *5th ed. (1979)* page 373 (emphasis supplied).

7

702 A.2d 1228
Supreme Court of Delaware.

EAGLE INDUSTRIES, INC.,
Defendant Below, Appellant,
v.
DeVILBISS HEALTH CARE, INC., Plaintiff Below, Appellee.

No. 51, 1997
|
Submitted: Sept. 16, 1997.
|
Decided: Nov. 25, 1997.

Synopsis

Corporation brought suit seeking construction and reformation of indemnification language in stock purchase agreement, and seller counterclaimed for reimbursement of expenditures. The Court of Chancery, New Castle County, granted summary judgment to corporation. Seller appealed. The Supreme Court, Veasey, C.J., held that: (1) indemnification provision was ambiguous as to whether seller's obligations depended on date on which product caused injury or date on which product was manufactured or purchased, and (2) trial court should have considered admissible extrinsic evidence.

Reversed and remanded.

West Headnotes (8)

[1] **Corporations and Business Organizations** Warranties and agreements to repurchase

Indemnification provision of stock purchase agreement, stating that indemnification was limited to damages "arising from such suits ... or other proceedings, the alleged basis for which arose or occurred on or prior to the Closing Date," was ambiguous, as reasonable third person would be uncertain whether seller's obligations should be determined by reference to date on which product caused injury or by reference to date on which product was manufactured or purchased.

2 Cases that cite this headnote

[2] **Contracts** Application to Contracts in General

Contract terms themselves will be controlling when they establish parties' common meaning so that reasonable person in position of either party would have no expectations inconsistent with contract language.

141 Cases that cite this headnote

[3] **Contracts** Existence of ambiguity

Evidence Nature and Existence of Ambiguity in General

When provisions in controversy are fairly susceptible of different interpretations or may have two or more different meanings, there is ambiguity, and then interpreting court must look beyond language of contract to ascertain parties' intentions.

217 Cases that cite this headnote

[4] **Evidence** Contracts and agreements in general

Evidence Creation of ambiguity in general

If contract is unambiguous, extrinsic evidence may not be used to interpret intent of parties, to vary terms of contract or to create ambiguity.

262 Cases that cite this headnote

[5] **Evidence** Nature and Existence of Ambiguity in General

When there is uncertainty in meaning and application of contract language, reviewing court must consider evidence offered to arrive at proper interpretation of contractual terms.

81 Cases that cite this headnote

[6] **Contracts** Preliminary negotiations and agreements

Contracts Construction by Parties

Customs and Usages Explanation of Contract

In construing ambiguous contractual provision, court may consider evidence of prior agreements and communications of parties as well as trade usage or course of dealing, notwithstanding presence of routine integration clause.

58 Cases that cite this headnote

[7] **Evidence** Showing Intent of Parties as to Subject Matter

One primary tenet of parol evidence rule is that relevant extrinsic evidence is that evidence which reveals parties' intent at time they entered into contract, and backward-looking evidence gathered after time of contracting is not usually helpful.

51 Cases that cite this headnote

[8] **Contracts** Intention of Parties

Evidence Nature and Existence of Ambiguity in General

It is a court's duty to preserve to the extent feasible the expectations that form the basis of a contractual relationship, and when meaning and application of contract terms are uncertain, court fulfills this duty by considering extrinsic evidence.

46 Cases that cite this headnote

***1229** Upon appeal from the Court of Chancery. **REVERSED and REMANDED.**

Court Below: Court of Chancery of the State of Delaware in and for New Castle County, C.A. No. 14189.

Attorneys and Law Firms

Josy W. Ingersoll, and James P. Hughes, Jr., of Young, Conaway, Stargatt & Taylor, Wilmington; and James D. Fiffer and Lisa S. Simmons (argued), of Wildman, Harrold, Allen & Dixon, Chicago, IL, for Appellant.

Michael F. Duggan, of Warren B. Burt & Associates, Wilmington, for Appellee.

Before VEASEY, C.J., WALSH, HOLLAND, HARTNETT and BERGER, JJ., constituting the Court en Banc.

Opinion

VEASEY, Chief Justice:

In this appeal we focus on the correctness of the grant of summary judgment in a contract dispute over the interpretation of an indemnification provision. In granting summary judgment, the Court of Chancery found the contract provision to be unambiguous. We disagree and hold that the indemnification provision is ambiguous, thus raising factual issues requiring consideration of extrinsic evidence to determine the intended meaning of the provision in light of the expectations of the contracting parties. We reverse the judgment of the Court of Chancery and remand the case for proceedings consistent with this opinion.

Facts

Eagle Industries, Inc. ("Eagle") and Homecare Acquisition, Inc. ("Buyer") entered into a Stock Purchase Agreement (the "Agreement") on August 13, 1990. Pursuant to the Agreement, Eagle and its wholly-owned subsidiary, DeVilbiss Holding Company, ***1230** Inc. ("Seller"), transferred substantially all of the stock of DeVilbiss Health Care, Inc. ("DHC") to Buyer on October 5, 1990 (the "Closing Date"). After the Closing Date, Buyer merged into DHC, and DHC succeeded to Buyer's interests and liabilities, including those set forth in the Agreement. DHC then became a wholly-owned subsidiary of Homecare Holdings, Inc. ("Holdings").

Article 10.8 of the Agreement provided that Eagle was responsible for fulfilling Seller's indemnification obligations under the Agreement. At issue in this case is the indemnification provision for product liability under Article 10.1 of the Agreement, which reads as follows:

> (b) In addition to and without limiting any other rights or remedies of Holdings and Buyer, Seller shall indemnify Holdings and Buyer and its subsidiaries (including the Companies), and their respective officers, directors, agents and employees, and hold them harmless at all times from

> and after the Closing Date against and in respect of any and all Damages (i) resulting from any suit, action, arbitration or legal, administrative, governmental or other proceeding or investigation, foreign or domestic, relating to any product manufactured, purchased or sold by Parent, Seller, the Companies, or any affiliates or predecessors of Parent, Seller or the Companies prior to the Closing (including such actions or potential actions set forth in Schedule 3.18 hereto), alleging that such product was defective or was negligently or improperly designed, manufactured, packaged or marketed, without regard to when such product is sold or when such Damages accrue or arise *(provided, that such indemnification shall be limited to Damages arising from such suits, actions, arbitrations or other proceedings the alleged basis for which arose or occurred on or prior to the Closing Date); ....*

(emphasis added). The emphasized language was added to Article 10.1 after negotiations between the parties concerning Eagle's indemnification of Buyer for product liability claims.

Buyer's initial offer dated July 9, 1990 proposed that Eagle indemnify Buyer for product liability claims involving goods manufactured or purchased by Eagle prior to the Closing Date. This proposal was reflected in the indemnification provision contained in the first draft of the Agreement. According to an affidavit submitted by Eagle's then-counsel, Bruce C. Strohm, Eagle objected to a manufacture or purchase date trigger to its indemnification obligation. At a meeting held on July 20, 1990, Strohm informed Buyer that Eagle's product liability insurance coverage was limited to suits based on alleged occurrences prior to the Closing Date. Accordingly, Eagle was not willing to indemnify Buyer for claims based on post-closing occurrences, and Buyer would have to obtain its own insurance to protect against such claims. After the July 20 meeting, the parties redrafted the indemnification provision to include the emphasized proviso.

Proceedings in the Court of Chancery

The parties disagreed concerning the proper interpretation of the final indemnification provision as it was to apply to product liability claims. DHC filed suit in the Court of Chancery seeking construction and reformation of the indemnification language in Article 10.1(b)(i) so that it provided the date on which the product was manufactured or purchased as a clear reference for determining Eagle's indemnification obligations. Eagle filed a counterclaim for reimbursement of expenditures made in connection with product liability claims, arguing that the parties had intended the date on which the product caused injury to be the triggering event for indemnification under the Agreement.

The parties then filed cross-motions for summary judgment. The Court of Chancery held that the indemnification provision unambiguously set forth the product's manufacture or purchase date as the trigger for Eagle's indemnification obligations and granted DHC's motion for summary judgment.[1] We recite here excerpts from the ***1231** Memorandum Opinion of the Court of Chancery:

> The parties are now faced with product liability claims, Damages for which may be covered by the terms of the Agreement. Because they are unable to agree on the proper interpretation of the above indemnification provision, they ask this Court to decide whether Eagle's indemnification obligations are to be determined by reference to the date on which a product causes injury or the date on which the product was manufactured or purchased.

* * *

> Thus, the question raised, according to DHC, is whether "the alleged basis for which" applies to the basis of the Damages or the basis of the suits, actions, arbitrations or other proceedings.

* * *

> Eagle argues that the indemnification provision in dispute is unambiguous and requires Eagle to indemnify DHC for product liability damages which result from injuries occurring before the Closing date of the stock transfer.... Eagle interprets "basis" as referring to the personal or property injury at the heart of a product liability suit.

* * *

> I conclude that Eagle's interpretation of the Agreement—an interpretation which does not give meaning to every provision of the contract and an interpretation which is internally inconsistent—is not the interpretation that would have been placed on the contract by a reasonable person in the position of the parties at the time of contracting.... I do not find that the Agreement is ambiguous.

* * *

> For all these reasons, I find that a reasonable person in the position of the parties—one with knowledge of the businesses and risks of medical products—would conclude that the Agreement intended to force the party with the best ability to prevent the harm to bear the risks associated with the harm. By such an arrangement, the Agreement minimized the overall potential costs of product liability suits by forcing the party with the most control over the prevention of harm to bear the risk of the harm. By minimizing the costs of this risk bearing, the parties maximized the gains generated by the stock sale—gains which the parties could then argue over how to distribute.
>
> The Agreement unambiguously provides that Eagle's indemnification obligations are triggered by reference to the date of product manufacture or purchase. Thus, DHC need not indemnify Eagle for damages arising from Eagle's negligence. I grant summary judgment in favor of plaintiff DHC and deny defendant Eagle's cross-motion for summary judgment.[2]

Ambiguity in the Indemnification Provision

[1] The key phrase in controversy is the language providing that indemnification is limited to damages "*arising from such suits ... or other proceedings, the alleged basis for which arose or occurred on or prior to the Closing Date.*" What does this phrase mean? Does it mean that Eagle is responsible for claims arising from products manufactured or purchased before the Closing Date? Or is Eagle responsible only for claims based on injuries occurring before the Closing Date?

We disagree with the Court of Chancery that the indemnification provision is unambiguous. Both parties now claim that the provision unambiguously supports their respective interpretations, but DHC stated in its initial complaint that the language in Article 10.1(b)(i) is reasonably susceptible to at least two possible meanings. We are not bound, and the trial court was not bound, by the parties' present claim that the provision is unambiguous. We determine that question *de novo.*

In our view, the indemnification provision can be read as creating an obligation on Eagle's part to cover damages arising from product defect claims when the allegedly defective ***1232** product was manufactured or purchased before the Closing Date. Alternatively, an equally reasonable interpretation of the indemnification provision would obligate Eagle only as to claims based on personal or property injury that occurred prior to the Closing Date.

The Court of Chancery held that Eagle's interpretation did not give proper effect to other portions of the provision. Specifically, the Court of Chancery determined that Eagle's argument that indemnification obligations occur with reference to the date of the alleged injury ignored the portion of Article 10.1(b)(i) stating that such obligations may be triggered "without regard to when such product is sold," as well as the portion stating that Eagle shall indemnify Buyer with respect to any damages resulting from any action relating to any product manufactured, purchased or sold by Eagle prior to the Closing.[3] Because it found that an interpretation calling for a product manufacture or purchase date trigger made better use of each portion of Article 10.1(b)(i), the Court of Chancery held that the indemnification provision was unambiguous. The Court of Chancery also rejected Eagle's interpretation because it found no clear language in the Agreement that would provide for DHC's assumption of liability for claims arising from alleged injuries occurring after the Closing Date.[4]

[2] **[3]** Contract terms themselves will be controlling when they establish the parties' common meaning so that a reasonable person in the position of either party would have no expectations inconsistent with the contract language.[5] When the provisions in controversy are fairly susceptible of different interpretations or may have two or more different meanings, there is ambiguity. Then the interpreting court must look beyond the language of the contract to ascertain the parties' intentions.[6] We find in this case that a reasonable third person reading the indemnification provision in Article 10.1(b)(i) would be uncertain whether Eagle's obligations should be determined by reference to the date on which the product caused injury or by reference to the date on which the product was manufactured or purchased. Since the indemnification language in the Agreement is ambiguous, consideration of the relevant evidence is required.

The Use of Extrinsic Evidence in Contract Interpretation

[4] **[5]** If a contract is unambiguous, extrinsic evidence may not be used to interpret the intent of the parties, to vary the terms of the contract or to create an ambiguity.[7] But when there is uncertainty in the meaning and application of contract language, the reviewing court must consider the

evidence offered in order to arrive at a proper interpretation of contractual terms.[8] This task may be accomplished by the summary judgment procedure in certain cases where the moving party's record is not *prima facie* rebutted so ***1233** as to create issues of material fact.[9] If there are issues of material fact, the trial court must resolve those issues as the trier of fact.

[6] **[7]** In construing an ambiguous contractual provision, a court may consider evidence of prior agreements and communications of the parties as well as trade usage or course of dealing.[10] In the instant case, Eagle presented the affidavit of Bruce Strohm to the effect that the parties had contracted for an occurrence date trigger to the indemnification provision in a manner consistent with its position. This affidavit, along with its attached exhibits containing correspondence between the parties, drafts of the Agreement and drafting session notes, provide insight into the type of risk allocation that the parties intended the Agreement to reflect. The Strohm affidavit relates to the circumstances that existed at the time the parties drafted the agreement and sets forth evidence that may show that the indemnification clause was designed to conform to Eagle's existing coverage as well as to the future coverage that Buyer expected to obtain.[11] Understandably, Eagle's willingness to indemnify Buyer was constrained by its own insurance liability coverage.

Because of the view of the Court of Chancery that the language in question was unambiguous, this evidence was not properly analyzed and the proceeding was truncated, we believe erroneously. On remand, the Court of Chancery should consider any admissible extrinsic evidence that may shed light on the expectations of the parties at the time they entered into the Agreement.

Conclusion

[8] In a perfect world, integrated contracts would always reflect plainly and accurately the compromises and allocation of risk that the parties intend. The reality is that the contractual language defining rights and obligations of the parties is sometimes ambiguous. It is a court's duty to preserve to the extent feasible the expectations that form the basis of a contractual relationship. ***1234** When, as in the instant case, the meaning and application of contract terms are uncertain, a court fulfills this duty by considering extrinsic evidence.

Accordingly, we reverse the decision of the Court of Chancery and remand for proceedings consistent with this opinion.

All Citations

702 A.2d 1228

Footnotes

1 *DeVilbiss Health Care, Inc. v. Eagle Indus., Inc.,* Del.Ch., C.A. No. 14189, 1996 WL 757096 (Jan. 22, 1997) (Mem.Op.).

2 *Id.* at 3, 8–11, 14–15.

3 *Id.* at 11–12.

4 *Id.* at 14 (citing *State v. Interstate Amiesite Corp.,* Del.Supr., 297 A.2d 41, 44 (1972)).

5 *Rhone–Poulenc v. American Motorists Ins.,* Del.Supr., 616 A.2d 1192, 1196 (1992).

6 *Id.; Pellaton v. Bank of New York,* Del.Supr., 592 A.2d 473 (1991).

7 *Pellaton,* 592 A.2d at 478; *Citadel Holding Corp. v. Roven,* Del.Supr., 603 A.2d 818 (1992). There may be occasions where it is appropriate for the trial court to consider some undisputed background facts to place the contractual provision in its historical setting without violating this principle. But the trial court must be careful in entertaining background facts to avoid encroaching on the basic principles set forth herein. In *Klair v. Reese,* Del.Supr., 531 A.2d 219 (1987), this Court reversed the Court of Chancery and held that the court should consider extrinsic evidence. Unfortunately, certain language in the Court's opinion is overbroad on the issue of when extrinsic evidence should be considered. *Id.* at 223. To the extent that such language may be read to be broader than, or at variance with, the principles set forth in this opinion, it is disapproved. The *Klair* opinion should be construed narrowly to conform with this opinion.

8 *Pellaton,* 592 A.2d at 478. Contract language is not ambiguous simply because the parties disagree concerning its intended construction. The true test is what a reasonable person in the position of the parties would have thought it meant. *Rhone–Poulenc,* 616 A.2d at 1196.

9 Rule 56 of the Rules of the Court of Chancery sets forth the procedure. The portions of that rule relevant here are as follows:

> **Rule 56. Summary judgment.**
>
> (a) ... A party ... may ... move with or without supporting affidavits for a summary judgment....
>
> * * *
>
> (c) ... The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.
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> * * *
>
> (e) ... When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of the adverse party's pleading, but the adverse party's response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If the adverse party does not so respond, summary judgment, if appropriate, shall be entered against the adverse party.

See Continental Airlines v. American General, Del.Supr., 575 A.2d 1160, 1164 n. 5, *cert. dismissed,* 498 U.S. 953, 111 S.Ct. 376, 112 L.Ed.2d 390 (1990) ("We note that the general rule is that cross-motions for summary judgment do not obligate the Court to render summary judgment, rather the trial court's duty is to determine independently whether there are any genuine issues of material fact.").

10 This is true notwithstanding the presence of a routine integration clause, an example of which is contained in Article 11.4 of the contract at issue here. That provision states in effect that the writing is to "set forth the entire understanding of the parties" so that "[a]ny and all prior or collateral representations, promises and conditions in connection with the subject matter hereof and any representation, promise or condition not incorporated herein or made a part hereof shall not be binding upon any party."

11 *See Cities Service Co. v. Gardinier, Inc.,* Del.Super., 344 A.2d 254, 259, *appeal dismissed,* 349 A.2d 744 (1975) (holding that evidence of one party's knowledge of the meaning ascribed to contract language by the other contracting party was also relevant to a proper interpretation of the contract). DHC offered evidence of Eagle's behavior after the Closing Date to support DHC's interpretation of the indemnification provision. Setting aside the issue of validity, which Eagle contests, this evidence threatens to transgress one of the primary tenets of the parol evidence rule: relevant extrinsic evidence is that which reveals the parties' intent *at the time they entered into the contract.* In this respect, backward-looking evidence gathered after the time of contracting is not usually helpful. *Demetree v. Commonwealth Trust Co.,* Del.Ch., C.A. No. 14354, Allen, C., 1996 WL 494910 (Aug. 27, 1996) (Mem.Op.).

8

43 Del.Ch. 196
Supreme Court of Delaware

Margaret H. FULWEILER, a Defendant Below, Appellant,

v.

P. Lea SPRUANCE, Plaintiff Below, Appellee, and

Preston Lea Spruance, Jr., Margaret Spruance Denham, William Halsey Spruance, and Blaine T. Phillips (Guardian Ad Litem for Alice Lea Spruance, II, Lea Spruance, William H. Spruance, Jr. and For All Unborn Issue of Preston Lea Spruance, Jr., Margaret Spruance Denham, William Halsey Spruance and Alice Lea Spruance, II), Defendants Below, Appellees.

July 28, 1966.

Synopsis
Plaintiff sought declaratory judgment as well as instructions on support agreement. The Court of Chancery granted judgment for plaintiff and defendant appealed. The Supreme Court, Wolcott, J., held that where corporation holding stock of another corporation as an asset distributed those stocks and charged them against paid-in surplus which diminished asset value of corporation making distribution and named distribution as distribution of income producing assets pursuant to court order, it was a court compelled return of capital to corporation's stockholders and not a dividend and beneficiaries could not compel transfer of such stocks from trustee as stock dividends which would decrease total value of securities held separately under support agreement made between husband and wife prior to divorce.

Affirmed.

West Headnotes (10)

[1] **Divorce** Personal property

Corporate stock received by former husband by virtue of his legal ownership of stock in corporation which held such stock as income producing asset and which was ordered to divest itself of them were not dividends on shares of stock held separately and beneficiaries could not have divested corporate stock transferred to them under support agreement made by former husband and former wife calling for transfer of "stock dividends" to beneficiaries.

[2] **Divorce** Personal property

Stocks of another corporation distributed as a result of divestiture of stocks held as income producing assets were not dividends on shares of stocks of corporations which held those divested stocks and beneficiaries could not have divested corporate stocks transferred to them under support agreement made between divorced husband and wife calling for transfer of "stock dividends" to beneficiaries.

1 Case that cites this headnote

[3] **Corporations and Business Organizations** What is a dividend

"Dividend" is a distribution to shareholders to be paid from profits or from net assets in excess of capital and is a return to shareholders upon their investment.

[4] **Corporations and Business Organizations** What is a dividend

Where a corporation divested stocks of another corporation held as an asset and charged them against paid-in surplus and diminished asset value of corporation making distribution and named divestiture as distribution of income-producing assets pursuant to court order, distribution was a court-compelled return of

capital to corporation's stockholders and not a cash dividend.

2 Cases that cite this headnote

[5] **Trusts** Merger, reorganization, divestiture, or liquidation, distributions pursuant to

Where corporation divested stocks of another corporation held as an asset and charged them against paid-in surplus and diminished asset value of corporation making distribution and named divestiture as distribution of income-producing assets pursuant to court order, distribution was a court-compelled return of capital to the corporation's stockholders and not a cash dividend within the meaning of a trust agreement between a divorced husband and wife, and accordingly such distribution was allocable to corpus, not to income.

7 Cases that cite this headnote

[6] **Trusts** Nature and requisites in general

When a question arises as to whether or not an agreement creates a trust, courts look objectively at result to determine matter.

[7] **Trusts** Sufficiency of Language Used

No particular form of words or conduct are necessary to create a trust and question is whether relationship known to law as trust has been created.

[8] **Trusts** Nature and essentials of trusts

A trust exists when one person holds legal title to property subject to an equitable obligation to use that property for benefit of another.

1 Case that cites this headnote

[9] **Trusts** Transactions between persons in confidential relations

The fact that divorced husband and wife had no thoughts of creating a trust at time of entering into support agreement was immaterial, where, in fact what they did had legal effect of a trust.

2 Cases that cite this headnote

[10] **Trusts** Transactions between persons in confidential relations

Where husband and wife set aside certain securities prior to divorce under a support agreement to pass beneficial interest to wife and children, and husband retained legal title but stop transfer orders made it impossible for husband to deal with it as his own, husband held securities separately in trust for purposes set forth in support agreement.

4 Cases that cite this headnote

****556** ***197** Appeal from Court of Chancery in and for New Castle County.

Attorneys and Law Firms

Vincent A. Theisen and Victor F. Battaglia, of Theisen & Lank, Wilmington, for Margaret H. Fulweiler.

John J. Morris, Jr., and Howard L. Williams of Morris, James, Hitchens & Williams, Wilmington, for P. Lea Spruance.

Blaine T. Phillips, of Berl, Potter & Anderson, Wilmington, for Preston Lea Spruance, Jr., Margaret Spruance Denham, and William Halsey Spruance, and as Guardian Ad Litem for Alice Lea ***198** Spruance, II, Lea Spruance, William H. Spruance, Jr., and for all unborn issue of Preston Lea Spruance, Jr., Margaret Spruance Denham, William Halsey Spruance and Alice Lea Spruance, II.

WOLCOTT, Chief Justice, CAREY, Justice, and DUFFY, President Judge, sitting.

Opinion

WOLCOTT, Chief Justice.

This is an appeal from the Court of Chancery which granted summary judgment for the plaintiff. The plaintiff (hereafter 'Lea') and principal defendant (hereafter 'Margaret'), formerly husband and wife, are now divorced. Named as additional defendants are three adult children of Lea and

Margaret and the Guardian Ad Litem for a minor child, two minor grandchildren and the unborn issue of the four children (all hereafter 'children').

Prior to the divorce of Lea and Margaret they entered into an Agreement under which it was provided, Inter alia, that in the event Margaret obtained a final decree of divorce from Lea, he would hold separately for the purposes set forth in the Agreement one-half of all shares of Christiana Securities Company (hereafter 'Christiana') common stock and one-half of all E. I. duPont deNemours & Co., Inc. (hereafter 'duPont') common stock which he owned of record, and one-half of all shares of duPont common stock to which he was beneficially entitled under a certain trust terminating in 1955.

Under the Agreement Lea is required to hold the shares of stock separately and within five days of the receipt of any cash dividends upon such shares, to pay to Margaret for her support and the support of the children a sum equal to such dividend or dividends. In addition, Lea is required to transfer to Margaret as her sole property any shares of stock received by him as a stock dividend on the stock held by him separately under the Agreement.

The Agreement by further provisions, not material here, provides for the distribution of the separately held stock in the event either Lea or Margaret predeceases the other and, finally, after the death of both, for the ultimate division of the separately held stock among the children and ****557** their issue. This last provision explains the ***199** presence of the children as defendants in this lawsuit for the protection of their interests in the income and ultimate disposition of the stock.

The stock holdings of Lea which give rise to this controversy are those of Christiana and duPont common stock. After the execution of the Agreement and the divorce of Lea and Margaret, those shares were actually held separately by Lea and, pursuant to the requirement of a supplementary Agreement, stop transfer orders were delivered to the transfer agents of the respective companies effectively preventing the sale or transfer of them by Lea.

The matter which gave rise to this controversy was the distribution in 1962, 1964 and 1965 by duPont and Christiana to their stockholders, pursuant to a Federal Court order, of General Motors Corporation common stock held by those companies. As a result of these distributions, Lea received as the registered holder of the separately held duPont and Christiana common stock 5946.32 shares of General Motors common stock. It is with respect to this General Motors stock that this lawsuit is concerned. Margaret claims it as her sole property under the Agreement, while Lea claims it as an addition to the separately held stock under the Agreement.

The main issue in this appeal is whether the General Motors shares now held by Lea shall be transferred to Margaret as her sole property or shall be retained by Lea and added to the shares separately held by him under the Agreement after selling sufficient of them to pay the capital gains tax assessed by reason of the distribution.

Several provisions of the Agreement are pertinent in connection with the arguments made. We quote them in full: '1(b) (iii) If at any time the Husband shall receive any additional or other shares of stock through any stock split on any of the shares * * * which are to be held separately by him, or by way of merger or through any other means whereby additional or other shares of stock are received by virtue of the ownership of said shares to be held separately, except a stock dividend, such shares shall similarly be held separately by the Husband for the purposes hereinafter set forth.

***200** '1(b) (iv) Whenever and from time to time the Husband receives any cash dividends upon any of the shares of stock to be held separately * * *, the Husband, within five days thereafter, shall pay unto the Wife a sum or sums equal to such dividend or dividends for her support and maintenance and for the support and maintenance of the minor children as hereinafter provided.

'1(b) (vi) Any shares of stock received by the Husband as a stock dividend or dividends on the shares of stock to be held separately by him hereunder shall be transferred and assigned unto the Wife as her sole property if she is living and, after her death, in the same manner and proportions as is provided herein for cash payments.'

Margaret argues that the General Motors stock received as a result of the distribution is either a 'cash dividend' which would mean that Lea under 1(b) (iv) is required to pay to Margaret within five days a sum equal to its value, or that the distribution constitutes shares of stock received by Lea as dividends on shares of stock held separately which means that Lea under 1(b) (vi) is required to transfer them to Margaret as her sole property.

Subparagraph 1(b)(iii) requires that if Lea receives any additional or other shares of stock by reason of a stock split, or by reason of a merger, or by any other means, that he

shall hold such additional or other shares separately for the purposes of the Agreement. Expressly excluded from this requirement, however, are shares of stock received as a stock dividend which, ****558** under the provisions of 1(b)(vi), are required to be transferred to Margaret.

In duPont v. duPont, Del., 208 A.2d 509, we held the divestiture of General Motors stock by the duPont Company was not a stock dividend. Margaret now concedes that the General Motors stock held by Lea was not received as a stock dividend and that she has no claim to it on this ground.

Margaret claims, however, that she is entitled to the stock under the provisions of 1(b)(vi) of the Agreement as shares of stock received by Lea as 'dividends on the shares of stock' held ***201** separately by him. By this contention Margaret seeks to construe 1(b)(vi) as requiring not only the transfer to her of stock dividends, but also the transfer to her of all stock of companies other than duPont and Christiana received by Lea. To adopt this contention would be to construe 1(b)(vi) as providing two exceptions to the direction of 1(b)(iii) which, in terms, provides only one, i.e., a stock dividend.

[1] **[2]** We think the construction sought to be put on 1(b)(vi) is artificial and strained. This result may be reached only by separating the phrase 'stock dividend' from the phrase 'dividends on the shares.' This may not be, however. Subparagraph 1(b)(vi) is obviously designed to provide for the enforcement of the one exception appearing in 1(b)(iii), that of a stock dividend. Such being so, the use by the draftsman of the singular and plural of the word 'dividend' must be considered as merely an example of cautious draftsmanship since, otherwise , the result would have the effect of broadening the single exception of 1(b)(iii) far beyond its scope. In essence, it would be to rewrite the provision.

We are of the opinion, therefore, that Margaret is not entitled to the General Motors stock by reason of any provision of 1(b)(vi).

Margaret further contends, however, that she is entitled to the stock, or its equivalent in money, under the provisions of 1(b)(iv). The argument is that the distribution of General Motors stock was the equivalent of a cash dividend paid to Lea.

The argument is based upon the fact that the recipients of the General Motors stock could have been taxed upon it as ordinary income but for 26 U.S.C. s 1111, and 30 Del.C. s 1148, which were enacted to give the recipients of the stock the tax benefit of treating it as a return of capital rather than as ordinary income. It is argued that this special treatment demonstrates that in fact the distribution of the General Motors stock was nothing more than an ordinary dividend.

We think, however, that the answer to the question is not to be found in the tax consequences which resulted from the stock distribution. The question of what in fact the distribution is finds its answer in the facts surrounding it.

***202** **[3]** In the general or ordinary sense a dividend is a distribution by a corporation to its shareholders of a share of the earnings of the corporation. 11 Fletcher Cyclopedia Corporations, s 5318. It ordinarily means a distribution to shareholders out of earnings, profits or undivided surplus. In Delaware dividends may be paid from profits or from net assets in excess of capital, but whatever the source of payment it is a return to the shareholders upon their investment. Penington v. Commonwealth Hotel Const. Corp., 17 Del.Ch. 394, 155 A. 514, 75 A.L.R. 1136.

The 63,000,000 shares of General Motors stock distributed under court order by duPont was acquired by duPont more than forty years ago and was treated throughout by the duPont Company as an investment and as part of its income-producing assets. Following its acquisition, all of the dividends received on the stock were passed on to duPont shareholders less tax payments made by the Company. This investment was revalued annually by duPont to reflect its equity in General Motors Corporation. ****559** The General Motors stock prior to the ordered divestiture constituted approximately 25% Of duPont's total assets.

Pursuant to the decree of the Federal Court, duPont distributed its General Motors stock to its shareholders. The distributions thus made were charged against duPont's Paid-In Surplus and its Earned Surplus was in no way diminished. Following each distribution, the market price of duPont stock dropped to reflect the diminution in asset value.

Prior to any distribution, each share of duPont stock reflected in its value the inclusion of the General Motors stock among the assets of duPont. It was stock reflecting this value which Lea and Margaret agreed would be held separately for her and her children's benefit. Following the distribution each share of duPont was of a lesser value by reason of the elimination of the General Motors asset, but each shareholder received in the form of General Motors stock that amount of value.

The directors of duPont in the resolutions adopted to comply with the decree of divestiture carefully refrained from

describing the ***203** distribution as a dividend, but in fact described it for what in fact it was-a partial distribution of duPont income-producing assets pursuant to the order of a court.

In duPont v. duPont, supra, we held that the divestiture by duPont Company of its General Motors stock was not a stock split, a stock dividend, or an 80% Liquidating dividend as a preliminary step toward total corporate liquidation. But we did not pass upon the question of what in fact it was because the question was not before us.

[4] **[5]** We now reach the question and are of the opinion that the circumstances permit the sole conclusion that the divestiture by duPont of its General Motors stock was a judicially forced distribution of a portion of the income-producing assets of duPont. It was in fact a court-compelled return of capital to duPont's shareholders. As such, it is not a dividend, either of cash or stock, and, thus, is not the property of Margaret under the Agreement, but must be held separately by Lea for her benefit and the benefit of her children. This is necessary to keep the total value of securities held separately under the Agreement intact.

There is ample authority from other jurisdictions which, by analogy, support this conclusion. See In re Bank of New York, Sup., 105 N.Y.S.2d 211; In re Matthews' Trust, 280 App.Div. 23, 111 N.Y.S.2d 405, aff. 305 N.Y. 605, 111 N.E.2d 731, and Koehler v. Koehler, 99 N.J.Eq. 141, 132 A. 751. Furthermore, by 12 Del.C. s 3526, the General Assembly has established as the policy of Delaware that a corporate distribution to a trustee shall be treated as an addition to principal to the extent that it is a diminution of an income-producing property. If it were held that the General Motors stock in question here was the sole property of Margaret, the result would be a diminution of the income-producing property held separately by Lea for the benefit of Margaret and the children. Such a result would be in violation of the policy of this State set forth in 12 Del.C. s 3526.

We therefore affirm the ruling below that the General Motors stock received by Lea as a result of the forced divestiture shall be held separately by him under the Agreement for the benefit of Margaret and the children.

***204** One further point remains for our consideration. The Vice Chancellor held that the Agreement in fact established a trust in the separately held securities, including the General Motors stock which he directed be added to corpus. In this appeal Margaret attacks this ruling while Lea and the children uphold it.

While our ruling to the effect that the terms of the Agreement, whether it be a trust or not, require that the General Motors stock be held separately by Lea under the Agreement disposes of the main controversy between the parties, i.e., the ownership of the General Motors stock, ****560** we think we must pass upon this further question for the future guidance of the parties, particularly since the complaint seeks a declaratory judgment as well as instructions.

Margaret argues that the Agreement creates only a debtor-creditor relationship between Lea and herself and the children because it requires Lea to pay them a sum or sums equal to dividends received by him, and to provide by will for the continuance of the receipt by them of these amounts in the event of his death. She further argues that she and Lea did not intend to create a trust and that, in fact, she would not have agreed to Lea as trustee if a trust had been intended.

[6] **[7]** When a question arises as to whether or not an Agreement creates a trust, the courts look objectively at the result to determine the matter. No particular form of words or conduct are necessary to the creation of a trust. The question in each instance is whether the kind of relationship known to the law as a trust has been created. 1 Scott on Trusts (2nd Ed.), s 24; Tippett v. Tippett, 24 Del.Ch. 115, 7 A.2d 612; Roberts v. Downs, 28 Del.Ch. 293, 42 A.2d 315.

[8] Fundamentally, a trust exists when one person holds legal title to property subject to an equitable obligation to use that property for the benefit of another. 1 Bogert, Trusts and Trustees, s 1; 1 Scott on Trusts (2nd Ed.), s 2.3. Such is the rule in Delaware. Delaware Land & Dev. Co. v. First & Central Presby. Church, 16 Del.Ch. 410, 147 A. 165; Bouree v. Trust Francais, 14 Del.Ch. 332, 127 A. 56; Wise v. Delaware Steeplechase & Race Ass'n, 28 Del.Ch. 532, 45 A.2d 547, 165 A.L.R. 830.

***205** In the case at bar all the elements exist to create the relationship known as a trust. Lea has set aside certain securities and by stop-transfer orders has made it impossible for him to deal with them as his own property. He has obligated himself to pass on the dividends received on these securities to his former wife and children. He has obligated himself to provide by will for the ultimate vesting of title to these in his children or their issue. In short, the Agreement divests Lea of any beneficial interest in the corpus, represented by the securities separately held, and

has transferred that interest to his wife and children. The fundamental elements of a trust relationship thus exist.

[9] The fact that neither Lea nor Margaret thought at the time of entering into the Agreement that they were creating a trust is immaterial if, in fact, what they did had that legal effect. 1 Scott on Trusts (2nd Ed.), s 2.8, s 23; Norris v. Norris (Ohio App.), 57 N.E.2d 254; Levy v. Levy, 309 Mass. 486, 35 N.E.2d 659.

[10] We think clearly that the Agreement before us created a trust. There is a corpus, i.e., the separately held shares. There is a trustee, i.e., Lea, who holds bare legal title to the separately held shares. There are beneficiaries, i.e., Margaret, who is entitled to part of the income, and the children, who are entitled to part of the income, and ultimately to the shares, themselves. All the necessary elements are present and, as a result, Lea holds the separately held shares in trust for the purposes set forth in the Agreement.

We understand the parties do not disagree with respect to the result in the event the Agreement creates a trust and in the event the General Motors stock is to be added to that corpus. Since the judgment of the Vice Chancellor provides for that result, it is affirmed.

All Citations

43 Del.Ch. 196, 222 A.2d 555

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9

35 Del.Ch. 411
Court of Chancery of Delaware, New Castle County.

Elizabeth Donner HANSON, as Executrix and Trustee under the last Will of Dora Browning Donner, deceased, Plaintiff,
v.
WILMINGTON TRUST COMPANY, a Delaware corporation, as Trustee, et al., Defendants.

Dec. 28, 1955.

Synopsis

Action was brought for declaratory judgment to determine persons entitled to assets under purported inter vivos trust agreement. Four motions for summary judgment were made. The Court of Chancery, in and for New Castle County, Herrmann, Acting Vice Chancellor, held that fact that agreement creating purported inter vivos trust reserved to the trustors the right to all net income for life, right to amend or revoke agreement in whole or in part, right to change trustee, and right to name and change an investment adviser, did not render the agreement invalid.

Motions for summary judgment filed by certain of the defendants denied, and other motions for summary judgment granted.

West Headnotes (15)

[1] **Judgment** Conclusiveness of Adjudication

Judgment in Florida action for declaratory judgment determining what passed under will and authority of executrix under Delaware trust agreement was not res judicata in subsequent action in Delaware for declaratory judgment determining persons entitled to assets under the agreement, since the actions involved different causes of action.

[2] **Res Judicata** Claims or Causes of Action in General

The refinement of the res judicata doctrine known as the doctrine of "collateral estoppel" may be applicable, though actions involve different causes of action.

[3] **Courts** Jurisdiction of Property or Other Subject-Matter Involved

In a direct proceeding, Florida court did not have jurisdiction to determine essential validity of inter vivos trust which was created in Delaware, and all assets of which were in Delaware, and the Trustee of which was a Delaware corporation not before the Florida court.

1 Case that cites this headnote

[4] **Res Judicata** Incidental or collateral matters

Where a court has incidentally determined a matter which it would have had no jurisdiction to determine directly, judgment is not conclusive in a subsequent action brought to determine directly such incidental matter.

[5] **Judgment** Conclusiveness of Adjudication

Delaware court had duty to determine essential validity of Delaware inter vivos trust in a direct proceeding brought for that purpose, though Florida court in a prior proceeding had incidentally determined the matter in a prior action in which neither the trust res nor the trustee was before the Florida court, and doctrine of collateral estoppel was not applicable.

1 Case that cites this headnote

[6] **Trusts** What law governs

Where purported inter vivos trust was created in Delaware, and assets of trust had been held by trustees in Delaware at all times, the home of the trust was in Delaware and its validity was required to be determined by Delaware law.

[7] **Judgment** Conclusiveness of Adjudication

Where application of doctrine of collateral estoppel in action in Delaware court for declaratory judgment to determine persons entitled to assets under purported inter vivos trust, would mean that as to parties before Florida court in prior action, disposition of assets would be governed by residuary clause of will, but that as to parties who were not before the Florida court, disposition of assets would be governed by the terms of the agreement creating the purported trust and power of appointment thereunder, and result would be chaos and injustice, doctrine would not be applied by Delaware court.

1 Case that cites this headnote

[8] **Trusts** Modification

Trusts Inclusion or omission of reservation as affecting validity of trust

Trusts Provisions of instrument creating trust

Fact that agreement creating purported inter vivos trust reserved to the trustors the right to all net income for life, right to amend or revoke agreement in whole or in part, right to change trustee, and right to name and change an investment adviser, did not render the agreement invalid.

[9] **Trusts** Nature and essentials of trusts

Intent of trustor was a critical and controlling factor in determining whether an agency or inter vivos trust was created by agreement executed by the trustor.

1 Case that cites this headnote

[10] **Wills** Trust or power

There is no established limit to the nature or extent of the powers which the settlor of a valid inter vivos trust may reserve so long as the settlor does not reserve the right to control the trustee as to the details of the administration of the trust, but if the settlor reserves such power to control the trustee as to the details of the administration of the trust as to make the trustee a mere agent of the settlor, the disposition may be testamentary so far as it is intended to take effect after the settlor's death.

[11] **Trusts** Nature and essentials of trusts

In absence of ambiguity, fraud, duress or mistake, intent of trustor and nature of relationship created by agreement creating purported inter vivos trust, was to be determined by the face of the instrument itself.

2 Cases that cite this headnote

[12] **Trusts** By acts, agreements, and conveyances

Alleged fact that trustee abandoned its powers and duties to adviser under instrument creating purported inter vivos trust, would not convert the agreement into an agency agreement, in absence of knowledge or consent of the trustor.

[13] **Trusts** Nature and essentials of trusts

A trustor, intending to create an inter vivos trust, may not be thwarted by an ex parte act or failure to act on part of trustee.

[14] **Wills** Trust or power

Where present interests were created at time of execution and delivery of agreement creating purported inter vivos trust and exercises of power of appointment thereunder, and agreement provided for an ultimate disposition of assets to then living issue of trustor, subject to defeasance by revocation or exercise of the power of appointment, principle that if no interest passes to beneficiaries of inter vivos trust before death of settlor, intended trust is testamentary was not applicable.

[15] **Trusts** Execution of powers in trust

Where inter vivos trust was valid, exercises by trustor of power of appointment thereunder by subsequent instruments were valid.

Attorneys and Law Firms

****903** ***413** William H. Foulk, Wilmington, for plaintiff Elizabeth Donner Hanson, executrix and trustee.

Caleb S. Layton (of Richards, Layton & Finger), Wilmington, for defendant Wilmington Trust Company, trustee.

Edwin D. Steel, Jr. (of Morris, Steel, Nichols & Arsht), Wilmington, guardian ad litem for defendants, Joseph Donner Winsor, Curtin Winsor, Jr., and Donner Hanson.

Josiah Marvel, Arthur G. Logan and Aubrey B. Lank (of Logan, Marvel, Boggs & Theisen), Wilmington, for defendants, Dora Stewart Lewis, Mary Washington Stewart Borie and Paula Browning Denckla.

Robert B. Walls, Jr., Wilmington, guardian ad litem for defendants, Dorothy B. R. Stewart and William Donner Denckla.

David F. Anderson (of Berl, Potter & Anderson), Wilmington, for defendant Delaware Trust Company, trustee.

Opinion

HERRMANN, Acting Vice Chancellor.

The Court is called upon to decide (1) whether the doctrine of collateral estoppel precludes the parties from litigating in this action the issue of the validity of a certain written agreement as an *inter vivos* trust agreement; and, if not, (2) whether the trust and the exercises of the power of appointment thereunder are valid or invalid.

This action for declaratory judgment was brought by Elizabeth Donner Hanson, Executrix and Trustee under the Will of Dora ***414** Browning Donner, to determine the persons entitled to assets valued at $417,000. The assets were held at the time of the death of Mrs. Donner by the defendant Wilmington Trust Company under an Agreement entered into by them in 1935. After Mrs. Donner's death, the assets were distributed by Wilmington Trust Company to certain recipients named in Instruments executed by Mrs. Donner in 1949 and 1950 in the exercise of the power of appointment reserved to her under the Agreement of 1935.

The case is before the Court upon four motions for summary judgment. Three of the motions are based upon the contention that the Agreement of 1935 created a valid trust, that the power of appointment thereunder was validly exercised in 1949 and 1950, and that the distributions by Wilmington Trust Company pursuant thereto were properly made in discharge of its duty as Trustee under the Agreement. This is the position taken in the motions for summary judgment filed by the plaintiff[1], by Wilmington Trust Company, Trustee, and Edwin D. Steel, Jr., Guardian Ad Litem for three minor defendants, Joseph Donner Winsor, Curtin Winsor, Jr., and Donner Hanson, grandchildren of Mrs. Donner. Opposed to this position is the cross-motion for summary judgment filed by the defendants Dora Stewart Lewis, Mary Washington Stewart Borie and Paula Browning Denckla, other grandchildren of Mrs. Donner. These defendants contend that by application of the doctrine of *res judicata* or collateral estoppel, or by reason of applicable principles of law, this Court must conclude that the Agreement of 1935 was an agency agreement and not a trust agreement; that, therefore, the Instruments of 1949 and 1950 were invalid testamentary acts and the transfer of assets by Wilmington Trust Company thereunder was erroneous because such assets should have been distributed under the Will of Mrs. Donner. These defendants cross-claim and seek a judgment against Wilmington Trust Company ****904** in the amount of $417,000. The defendant Delaware Trust Company, Trustee, supports the motions of the proponents of the Trust. Robert B. Walls, Jr., Guardian ***415** Ad Litem for the defendants Dorothy B. R. Stewart and William Donner Denckla, incompetent daughter and minor grandson of Mrs. Donner, supports the motion of the opponents of the Trust. The pending motions are based upon the pleadings and exhibits thereto, affidavits, depositions and certified copies of the Florida proceedings hereinafter discussed.

There does not appear to be any genuine issue as to any of the following facts:

Under the Agreement with Wilmington Trust Company, dated March 25, 1935, Mrs. Donner transferred to it certain designated securities. The Agreement provided that Wilmington Trust Company, as Trustee, should pay the net income of the trust fund to Mrs. Donner for life and, upon her death, should transfer the trust fund, free from the trust, ‘unto such person or persons * * * as Trustor shall have

appointed by the last instrument in writing which she shall have executed and delivered to Trustee.'

Thereafter, Mrs. Donner executed and delivered to Wilmington Trust Company an Instrument, dated December 3, 1949, in which, after revoking earlier Instruments by which she purportedly had exercised her power of appointment, she again purported to exercise the power of appointment by directing that, upon her death, the Trustee should transfer the trust fund as follows: (1) $4,000 to three named individuals; (2) $1,000 to each of certain servants; (3) $10,000 to Louisville Trust Company in trust for Benedict H. Hanson, a son-in-law of Mrs. Donner; (4) $10,000 to the Bryn Mawr Hospital; (5) $200,000 to the Delaware Trust Company in trust for Joseph Donner Winsor; (6) $200,000 to the Delaware Trust Company in trust for Donner Hanson; and (7) the residue to the Executrix under Mrs. Donner's Will to be dealt with as stated therein. Mrs. Donner thereafter executed and delivered to Wilmington Trust Company an Instrument, dated July 7, 1950, which purported to partially revoke the Instrument of December 3, 1949 by deleting therefrom the provision for $10,000 to the Louisville Trust Company, Trustee. In all other respects, the Instrument of 1950 confirmed the Instrument of 1949.

***416** At the time of the execution of the Agreement of 1935, Mrs. Donner was a resident of Pennsylvania. The securities referred to in the Agreement were delivered to Wilmington Trust Company in Delaware and they remained in Delaware in the possession of and under the administration of the Trust Company. Wilmington Trust Company has no place of business and transacts no business outside of Delaware.

When Mrs. Donner died in 1952, she was a resident of Palm Beach County, Florida, and had been such since 1944. The Will of Mrs. Donner, dated December 3, 1949, was probated there and the plaintiff herein, Elizabeth Donner Hanson, duly qualified as Executrix under the Will. After bequeathing her personal and household effects to Mrs. Hanson and Dora Donner Ide, two of her daughters, Mrs. Donner made the following disposition of the residue of her property 'including any and all porperty, rights and interest over which I may have power of appointment which prior to my death has not been effectively exercised by me or has been exercised by me in favor of my Executrix': (1) Payment of all death taxes on property appointed by Mrs. Donner under the 1935 Agreement; and (2) the balance to be divided into two equal parts: (a) one part to Delaware Trust Company in trust for Katherine N. R. Denckla, another daughter; and (b) the other part to Mrs. Hanson in trust for Dorothy B. Rodgers Stewart, another daughter, during her lifetime and after her death to Delaware Trust Company in trust for Mrs. Denckla.

When Mrs. Donner died, the securities and cash held by Wilmington Trust Company under the 1935 Agreement amounted to $1,493,629.91. Thereafter, Wilmington Trust Company distributed cash and securities aggregating $417,000 in accordance ****905** with the provisions of the Instruments of 1949 and 1950 and deposited the balance to the account of Mrs. Hanson as Executrix and Trustee under the Will of Mrs. Donner. None of the trust funds distributed to Delaware Trust Company, Trustee, have ever been held or administered outside of Delaware.

In January 1954, Mrs. Denckla and Elwin L. Middleton, guardian of the property of Mrs. Stewart, brought an action in the ***417** Circuit Court of Palm Beach County, Florida, against Mrs. Hanson, individually and as Executrix of Mrs. Donner's Will, Wilmington Trust Company, Delaware Trust Company and others who were interested in the assets, directly or beneficially, by reason of appointment or the residuary clause of the Will. The Florida action sought a declaratory judgment determining what passed under the Will and the authority of the Executrix over the assets held by Wilmington Trust Company under the 1935 Agreement. Neither Wilmington Trust Company, Delaware Trust Company nor any of the other appointees under the Instrument of 1949, named defendants in the action, were served personally and they did not appear in the action. None of the assets held by Wilmington Trust Company under the Agreement of 1935 have ever been held or administered in Florida. On January 14, 1955, a 'summary final decree' was entered by the Florida Court holding (1) that the Court lacked jurisdiction over the assets in Delaware and over Wilmington Trust Company, Delaware Trust Company, and the other nonanswering defendants and that the complaint be dismissed without prejudice as to all such defendants; and (2) that no present interest passed to any beneficiary other than Mrs. Donner under the Agreement of 1935 and the Instrument of 1949 and that the Instrument was testamentary in character and invalid as a testamentary disposition because it was not subscribed by two witnesses as required by Florida law; and (3) that, therefore, as to the parties before the Florida Court, the assets held by Wilmington Trust Company under the Agreement of 1935 passed under the residuary clause of Mrs. Donner's Will.

In the meanwhile, in July 1954, the instant action was begun by Mrs. Hanson as Executrix and Trustee under Mrs. Donner's Will. Named herein as defendants are Wilmington Trust

Company as Trustee, Delaware Trust Company as Trustee, the appointees named in the Instruments of Appointment executed by Mrs. Donner, residuary legatees under Mrs. Donner's Will and others having beneficial interests. The complaint herein alleges that it was filed because of the desire of the Executrix to settle the matters in controversy finally and conclusively 'as to all parties so that she may effectively perform all of her duties, account as Executrix ***418** and enter upon her duties as Trustee.' The complaint alleges that no part of the assets involved were located in Florida and that Wilmington Trust Company, Delaware Trust Company and certain other indispensable parties were not before the Florida Court; that, therefore, that Court could not render 'an effective and binding decree.' The prayer of the complaint in this action is that this Court determine by declaratory judgment the persons who, at the time of Mrs. Donner's death, were entitled to participate in the assets held in trust by Wilmington Trust Company under the 1935 Agreement.

I. *Collateral Estoppel*

The first question to be decided is whether by reason of the Florida decree, the parties hereto are precluded from litigating in this action the issue of the validity of the Agreement of 1935 as a trust agreement. This is the ultimate question because the validity of the exercises of the power of appointment depends, in this case, upon the validity of the basic Agreement. See Wilmington Trust Co. v. Wilmington Trust Co., 26 Del.Ch. 397, 24 A.2d 309, 312, 139 A.L.R. 1117.

[1] **[2]** The opponents of the Trust assert the doctrines of *res judicata* and collateral estoppel. The doctrine of *res judicata* is not applicable because the Florida action and this action involve different causes of action. The refinement of the *res judicata* doctrine known as the doctrine of collateral estoppel may be applicable, ****906** however, the difference in causes of action notwithstanding. See Niles v. Niles, Del.Ch., 111 A.2d 697; Petrucci v. Landon, 9 Terry 491, 107 A.2d 236; Scott, 'Collateral Estoppel by Judgment', 56 Harv.L.Rev. 1. The question, then, is whether the doctrine of collateral estoppel may be invoked as an affirmative defense by the opponents of the Trust to preclude the other parties from obtaining a determination by the courts of this State as to the validity of the Trust. I am of the opinion that this question must be answered in the negative.

The Florida Court made determinations incidentally that it would not have had the jurisdiction to make directly. The action before the Florida Court was brought to determine what passed ***419** under the residuary clause of the Will of Mrs. Donner, a Florida domiciliary. As necessary but incidental determinations in that action, the Florida Court concluded that the Agreement of 1935 was invalid as a trust agreement and that, therefore, the exercise of the power of appointment in 1949 was testamentary.[2]

[3] In a direct proceeding, the Florida Court would not have had the jurisdiction to determine the essential validity of an *inter vivos* trust created in Delaware, all of the assets of which were in Delaware and the Trustee of which is a Delaware corporation which was not before the Court. Since neither the Trust *res* nor the Trustee were within the jurisdiction of the Florida Court, it is clear that that Court could not have determined the essential validity of the purported Trust in a direct proceeding brought for the purpose. 54 Am.Jur. 'Trusts' §§ 564, 584; Lines v. Lines, 142 Pa. 149, 21 A. 809; compare In re Harriman's Estate, 124 Misc. 320, 208 N.Y.S. 672; Harvey v. Fiduciary Trust Co., 299 Mass. 457, 13 N.E.2d 299; Land, 'Trusts in the Conflict of Laws', Secs. 41, 43.

[4] The principle is settled that where a court has incidentally determined a matter which it would have had no jurisdiction to determine directly, the judgment is not conclusive in a subsequent action brought to determine directly such incidental matter. In his important and widely quoted discussion of 'Collateral Estoppel by Judgment', 56 Harv.L.Rev. 1, 18, Professor A. W. Scott states:

'* * *. It may happen, however, that the court has jurisdiction to determine the cause of action, but that in determining it the court must necessarily decide a question which it would have no jurisdiction to determine in an action brought expressly for its determination. In such a case the judgment of the court is valid, and the cause of action will be extinguished, the judgment operating by way of merger or bar. The question ***420** then arises as to the effect by way of collateral estoppel of the determination of the particular matter on which the judgment was based. Although the authorities are somewhat meager, it seems clear that the judgment should not preclude the parties as to the matter in a subsequent action between them brought expressly to determine the matter in a court which has jurisdiction to determine it. It seems clear, also, that after such determination in a subsequent suit, it is the determination of the court in that suit, and not the incidental determination in the prior suit, which is conclusive between the parties.'

See also Restatement of Judgments, § 71; Petrucci v. Landon, supra; dissent of Rutledge, J. in Geracy, Inc., v. Hoover, 77 U.S.App.D.C. 55, 133 F.2d 25, 147 A.L.R. 185.

**907 In the final analysis, the question becomes one of public policy. At 56 Harv.L.Rev. 1, 22, Professor Scott states: 'The question in all these cases is one of public policy. Should a court which has not been entrusted with jurisdiction to determine a matter directly be permitted to determine it incidentally, not merely for the purpose of deciding the controversy which it can properly decide, but also with the effect of precluding the parties from litigating the question in those courts which alone are entrusted with jurisdiction to determine it directly?'

This eminent authority on the subject concludes with the admonition that the application of the doctrine of collateral estoppel must always be based upon a sound public policy and that care 'must be exercised in its application to see that it works no injustice.'

[5] It is my opinion that it would be contrary to sound public policy for this Court to consider itself bound and divested of its duty to determine the essential validity of a Delaware *inter vivos* trust in a direct proceeding brought for the purpose on the ground that a Court in a sister jurisdiction has incidentally determined the matter in another cause of action in which neither the trust *res* nor the Trustee was before the Court. The doctrine of collateral estoppel *421 is a judge-made rule. I do not think that it should be enlarged to the extent of depriving the parties herein of a direct determination by this Court as to the validity of the Trust.

[6] Since the purported Trust was created in Delaware and since the assets have been held by the Trustees in Delaware at all times, the 'home' of the Trust is in Delaware and its validity must be determined by the law of Delaware. Wilmington Trust Co. v. Wilmington Trust Co., supra; Wilmington Trust Co. v. Sloane, 30 Del.Ch. 103, 54 A.2d 544. This is a case of first impression in this State as to an important phase of the question of the validity of the Trust. The law of this State must be formulated here. It would be contrary to public policy for the Courts of this State to relinquish their duty of enunciating the law controlling a trust having its situs in Delaware and to thereby relegate the Trustee and the Trust *res* here involved to the law prevailing in another jurisdiction. Compare Taylor v. Crosson, 11 Del.Ch. 145, 98 A. 375.

[7] Moreover, the application of the doctrine of collateral estoppel might work injustice in this, a case which involves only questions of law. It could mean that the parties who were before the Court in the Florida action would be subjected to one conclusion of law while Wilmington Trust Company, Delaware Trust Company and other appointees and beneficiaries, who did not appear in the Florida action, would be controlled by a different rule of law. This could mean that (1) as to the parties before the Florida Court, the disposition of assets would be governed by the residuary clause of the Will, but (2) as to the parties who were not before the Florida Court, the disposition of assets would be governed by the terms of the 1935 Agreement and the exercises of the power of appointment thereunder. This would result in chaos and injustice. The possibility of such result militates against application of the doctrine of collateral estoppel in any case. See Restatement of Judgments, § 70 and com. f, 1948 Supp.; Scott 'Collateral Estoppel by Judgment', 56 Harv.L.Rev. 1, 10.

The opponents of the Trust place principal reliance upon Niles v. Niles, supra. That case is not applicable because there the issue *422 previously determined incidentally by the New York Court also arose incidentally before the Chancellor. I do not consider anything stated herein to be in conflict with the decision in the Niles case. The other cases cited by the opponents of the Trust have been examined and have been found to be inapposite. See Slater v. Slater, 372 Pa. 519, 94 A.2d 750; Ugast v. Lafontaine, 189 Md. 227, 55 A.2d 705; United States v. Silliman, 3 Cir., 167 F.2d 607; **908 William Whitman Co. v. Universal Oil Products Co., D.C.D.Del., 92 F.Supp. 885; United States v. Stone & Downer Co., 274 U.S. 225, 47 S.Ct. 616, 71 L.Ed. 1013.

It is concluded that no determination made in the Florada action is conclusive in this action as to the validity of the Agreement of 1935 as a trust agreement. The parties herein will not be precluded by the defense of collateral estoppel from obtaining the decision of this Court upon that issue.

II. *Essential Validity of the Trust Agreement*

In order to determine the essential validity of the Agreement of 1935 as a trust agreement, it is necessary to consider its pertinent provisions in some detail.

The Agreement was a formal document, executed by Mrs. Donner and Wilmington Trust Company, in which Mrs. Donner was referred to as Trustor and Wilmington Trust Company was referred to as Trustee. It was recited that the

Trustor 'desires to establish a trust of certain securities and property' referred to as the 'trust fund'. It was stated that the Trustor thereby 'assigned, transferred and delivered' certain listed securities and property to the Trustee in trust to 'hold, manage, invest and reinvest the trust fund, collect the income thereof and pay out of such income all taxes, charges and expenses payable thereout'. The Agreement provided for the payment of the net income of the trust fund to the Trustor during her lifetime and, upon her death, the Trustee was directed to convey the fund 'free from this trust, unto such person or persons and in such manner and amounts and upon such trusts, terms and conditions as Trustor shall have appointed by the last instrument in writing which ***423** she shall have exerted and delivered to Trustee'; or in the absence of such instrument, 'by her Last Will and Testament, or in default of any such appointment then unto the then living issue of Trustor, per stirpes and not per capita'. The default of exercise of the power of appointment and living issue, the fund was to go to the Trustor's next of kin. The Agreement then conferred upon the Trustee all of the ordinary general and broad powers usually conferred upon a Trustee, including the power to retain any and all stocks and securities, to sell and exchange the same, to invest the proceeds of any sales, to vote stock, to participate in reorganizations, to determine whether expenses and other disbursements shall be charged against income or principal, and to hold bearer securities in its own name or in the name of its nominees. It was provided, however, that the Trustee shall exercise its power to sell or exchange trust property, to invest the proceeds of any such sale or other available money and to participate in plans of reorganization, merger, etc., only upon the written direction of, or with the written consent of the Adviser of the trust; provided that if there should be no Adviser, or if the Adviser should fail to act within a ten day period, the Trustee might exercise all such powers and 'take such action in the premises as it, in its sole discretion, shall deem to be for the best interest of the beneficiary of this trust'. The Trustor named as Adviser her husband or 'such other person or persons as Trustor may nominate in writing delivered to Trustee during her lifetime'. The Trustor reserved the right to amend or revoke the Trust Agreement in whole or in part and, further, she reserved the right to change the Trustee.

Thus, by the Agreement of 1935, Mrs. Donner reserved to herself the following significant rights and powers: (1) the right to all of the net income for life; (2) the right to amend or revoke the Agreement in whole or in part; (3) the right to change the Trustee; (4) the right to name and change an investment Adviser. The question here presented revolved about those reservations. The opponents of the Trust contend that the cumulation of the reservations created an agency relationship between Mrs. Donner and the Wilmington Trust Company and not a trust relationship; that, therefore, the disposition, insofar as it was intended to take effect after Mrs. ***424** Donner's death, was testamentary and invalid for failure to comply with the Florida law relating to the validity of Wills.

[8] It is my opinion that under the law of this State, which governs the essential ****909** validity of the Agreement of 1935 as a trust agreement, the reservations of rights and powers made therein by Mrs. Donner did not defeat the *inter vivos* trust she so clearly intended to create by that Instrument.

The law seems settled as to the first three reservations here involved. Equitable Trust Co. v. Paschall, 13 Del.Ch. 87, 115 A. 356, stands for the proposition that the reservation of a life interest plus the reservation of the power to revoke an *inter vivos* trust does not invalidate the trust. See also 1 Scott on Trusts, § 57.1; Restatement of Trusts, § 57; 1 Bogert, Trusts and Trustees, p. 483; Leahy v. Old Colony Trust Co., 236 Mass. 49, 93 N.E.2d 238. Furthermore, the power of the settlor of an *inter vivos* trust to change the trustee has judicial sanction in this State. See Wilmington Trust Co. v. Wilmington Trust Co., supra.

The brunt of the attack on the Agreement of 1935 is centered upon its provisions for the appointment of an investment Adviser and the requirement that the Trustee be governed by the Adviser as to (1) any sale or exchange of trust property; (2) any investment of the proceeds of such sale or of other available money; and (3) any participation in plans of reorganization, merger, etc., of any company in which the Trustee might hold securities. It appears that the effect of such provisions upon the validity of an *inter vivos* trust has not been directly decided in this State.

It seems to be settled that an intended *inter vivos* trust does not become testamentary because the trustor reserves the power to direct the trustee as to the making of investments. See Restatement of Trusts, § 57(2) and comment thereon; 1 Scott on Trusts, § 57.2; 1 Bogert, Trusts and Trustees, § 104; National Shawmut Bank of Boston v. Joy, 315 Mass. 457, 53 N.E.2d 113, 125. If the trustor may personally direct or veto investments by the trustee without impairing the validity of an *inter vivos* trust, it would seem to follow that the trustor may assign that authority to a third party, called ***425** 'ADVISER', WITHOUT DESTROYING THE VALIDITY of the trust. such investment counselor has been considered to be a fiduciary, a co-trustee or a quasi-trustee.

See Gathright's Trustee v. Gaut, 276 Ky. 562, 124 S.W.2d 782, 120 A.L.R. 1403, and Annotation 120 A.L.R. 1407; Restatement of Trusts, § 185; Scott on Trusts, § 185; 1 Bogert, Trusts and Trustees, p. 536. In Equitable Trust Co. v. Union National Bank, 25 Del.Ch. 281, 18 A.2d 288, this Court found it unnecessary to determine whether or not an investment adviser was a fiduciary. Whatever the precise relationship between the Trustor and the Adviser or the Trustee and the Adviser may be called, I think it is clear that if Mrs. Conner might have reserved to herself the power to specify investments and to direct or veto the Trustee as to investment policy, without impairing the validity of the *inter vivos* Trust, she may properly delegate that power to another without destroying the *inter vivos* Trust she so clearly intended to create.

[9] The intent of the Trustor is a critical and controlling factor in determining whether an agency or a trust was created by the Agreement of 1935. See 1 Scott on Trusts (1954 Supp.) § 57.2, p. 74. It is beyond question, I think, that it was Mrs. Donner's intent that the 1935 Agreement should create an *inter vivos* trust. In the document, she called herself 'Trustor', she called Wilmington Trust Company 'Trustee' and she referred to the 'trust fund' she was thereby conveying to the Trustee.

[10] It appears that there is no established limit to the nature or extent of the powers which the settlor of a valid *inter vivos* trust may reserve so long as the settlor does not reserve the right to control the trustee as to the details of the administration of the trust. If, however, the settlor reserves such power to control the trustee as to the details of the administration of the trust as to make the trustee a mere agent of the settlor, the disposition may be testamentary so far as it is intended to take effect after the settlor's death. See ****910** Restatement of Trusts, § 57(2); 1 Bogert, Trusts and Trustees, § 104, p. 490.

In the Agreement of 1935, Mrs. Donner did not reserve to herself control over the details of the administration of the Trust as ***426** would constitute the Trustee an agent under the principle above stated. In the Agreement, she conveyed title and broad powers to the Trustee limited only by the obligation of the Trustee to consult and follow the advice of the investment counselor. The opponents of the Trust contend, however, that an examination of the actual operation of the Trust Fund, as disclosed by affidavits and depositions, reveals that the Trustee permitted the Adviser to usurp all of its powers and functions as to the details of administration and that, in reality, the Trustee was nothing more than a custodian of the securities.

[11] **[12]** **[13]** Under the circumstances of this case, the *modus operandi* adopted by the Trustee and the Adviser is immaterial to the question of whether the Agreement of 1935 created a relationship of trust or of agency. In the absence of ambiguity, fraud, duress or mistake, the intent of the Trustor and the nature of the relationship created by the Agreement of 1935 is to be determined from the face of the Instrument itself. See Restatement of Trusts, § 38(2), Comment a. There is no showing that Mrs. Donner knew of the facts relied upon by those who assert an agency instead of a trust, nor is there any showing that she was in any way responsible for any surrender of function which may have taken place as between the Trustee and the Adviser in the operation of the trust. Even if we disregard its vigorous denials and assume that the Trustee abandoned its powers and duties to the Adviser, as asserted by the opponents of the Trust, such situation would not convert a trust agreement into an agency agreement in the absence of the knowledge or consent of Mrs. Donner. A trustor, intending to create an *inter vivos* trust, may not be thwarted by an *ex parte* act or failure to act on the part of the trustee.

It is manifest upon the face of the Agreement that an *inter vivos* trust was intended. Effect will be given to the Agreement in accordance with its plain terms so that the clear intent of the Trustor will not be defeated.

[14] The opponents of the Trust place principal reliance upon Restatement of Trusts, § 56; In re Pengelly's Estate, 374 Pa. 358, 97 A.2d 844; Frederick's Appeal, 52 Pa. 338, and In re Hurley's Estate, 16 Pa. Dist. & Co. 521. In Restatement of Trusts, § 56, ***427** it is stated that if no interest passes to the beneficiaries before the death of the settlor, the intended trust is testamentary. That principle is not applicable in the instant case because present interests were created at the time of the execution and delivery of the Agreement of 1935 and the exercises of the power of appointment thereunder. The Agreement provided for an ultimate disposition of the assets to 'them living issue of Trustor', subject to defeasance by revocation or exercise of the power of appointment. Present interests were thus created when the Agreement and exercises thereunder were executed, even though such interests could not fall into possession until after the death of Mrs. Donner and even though such interests might be ultimately defeated by further exercise of the power of appointment or by revocation. See 1 Bogert, Trusts and Trustees, pp. 484–483; Restatement of Property, § 157, Comments P, Q and R; Gray on Perpetuities, § 112; Simes, Future Interests, § 80;

Leahy v. Oil Colony Trust Co., supra. Since present interests passed under the Agreement and the exercises of the power of appointment and only the enjoyment thereof was postponed until the Settlor's death, the *inter vivos* trust here is not defeated by application of the principle stated in § 56 of the Restatemnt of Trusts. See Brown v. Pennsylvania Co., 2 W.W.Harr. 525, 126 A. 715; Security Trust & Safe Deposit Co. v. Ward, 10 Del.Ch. 408, 93 A. 385; Wilmington Trust Co. v. Wilmington Trust Co., supra; Restatement of Trusts, § 57(1); 1 Scott on Trusts, § 57.1.

****911** The case of In re Pengelly's Estate, supra, does not aid the opponents of the Trust because that case is distinguishable on its facts. There it was found by the Court that the trust instrument merely continued a previously existing agency relationship and the Settlor had reservd complete power to control the Trustee in the administration of the trust. Moreover, the Court in the cited case was concerned with the public policy requiring protection of the rights of widows. The cases of Frederick's Appeal, supra, and In re Hurley's Estate, supra, are likewise clearly distinguishable on their facts and of no assistance.

[15] It is held that the Agreement of 1935 created a valid *inter vivos* Trust. Since the Trust was valid, the exercises of the power ***428** of appointment thereunder by the Instruments of 1949 and 1950 were valid. Wilmington Trust Co. v. Wilmington Trust Co., supra. Accordingly, the distributions made by Wilmington Trust Company constituted a proper discharge of its duties as Trustee under its Agreement with Mrs. Donner.

The motions for summary judgment filed by the Lewis defendants will be denied. The other motions for summary judgment filed herein will be granted.

All Citations

35 Del.Ch. 411, 119 A.2d 901

Footnotes

1 The plaintiff has been barred from proceeding further herein by an injunction issued to her by the Circuit Court of the Fifteenth Judicial Circuit of Florida, in and for Palm Beach County, pursuant to the decree of that Court hereinafter discussed.

2 The decree of the Florida Court contained no expressed conclusion regarding the invalidity of the Agreement of 1935 as an agreement of trust. Since, however, such determination must have been made before the Court could reach the expressed conclusion that the exercise of the power was testamentary, the prerequisite determination as to the invalidity of the Agreement must be said to be implicit in the decree.

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622 A.2d 648
Supreme Court of Delaware.

Monica Lewis HOGG,
Plaintiff Below, Appellant,
v.
Gerald H.E. WALKER,
Defendant Below, Appellee.

Submitted: Feb. 17, 1993.
|
Decided: March 16, 1993.
|
Rehearing Denied April 8, 1993.

Synopsis

Beneficiary sued constructive trustee to compel distribution of corpus. The Court of Chancery, New Castle County, ruled that it could not compel trustee to disgorge trust corpus which had been dissipated. Beneficiary appealed. The Supreme Court, Moore, J., held that trial court erred in failing to craft remedy for beneficiary following trustee's breach.

Reversed.

West Headnotes (17)

[1] **Trusts** Nature of Constructive Trust

Doctrine of constructive trust effectuates principle of equity that one who would be unjustly enriched, if permitted to retain property, is under equitable duty to convey it to rightful owner; it is equitable remedy of great flexibility and generality and is viewed as remedial and not substantive institution.

12 Cases that cite this headnote

[2] **Trusts** Nature of Constructive Trust

Constructive trust is not designed to effectuate presumed intent of party, but to redress wrong.

5 Cases that cite this headnote

[3] **Trusts** Fraud or Other Wrong in Acquisition of Property in General

When one party, by virtue of fraudulent, unfair or unconscionable conduct, is enriched at expense of another to whom he or she owes some duty, constructive trust will be imposed; some fraudulent or unfair and unconscionable conduct is essential.

18 Cases that cite this headnote

[4] **Trusts** Nature of Constructive Trust

As a remedial measure, constructive trust avoids continuing relationship with beneficiary by requiring transfer of property to plaintiff who has established equitable entitlement.

[5] **Trusts** Duty of Trustee in General

Only duty of constructive trustee is to transfer property to equitable owner.

3 Cases that cite this headnote

[6] **Trusts** Fraud or Other Wrong in Acquisition of Property in General

Duty of trustee to transfer property relates back to date of wrongful act that created constructive trust.

3 Cases that cite this headnote

[7] **Trusts** Nature of Constructive Trust

Constructive trust is remedy that relates to specific property or identifiable proceeds of specific property.

8 Cases that cite this headnote

[8] **Equity** Mistake

Equity Fraud

Courts of equity have full jurisdiction to relieve against fraud or mistake, and that power extends to cases where person has procured deed to property rightfully belonging to another.

1 Case that cites this headnote

[9] **Trusts** Nature of Constructive Trust

Where one party has acquired legal right to property to which another has better right, court of equity will convert that person into trustee of true owner, and compel him or her to convey legal title.

1 Case that cites this headnote

[10] **Trusts** Representation of Cestui Que Trust by Trustee

Trusts Right of Action by Beneficiary

Breach of duty by trustee is violation of correlative right of beneficiary, and gives rise to liability on part of trustee and correlative cause of action on part of beneficiary for any loss to trust estate; rule is applicable to positive acts, as well as omissions or negligence, which constitute breach of duty by trustee.

[11] **Trusts** Personal Liability of Trustee for Violation of Trust

Trustee's liability for breach of trust is personal in character with all consequences and incidents of personal liability.

1 Case that cites this headnote

[12] **Executors and Administrators** Trust Estates and Other Equitable Estates and Interests

Executors and Administrators Miscellaneous Claims

Trusts Personal Liability of Trustee for Violation of Trust

Trustee may be required, because of past loss of trust corpus, to use his or her own resources to replenish corpus; since liability is personal one, it is not part of corpus of trust estate which beneficiary can follow into hands of personal representative of trustee and in respect of such liability, beneficiary must proceed as general creditor against estate.

1 Case that cites this headnote

[13] **Trusts** Personal Liability of Trustee for Violation of Trust

Neither trust estate nor trust property are recognized as separate legal entities which immunize trustee from consequences of misconduct.

1 Case that cites this headnote

[14] **Trusts** Scope and Extent of Relief

Enforcing plaintiff has right to receive property or its proceeds from constructive trustee, as well as right to receive money judgment for property received against constructive trustee.

1 Case that cites this headnote

[15] **Trusts** Duty of Trustee in General

Property was subject to constructive trust in favor of equitable owner, and legal owner breached his trust obligation as trustee, by failing to transfer proceeds of trust corpus to beneficiary, upon sale of property.

2 Cases that cite this headnote

[16] **Trusts** Forfeiture or Deprivation

For failure to account as required by court order, constructive trustee may be surcharged or be required to pay compensatory damages.

1 Case that cites this headnote

[17] **Trusts** Who Liable to Account in General

Trusts Personal Liability of Trustee for Violation of Trust

Trusts Scope and Extent of Relief

Constructive trust on proceeds of sale of house related back to date of sale, and dissipation of res by legal owner did not foreclose equitable remedy to make equitable owner whole for legal owner's breach of his duty to transfer proceeds of trust corpus to equitable owner; court could order legal owner to account for

trust property, surcharge him or require him to pay compensatory damages, or enter personal judgment against him.

6 Cases that cite this headnote

***650** On appeal from the Court of Chancery. REVERSED.

Attorneys and Law Firms

Kester I.H. Crosse, Potter, Crosse & Leonard, P.A., Wilmington, for appellant.

Michael J. Goodrick and David S. Lank, Theisen, Lank, Mulford & Goldberg, P.A., Wilmington, for appellee.

Before HORSEY, MOORE and WALSH, JJ.

Opinion

MOORE, Justice.

The plaintiff, Monica Lewis Hogg, appeals from the Court of Chancery's refusal to grant her petition for a Rule to Show Cause and Writ of Attachment to compel the distribution of an $8,000 corpus held in a constructive trust by the defendant Gerald Walker ("Walker"). Because the defendant had dissipated the trust corpus, the Court of Chancery ruled that it could not compel the defendant to disgorge that which he did not have. Hogg challenges this ruling on several grounds. Her primary claim, however, is that the court erred as a matter of law in concluding that the defendant's disposal of the *res* of the constructive trust precludes its enforcement. We conclude that the Court of Chancery erred in failing to use its equitable powers to shape an appropriate remedy to compel the asset distribution of the plaintiff's constructive trust or its equivalent. Accordingly, we reverse.

I.

In 1978, the plaintiff and Walker were close personal friends. Hogg wanted to buy a house, but lacked sufficient credit to do so. Walker had a stable employment and earnings history, and he agreed to help Hogg buy a row house in Wilmington. On June 20, 1978, Walker executed an installment sales contract for the house with the Administrator of Veterans Affairs ("V.A.") for $14,500. Hogg provided the down payment for the purchase. Additionally, Hogg and Walker verbally agreed that Hogg would occupy the premises and make the monthly installment payments.

Thereafter, the personal relationship between Hogg and Walker deteriorated and eventually became hostile. On January 10, 1979, the parties entered into an "Assignment of Installment Contract," wherein Walker assigned to Hogg "all his right, title and interest" to the property. Additionally, Walker "assign[ed], transferr[ed], convey[ed], release[d], and [sold] all of his right, title and interest to all credits, equities, rights and privileges" to which he was entitled pursuant to the sales contract to Hogg. This assignment was not sent to the V.A. until May, 1983, and the V.A. rejected it upon receipt.

From 1978 to 1987 Hogg sporadically made monthly payments under the installment sales contract, but was frequently in arrears. The record, however, is not clear on the actual number of payments Hogg missed. Nonetheless, since Walker was legally obligated under the terms of his agreement with the V.A. to make the monthly payments, the V.A. sent him notices of arrearage and he consequently paid a number of past due installments.

***651** Prior to 1987, Walker filed a series of actions against Hogg, including suits for ejectment, contractual damages, and to foreclose upon Hogg's equitable interest in the property. Walker mistakenly believed that his assignment of the installment contract to Hogg had been accepted by the V.A., and that the equitable foreclosure action in Chancery was necessary to obtain legal title to the property. Upon learning that the V.A. had refused the assignment, Walker obtained a dismissal of the action in the Court of Chancery, apparently assuming that Hogg no longer had an enforceable interest in the property.

At a later unspecified date Walker encumbered the property with a mortgage to secure a personal loan. In April, 1987, Walker paid the outstanding balance owed to the V.A. and received a deed to the property in his name.[1] After Walker obtained legal title, Hogg was evicted from the property by an order of the Superior Court dated May 27, 1987.

Hogg filed this suit in equity in June, 1987, seeking imposition of a resulting or constructive trust on the property. With the suit in Chancery pending, Walker arranged to sell the property in November, 1987. Upon learning this, Hogg filed a motion to hold the sale funds in escrow, which the Court of Chancery denied. Although that particular sale was not consummated, Walker did sell the property on February

22, 1988, for $30,318.62 in cash. Hogg then sought a resulting or constructive trust on the proceeds of the sale.

On October 27, 1989, the Court of Chancery found that Walker's legal ownership was subject to a resulting trust in favor of Hogg because of the latter's equitable title to the property. Upon Walker's sale of the property, however, the court held that a constructive trust arose in favor of Hogg with respect to the proceeds in the amount of $8,324.58. The court determined the amount by offsetting $21,994.04 against the proceeds, consisting of $8,205 in installment payments made by Walker, together with Walker's final payment of $13,789.04 to satisfy the installment sales contract.

After further disputes between the parties, in July 1991 the Court of Chancery held that Walker had taken possession of an $8,000 trust corpus after the sale of the property, and that the corpus had to be distributed to Hogg. Despite this ruling, Walker did not pay the trust corpus to Hogg, and Hogg filed a petition for a rule to show cause or for writ of attachment. Walker responded to the motion by contending that the proceeds had been dissipated, and there remained no corpus upon which the constructive trust could attach.

On September 10, 1992, the Vice Chancellor stated in a letter opinion that "constructive trust exists only insofar as a beneficiary can identify the trust property or proceeds," and that a beneficiary is not entitled to a general lien on the trustee's nontrust-related property. Accordingly, the court held that when Walker dissipated the corpus of the trust, a general lien could not be imposed on Walker's nontrust-related property. Thus, Hogg could not invoke equity's civil contempt power to compel Walker to disgorge what he did not possess.

The Court of Chancery denied a subsequent motion for reconsideration on two grounds. First, the motion was not timely filed. Second, even if timely filed, the court considered the motion to be an attempt to "reargue [Hogg's] right to obtain a personal judgment against the defendant" for breach of trust. The court stated that it had not made any determination that Walker had violated his fiduciary duties as constructive trustee.

II.

In denying the motion for a Rule to Show Cause, the Court of Chancery ruled that enforcement of the constructive trust was prevented by the absence of a trust *res.* We review such conclusions as a question of law. *See Fiduciary Trust Co. v. Fiduciary Trust Co.,* Del.Supr., 445 A.2d 927, 930 (1982).

***652** **[1]** **[2]** **[3]** The doctrine of constructive trust effectuates the principle of equity that one who would be unjustly enriched, if permitted to retain property, is under an equitable duty to convey it to the rightful owner. It is an equitable remedy of great flexibility and generality, and is viewed as "a remedial [and] not a substantive" institution. *McMahon v. New Castle Associates,* Del.Ch., 532 A.2d 601, 608 (1987); Restatement of Restitution § 160. As Judge Cardozo stated in *Beatty v. Guggenheim Exploration Co.:*

> A constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee.

225 N.Y. 380, 122 N.E. 378, 380 (1919). A constructive trust is not designed to effectuate the presumed intent of the parties, but to redress a wrong. When one party, by virtue of fraudulent, unfair or unconscionable conduct, is enriched at the expense of another to whom he or she owes some duty, a constructive trust will be imposed. *Adams v. Jankouskas,* Del.Supr., 452 A.2d 148, 152 (1982); *see also* Restatement of Restitution § 160, Comment d. Some fraudulent or unfair and unconscionable conduct is essential. *Greenly v. Greenly,* Del.Ch., 49 A.2d 126, 129 (1946).

[4] **[5]** **[6]** As a remedial measure, a constructive trust avoids a continuing relationship with the beneficiary by requiring transfer of the property to the plaintiff who has established an equitable entitlement. *See Adams v. Jankouskas,* Del.Supr., 452 A.2d 148 (1982); Restatement of Restitution § 160. Indeed, the only duty of the constructive trustee is to transfer the property to the equitable owner. *Simpson v. Dailey,* R.I.Supr., 496 A.2d 126, 128 (1985). Significantly, the duty to transfer the property relates back to the date of the wrongful act that created the constructive trust. *Andre v. Morrow,* Idaho Supr., 106 Idaho 455, 680 P.2d 1355, 1363 (1984); *Pioneer Annuity Life Insurance Company v. National Equity Life Insurance Company,* Ct.App., 159 Ariz. 148, 765 P.2d 550, 556 (1989).

[7] Historically, a constructive trust was impressed upon specific property and the legal owner was required by equity to hold that property as if upon a trust. However, Hogg does not seek to impress specific property *per se,* but rather the monetary proceeds resulting from the specific property,

namely the sale of the house. The constructive trust is a remedy that relates to specific property or identifiable proceeds of specific property. *McMahon v. New Castle Associates,* Del.Ch., 532 A.2d 601, 608 (1987); *Accord,* Restatement of Restitution § 160, comment a (1937).

The constructive trust concept has been applied to the recovery of money, based on tracing an identifiable fund to which plaintiff claims equitable ownership, or where the legal remedy is inadequate—such as the distinctively equitable nature of the right asserted. *See, e.g., Adams v. Jankouskas,* Del.Supr., 452 A.2d 148 (1982). In *Adams* the relationship between plaintiff and the decedent, against whose estate he made claim, was one uniquely cognizable in equity. It was a case "in which joint funds were committed in obvious trust to one partner and then pooled to purchase property and make investments for the mutual benefit of both." *Adams,* 452 A.2d at 153. When a trustee-beneficiary relationship exists there is a conclusive presumption in equity that "a trustee dissipates or spends his or her own funds first, before touching or encroaching upon the trust funds." *People v. Barrett,* 405 Ill. 188, 90 N.E.2d 94, 98 (1950); *see also Brown & Williamson Tobacco Corp. v. First National Bank,* 504 F.2d 998, 1002 (7th Cir.1974); *Importers' and Traders' Bank v. Peters,* 123 N.Y. 272, 25 N.E. 319 (1890).

III.

A.

[8] **[9]** Courts of equity have full jurisdiction to relieve against fraud or mistake, and that power extends to cases where a person has procured a deed to property rightfully belonging to another. *See Meader* ***653** *v. Norton,* 78 U.S. (11 Wall.) 442, 457–58, 20 L.Ed. 184 (1870). Where one party has acquired the legal right to property to which another has the better right, a court of equity will convert that person into a trustee of the true owner, and compel him or her to convey the legal title. *Id.*

[10] A breach of trust, or, in other words of duty, by a trustee is a violation of a correlative right of the beneficiary, and gives rise to liability on the part of the trustee and a correlative cause of action on the part of the beneficiary for any loss to the trust estate. *Citizens & Southern Nat. Bank v. Haskins,* 254 Ga. 131, 327 S.E.2d 192, 197 (1985). The rule is applicable to positive acts, as well as omissions or negligence, which constitute a breach of duty by the trustee. *Cartee v. Lesley,* 290 S.C. 333, 350 S.E.2d 388, 390 (1986).

[11] **[12]** A trustee's liability for a breach of trust is personal in character with all the consequences and incidents of personal liability. *In re Jacobs,* 91 N.C.App. 138, 370 S.E.2d 860, 865 (1988). A trustee may be required, because of past loss of the trust corpus, to use his or her own resources to replenish the corpus. Since the liability is a personal one, it is not part of the corpus of the trust estate which the beneficiary can follow into the hands of the personal representative of the trustee, and, in respect of such liability, the beneficiary must proceed as a general creditor against the estate. *See* 76 Am.Jr.2d *Trusts* § 367.

B.

[13] The thrust of Walker's argument is that a constructive trustee is shielded from personal liability for his or her actions unless the trustee is sued in an action at law. However, neither a trust estate nor trust property are recognized as separate legal entities which immunize a trustee from the consequences of misconduct. George Gleason Bogert, The Law of Trusts and Trustees §§ 718, 731 (rev. 2d ed. 1982); *In re Jacobs,* 91 N.C.App. 138, 370 S.E.2d 860, 865 (1988). Moreover, general common law principles hold that a trustee's breach of trust subjects that fiduciary to personal liability in the nature of a surcharge. IIIA Austin Wakeman Scott, The Law of Trusts, § 261 (4th ed. 1988); 76 Am.Jur.2d *Trusts* § 304. *See generally, Pennsylvania Company v. Wilmington Trust Company,* Del.Ch., 186 A.2d 751 (1962); *aff'd sub nom., Wilmington Trust Company v. Coulter,* Del.Supr., 200 A.2d 441 (1964).

[14] When a plaintiff succeeds in enforcing a constructive trust, courts treat that beneficiary as if he or she were enforcing a duty to deliver property under an express trust. George Gleason Bogert, The Law of Trusts and Trustees § 471, at 6–7 (2d ed. 1982); *Capital Investors Co. v. Executors of Estate of Morrison,* 800 F.2d 424, 427 (4th Cir.1986); *Buffum v. Peter Barceloux Co.,* 289 U.S. 227, 237, 53 S.Ct. 539, 543, 77 L.Ed. 1140 (1933). As a result, an enforcing plaintiff has the right to receive the property or its proceeds from the constructive trustee, *Soderstrom v. Kungsholm Baking Co.,* 189 F.2d 1008, 1013 (7th Cir.1951); *White v. Roberts,* Mo.Ct.App., 637 S.W.2d 332 (1982), George Gleason Bogert, The Law of Trusts and Trustees § 866 (2d ed. 1982), as well as the right to receive a money judgment for

property received against the constructive trustee. *Meadows v. Bierschwale,* Tex.Supr., 516 S.W.2d 125 (1974); *Baron Bros. Co. v. Stewart,* 182 F.Supp. 893 (S.D.N.Y.1960), Restatement of Restitution § 202 (1937). In fact, where it is necessary to make the successful plaintiff whole, courts have been quite willing to allow the plaintiff to recover a portion of the trust property or its proceeds along with a money judgment for the remainder. *Meadows v. Bierschwale,* Tex.Supr., 516 S.W.2d 125 (1974); *Church v. Bailey,* 90 Cal.App.2d 501, 203 P.2d 547 (1949); *Van Blarcom v. Van Blarcom,* 124 N.J.Eq. 19, 199 A. 383 (1938); George Gleason Bogert, The Law of Trusts and Trustees § 867, at 72–73 (2d ed. 1982).

Analogous support can be found in Delaware law. For example, it is settled that when equity obtains jurisdiction over some portion of a controversy, it will proceed to decide the whole controversy and give complete ***654** and final relief. As this Court has stated:

> [T]his suit falls within a field of original equity jurisdiction.... This being the case, it is settled law that when equity obtains jurisdiction over some portion of the controversy it will decide the whole controversy and give complete and final relief, even though that involves the grant of a purely law remedy such as a money judgment. Therefore, even though the judgment below be regarded as in part at least a judgment for money, which we think not, that lies within the power of the Vice Chancellor to order.

Wilmont Homes, Inc. v. Weiler, Del.Supr., 202 A.2d 576, 580 (1964) (citations omitted). *See also Wilmington Trust Co. v. Barry,* Del.Super., 397 A.2d 135 (1979); *New Castle County Volunteer Firemen's Assn. v. Belvedere Volunteer Fire Co.,* Del.Supr., 202 A.2d 800 (1964). Equitable relief, including damages, if appropriate, will be tailored to suit the situation as it exists. *Tenney v. Jacobs,* Del.Supr., 240 A.2d 138 (1968). "While a court of equity has no jurisdiction to entertain a suit brought purely for compensatory damages, those being awarded at law, it may nevertheless award compensatory damages as a part of the final relief in a cause over which it admittedly has jurisdiction." *Tull v. Turek,* Del.Supr., 147 A.2d 658 (1958); *accord, Anzilotti v. Andrews Construction Co.,* Del.Ch., 115 A.2d 493 (1955).

C.

[15] In denying Hogg's motion for reconsideration, the Vice Chancellor stated that he had made no determination that Walker was liable for a breach of trust or that Walker had "violated his fiduciary duties as constructive trustee on behalf of the beneficiary, Monica Hogg." That is not a correct treatment of the law. As we noted in *Adams v. Jankouskas,* Del.Supr., 452 A.2d 148, 152 (1982), the imposition of a constructive trust implies a duty on the part of the constructive trustee. In this case, the duty of Walker was to transfer the proceeds of the trust corpus to Hogg. In failing to perform that duty, he breached his trust obligation.

[16] **[17]** The fact that the *res* of the trust was dissipated does not foreclose an equitable remedy to make Hogg whole. The Court of Chancery has a number of equitable powers at its disposal. The court can order the constructive trustee to account for the trust property. *See* George Gleason Bogert, The Law of Trusts and Trustees § 963, at 40–44 (2d ed. 1982). For a failure to account as required by court order, the constructive trustee may be surcharged or be required to pay compensatory damages. *Id.* at 61. It is an established principle of law in Delaware that a surcharge is properly imposed to compensate the trust beneficiaries for monetary losses due to a trustee's lack of care in the performance of his or her fiduciary duties. *See Wilmington Trust Co. v. Coulter,* Del.Ch., 200 A.2d 441, 452 (1964). Another possible remedy includes a personal judgment against Walker.

The range of remedies is particularly important here. Although Walker sold the house in 1987, the constructive trust was not imposed until 1989. It is, of course, entirely possible that the proceeds were dissipated by the time of the trust's imposition. That, however, does not defeat the effect of the trust, which relates back to the date of the sale of the house. *Andre v. Morrow,* 106 Idaho 455, 680 P.2d 1355, 1363 (1984); *Pioneer Annuity Life Insurance Company v. National Equity Life Insurance Company,* Ct.App., 159 Ariz. 148, 765 P.2d 550, 556 (1989). Thus, the trial court has broad latitude to exercise its equitable powers to craft a remedy. Its failure to do so under all of the circumstances here was an error of law.

The judgment of the Court of Chancery is REVERSED.

All Citations

622 A.2d 648

Footnotes

1 The record does not establish whether the personal loan was used to pay off the installment sales contract. However, the Vice Chancellor determined that question to be irrelevant.

End of Document

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426 B.R. 511
United States Bankruptcy Court, D. Delaware.

In re AE LIQUIDATION, INC., et al., Debtors.
Over and Out, Inc., et al., Plaintiffs,
v.
Eclipse Aviation Corp., et al., Defendants.

Bankruptcy No. 08–13031 (MFW)
|
Adversary No. 09–50029(MFW)
|
April 9, 2010.

Synopsis
Background: Customers who had placed deposits with debtor-jet manufacturer toward purchase of single-engine aircraft that debtor was developing brought adversary proceeding against debtor, alleging breach of deposit agreements, conversion, and breach of fiduciary duty and seeking damages, imposition of constructive trust, and injunctive relief. After case was converted from Chapter 11 and Chapter 7 trustee sold debtor's assets, noteholders that asserted secured claim against substantially all of debtor's assets intervened and moved to dismiss claims for constructive trust and injunction.

Holdings: The Bankruptcy Court, Mary F. Walrath, J., held that:

[1] allegations underlying customers' conversion claim asserted wrongful conduct sufficient to support imposition of constructive trust;

[2] allegations underlying customers' claim for breach of fiduciary duty asserted wrongful conduct sufficient to support imposition of constructive trust; and

[3] customers sufficiently alleged facts to identify res, as required to state claim for imposition of constructive trust under New Mexico law.

Motion denied.

West Headnotes (7)

[1] **Bankruptcy** Rights of Action Against Trustee or Debtor
Bankruptcy Intervention

Customers' requests for imposition of constructive trust and for injunction barring debtor or its estate from retaining or using customers' prepetition deposits were claims for remedies based on customers' claims alleging conversion and breach of fiduciary duty, rather than independent causes of action, and therefore noteholders acted within scope of stipulation permitting them to intervene as to constructive trust and injunction claims by filing motion to dismiss those claims, even though, in doing so, they had to reference other counts of adversary complaint.

[2] **Trusts** Fraud or other wrong in acquisition of property in general

Allegations underlying customers' conversion claim against jet manufacturer asserted wrongful conduct sufficient to support imposition of constructive trust under New Mexico law where customers asserted that deposits transferred to manufacturer pursuant to deposit agreements belonged to customers, that manufacturer agreed to hold deposits for customers' benefit, and that manufacturer unlawfully exercised dominion over customers' property by refusing to return deposits to them.

[3] **Trusts** Fraud or other wrong in acquisition of property in general

Type of wrongful conduct which warrants imposition of a constructive trust under New Mexico law is any breach of any legal or equitable duty or the commission of a wrong.

1 Case that cites this headnote

[4] **Trusts** Breach of Duty by Person in Fiduciary Relation in General

Allegations underlying customers' claim against jet manufacturer for breach of fiduciary duty asserted wrongful conduct sufficient to support imposition of constructive trust under New Mexico law where customers alleged that manufacturer was acting in fiduciary capacity by agreeing to receive and hold deposits for customers and that manufacturer breached its fiduciary duty by refusing to return deposits in accordance with terms of deposit agreements.

[5] **Trusts** Nature of constructive trust

Under New Mexico law, imposition of a constructive trust does not depend on the parties' intent.

1 Case that cites this headnote

[6] **Trusts** Breach of Duty by Person in Fiduciary Relation in General

In seeking imposition of constructive trust under New Mexico law, customers of debtor-jet manufacturer sufficiently alleged that debtor-manufacturer was required to segregate and return deposits that customers gave to debtor-manufacturer for use in developing new aircraft, and that debtor-manufacturer had fiduciary duty to customers that it breached by retaining and refusing to return deposits, such that constructive trust could be imposed even if narrow construction had to be given to that remedy in bankruptcy proceedings.

1 Case that cites this headnote

[7] **Trusts** Identification of Property

Customers of debtor-jet manufacturer alleged existence of a res, in form of deposits which they gave to debtor-manufacturer before it filed its bankruptcy petition, and which debtor acknowledged were segregated shortly before it filed petition, and therefore customers sufficiently alleged facts to identify res, as required to state claim for imposition of constructive trust under New Mexico law.

Attorneys and Law Firms

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Robert J. Stearn, Jr., Esquire, Cory D. Kandestin, Esquire, Richards, Layton & Finger, P.A., Wilmington, DE, for the Noteholders.

MEMORANDUM OPINION [1]

MARY F. WALRATH, Bankruptcy Judge.

Before the Court is the Motion of the Noteholders[2] to dismiss counts 4 and 5 of the Complaint filed by the Plaintiffs.[3] For the reasons stated below, the Court will deny the Motion.

I. *BACKGROUND*

Eclipse Aviation Corporation (the "Debtor") was a manufacturer of private jets with its principal place of business in Albuquerque, New Mexico. The Plaintiffs executed Eclipse 400 Aircraft Deposit Agreements (the "Agreements") with the Debtor pursuant to which the Plaintiffs deposited $100,000 (the "Deposits") toward ***513** the purchase of an Eclipse 400 single-engine aircraft that the Debtor was developing. Pursuant to the Agreements, the Debtor was to use the Deposits only for costs related to the development and production of the Eclipse 400 aircraft and not for general operating expenses. The Plaintiffs could receive a refund of the Deposits at any time before November 30, 2009. After that date, the Deposits were to be applied to the final purchase price of the Eclipse 400 aircraft or as liquidated damages if the Plaintiffs did not purchase an Eclipse 400 aircraft. The Deposits received from the Plaintiffs totaled not less than $3.2 million.

In August 2008, the Debtor advised its customers that the development of the Eclipse 400 aircraft had been placed on hold. In September 2008, the Debtor stated in a conference call with customers that none of the Deposits had been spent and were still segregated in accordance with the Agreements.

Several of the Plaintiffs filed Eclipse 400 Refund Request Forms with the Debtor, but none of the Plaintiffs received any refund of their Deposits from the Debtor.

On November 25, 2008, the Debtor filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code. The Debtor sought to sell all of its assets pursuant to proposed bid procedures. The Court approved the bid procedures, with substantial modification, on December 23, 2008.

On January 15, 2009, the Plaintiffs commenced the instant adversary proceeding by filing a Complaint against the Debtor asserting the Debtor breached the Agreements, converted their money (the Deposits), and breached its fiduciary duty. As a result, the Plaintiffs seek, in addition to damages, the imposition of a constructive trust and an injunction prohibiting the Debtor from retaining or commingling the Deposits with the Debtor's general funds. On January 23, 2009, the Court entered an order authorizing the sale of substantially all of the Debtor's assets to EclipseJet Aviation International, Inc. ("EclipseJet") finding it had presented the highest and best offer. In conjunction with that sale, the Court directed that $3.2 million of the sale proceeds be set aside in a separate account until the issues raised by this adversary proceeding could be determined. Despite approval, the sale to EclipseJet was never consummated.

As a result, on March 5, 2009, the case was converted to chapter 7 and Jeoffrey L. Burtch was appointed trustee (the "Trustee"). The Trustee renewed efforts to sell the Debtor's assets. On August 28, 2009, the Court authorized the Trustee to sell the Debtor's assets to Eclipse Aerospace, Inc., for $20 million in cash and a $20 million note. Once again, as a result of the Plaintiffs' Limited Objection to the sale, the Court directed that $3.2 million of the sale proceeds be set aside pending resolution of this adversary proceeding. The sale to Eclipse Aerospace, Inc., closed on September 4, 2009.

The Plaintiffs, the Trustee and the Noteholders consented to the intervention of the Noteholders in the adversary proceeding, which was granted on September 28, 2009. On October 13, 2008, the Noteholders filed a Motion to dismiss counts 4 (constructive trust) and 5 (injunction) of the Complaint. Briefing on the Motion was completed on December 8, 2009, and the matter is now ripe for decision.

II. *JURISDICTION*

The Court has subject matter jurisdiction over this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b) & 157(b)(1). This proceeding is a core matter pursuant to 28 U.S.C. § 157(b)(2)(A), (B), (K), (N), & (O).

***514** III. *DISCUSSION*

A. *Standard of Review*

A Rule 12(b)(6) motion to dismiss is designed to test the legal sufficiency of the factual allegations in the plaintiff's complaint. *Kost v. Kozakiewicz,* 1 F.3d 176, 183 (3d Cir.1993).

"Standards of pleading have been in the forefront of jurisprudence in recent years." *Fowler v. UPMC Shadyside,* 578 F.3d 203, 209 (3d Cir.2009). With the Supreme Court's recent decisions in *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007) and *Ashcroft v. Iqbal,* ——U.S. ——, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009), "pleading standards have seemingly shifted from simple notice pleading to a more heightened form of pleading, requiring a plaintiff to plead more than the possibility of relief to survive a motion to dismiss." *Fowler,* 578 F.3d at 210.

"Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements" are insufficient to survive a motion to dismiss. *Iqbal,* 129 S.Ct. at 1949. Rather, "all civil complaints must now set out sufficient factual matter to show that the claim is facially plausible." *Fowler,* 578 F.3d at 210. A claim is facially plausible "when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal,* 129 S.Ct. at 1949. Determining whether a complaint is "facially plausible" is "a context-specific task that requires the reviewing court to draw on its judicial experience and common sense. But where the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct, the complaint has alleged—but it has not shown—that the pleader is entitled to relief." *Id.* at 1950.

After *Iqbal,* the Third Circuit has instructed this Court to "conduct a two-part analysis. First, the factual and legal elements of a claim should be separated. The [reviewing court] must accept all of the complaint's well-pleaded facts as true, but may disregard any legal conclusions." *Fowler,* 578 F.3d at 210–11. Next, the reviewing court "must then determine whether the facts alleged in the complaint are sufficient to show that the plaintiff has a plausible claim for relief." *Id.*

B. *Noteholders' Motion to Dismiss*

The Noteholders move for dismissal of the claims for imposition of a constructive trust and for an injunction prohibiting the Debtor or its estate from retaining or using the Deposits.

1. *Scope of Intervention Stipulation*

[1] Preliminarily, the Plaintiffs assert that the Noteholders' Motion to Dismiss must be denied because it exceeds the scope of the stipulation providing for the Noteholders' intervention. *See, e.g., Gautreaux v. Pierce,* 743 F.2d 526, 530 n. 8 (7th Cir.1984) (affirming denial of motion which exceeded the limited scope of intervention). The Plaintiffs contend that the stipulation permitting the Noteholders' intervention was limited to counts 4 and 5 but that the Noteholders' Motion actually attacks the Plaintiffs' other claims.

The Plaintiffs concede, however, that counts 4 and 5 are claims for remedies for the Debtor's conversion (count 2) and breach of fiduciary duty (count 3) and are not independent causes of action. Therefore, the Court agrees with the Noteholders that their motion is not barred by the intervention stipulation. Their motion seeks to dismiss counts 4 and 5 for which they were permitted to intervene. To the extent that those counts are remedies for the other counts, as the Plaintiffs allege, ***515** the Noteholders must be able to reference those other counts to protect their interests. *Stone & Webster,* Adv. No. 088–51839, 2009 WL 426118, at *4–5 (Bankr.D.Del. Feb.18, 2009) (noting that accounting claim was an equitable remedy tied to breach of fiduciary duty claim and should not be dismissed because fiduciary duty claim was not dismissed).

2. *Constructive Trust*

[2] Under New Mexico law,[4] the Noteholders argue that for the imposition of a constructive trust there must be "unjust enrichment that would result if the person having the property were permitted to retain it." *Gushwa v. Hunt,* 145 N.M. 286, 197 P.3d 1, 7 (2008). They contend that unjust enrichment occurs only where there has been fraud, undue influence or abuse of a fiduciary relationship. The Noteholders argue that the Debtor's mere breach of the Agreements or failure to pay the Plaintiffs when they demanded return of the Deposits is insufficient to create a constructive trust. *McKey v. Paradise,* 299 U.S. 119, 122–23, 57 S.Ct. 124, 81 L.Ed. 75 (1936) ("The bankrupt was a debtor which had failed to pay its debt. We know of no principle upon which that failure can be treated as a conversion of property held in trust.... [T]he mere failure to pay a debt does not belong in that category."); *Marwin Prod. Sys., Inc. v. Pratt & Whitney Co. (In re Pratt & Whitney Co.),* 140 B.R. 327, 332 (Bankr.D.Conn.1992) (court refused to impose constructive trust where debtor failed to pay after repeated demands by the creditor finding that "the debtor has committed no wrongdoing outside of not paying."); *In re Rowland,* 140 B.R. 206, 209 (Bankr.S.D.Ohio 1992) (noting that "generally, a mere breach of contract is insufficient to raise a constructive trust.").

[3] The Plaintiffs respond that the cases where a constructive trust may be found under New Mexico law are extensive:

> [A] constructive trust ... is imposed to prevent the unjust enrichment that would result if the person having the property were permitted to retain it. The circumstances where a court might impose such a trust are varied. They may involve fraud, constructive fraud, duress, undue influence, breach of a fiduciary duty, or similar wrongful conduct.

Butt v. Bank of America, N.A., 477 F.3d 1171, 1185 (10th Cir.2007). The type of wrongful conduct which warrants imposition of a constructive trust is any "breach of any legal or equitable duty" or the "commission of a wrong." *Tartaglia v. Hodges,* 129 N.M. 497, 10 P.3d 176, 189 (N.M.App.2000) (affirming imposition of constructive trust). The Plaintiffs assert that they have adequately pled a wrong in counts 2 (conversion of their property) and 3 (breach of fiduciary duty).

[4] The Court agrees with the Plaintiffs that the allegations in counts 2 and 3, if proven, are sufficient to support the imposition of a constructive trust. In count 2, the Plaintiffs allege that under the Agreements the Deposits belong to the Plaintiffs and the Debtor agreed to hold them for the benefit of the Plaintiffs. They further allege that the Debtor unlawfully exercised dominion over the Plaintiffs' property when it refused to return the Deposits to them. In count 3, the Plaintiffs allege that by agreeing to receive and hold the Deposits for the benefit of the Plaintiffs, the Debtor was acting in a fiduciary capacity and that by refusing to return the Deposits in accordance with the terms of the Agreements, the Debtor ***516** breached that duty. These allegations, if proven, are sufficient for the imposition of a constructive trust under New Mexico law. *See, e.g., Butt,* 477 F.3d at 1185 (remanding to district court to find whether constructive trust should be imposed under New Mexico law where bank, though not acting under express trust, was alleged to have

kept profits that belonged to plaintiff); *Tartaglia,* 10 P.3d at 189 (stating that a constructive trust is imposed to prevent unjust enrichment whenever any wrongful conduct warrants it, including breach of a legal or equitable duty, fraud, duress, undue influence, abuse of a confidence or breach of fiduciary duty).

a. *Trust Relationship*

The Noteholders contend nonetheless that to impose a constructive trust, there must be a fiduciary relationship or the intent to enter into a trust relationship. To create a trust relationship, the Noteholders argue, the parties must objectively manifest their intent to enter into that type of relationship. *See, e.g., Aragon v. Rio Costilla Cooperative Livestock Assoc.,* 112 N.M. 152, 812 P.2d 1300, 1302 (1991) (stating that an express trust "arises as a result of a manifestation of an intention to create it."); *Tartaglia,* 10 P.3d at 188 ("an express trust is one that is created by the manifest intention of the settlor to create it.").

The Noteholders contend that there is nothing in the Agreements evidencing the parties' intent to create an express trust or fiduciary relationship. They note that nowhere in the Agreements are the words "trust" or "fiduciary." Further they contend that there are provisions in the Agreements that are inconsistent with such a relationship. For example, the Agreements allowed the Debtor to assign all of its obligations under the Agreements. *See* 3 Scott & Ascher on Trusts § 17.3.1 (5th ed.2007) ("a trustee clearly cannot transfer to another the whole responsibility for administering the trust."). The Agreements also provide that the Deposits will be forfeited as liquidated damages if the customers fail to execute final purchase agreements, which is inconsistent with an understanding that the Deposits are held in trust for the customer. (Agreements at § 3.)

Finally, the Noteholders argue that the Agreements provide that each Deposit of $100,000 provided the customer with a credit of $125,000 toward the purchase of the Eclipse 400 Aircraft (a bargained-for exchange, more consistent with a debtor-creditor relationship than a trust relationship). *See, e.g., Schrider v. Schlossberg (In re Greenbelt Rd. Second Ltd. P'ship),* No. 94–1522, 1994 WL 592766, at *3–4 (4th Cir. Oct.31, 1994) (dismissing complaint and denying imposition of constructive trust on earnest money deposit that had not been segregated); *In re Faber's, Inc.,* 360 F.Supp. 946, 950 (D.Conn.1973) (finding no constructive trust over pre-petition cash deposits that a debtor-retailer received from consumers for the purchase of goods). On very similar circumstances, the Noteholders argue, the District Court in *Drexel Burnham* found no trust:

> The Appellant's so-called deposit was not more than an ordinary payment of earnest money on account of a purchase of property.... The letter agreement expressing the contractual arrangement called for a down-payment, the so-called deposit, against the purchase price. The agreement made no requirement that the payment be segregated, trusteed, escrowed or otherwise be specially identified or separated in the seller's account or placed with anyone else for safekeeping or at interest. The letter agreement specifically provided that the Appellant's payment was to be nonrefundable, ***517** except in limited circumstances, in consideration of Group "foregoing [substantial other] opportunities." In short, there was no fiduciary arrangement contemplated or arranged.

Majutama v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 142 B.R. 633, 636 (S.D.N.Y.1992).

The Plaintiffs respond that the cases cited by the Noteholders are not persuasive because they deal with *express,* not *constructive* trusts, or apply law other than New Mexico law. *See, e.g., Greenbelt,* 1994 WL 592766, at *4 (applying Maryland law); *In re Morales Travel Agency,* 667 F.2d 1069, 1071–72 (1st Cir.1981) (applying Puerto Rico law); *Faber's,* 360 F.Supp. at 946 (applying Connecticut law); *Skilled Nursing Prof. Servs. v. Sacred Heart Hosp. of Norristown (In re Sacred Heart Hosp. of Norristown),* 175 B.R. 543, 554 (Bankr.E.D.Pa.1994) (applying Pennsylvania law); *Drexel Burnham,* 142 B.R. at 636 n. 2 (applying New York law); *Fox v. Shervin (In re Shervin),* 112 B.R. 724, 731 (Bankr.E.D.Pa.1990) (applying Pennsylvania law); *Aragon,* 812 P.2d at 1302 (dealing with express trusts). In fact, the *Sacred Heart* Court noted that "the parties' intent is largely irrelevant to the creation of a constructive trust, which is nothing more than an imposition of an equitable remedy." *Sacred Heart Hosp.,* 175 B.R. at 552.

[5] The Court agrees with the Plaintiff that the imposition of a constructive trust does not depend on the parties' intent under New Mexico law. Rather it is an equitable remedy available in the event of wrongdoing by the defendant. *See, e.g., Butt,* 477 F.3d at 1185 (remanding for determination of whether constructive trust should be imposed under New Mexico law after finding bank was not acting under express trust); *Tartaglia,* 10 P.3d at 189 (finding sufficient evidence for the imposition of a constructive trust based on findings of fraud, constructive fraud and a wrongful act in transferring

property so that express trust could not attach). Therefore, the Court finds the cases cited by the Noteholders to be unpersuasive and finds that New Mexico law supports the Plaintiffs' count for imposition of a constructive trust.

b. *Narrowly Construed*

[6] The Noteholders contend, however, that constructive trusts are construed narrowly in bankruptcy and that a typical debtor-creditor relationship is not sufficient to warrant the imposition of a constructive trust. *Ades & Berg Group Investors v. Breeden (In re Ades & Berg Group Investors),* 550 F.3d 240, 245 (2d Cir.2008) (affirming dismissal of complaint and noting that court must be "mindful, in applying state constructive trust law, that the equities of bankruptcy are not the equities of common law."); *Albuquerque Plaza Partners v. Carmichael (In re PKR, P.C.),* 220 B.R. 114, 118 (10th Cir. BAP 1998) ("[T]he relationship of creditor-debtor is [in]sufficient to support the imposition of a constructive trust under either New Mexico law or that of any other jurisdiction. If the retention of funds or goods by an insolvent debtor were sufficient to support a claim for a constructive trust, the entire bankruptcy system would be unworkable."); *Rowland,* 140 B.R. at 209 ("One who keeps property or retains the benefit of services without paying may be viewed as being unjustly enriched [but] this is precisely what occurs in many bankruptcy cases with respect to the claims of unsecured creditors.").

The Plaintiffs argue that the cases cited by the Noteholders are distinguishable. They contend that they have alleged in the Complaint that there existed a fiduciary ***518** duty to segregate the funds. Specifically, the Plaintiffs contend the Complaint alleges that the parties understood that the Deposits would be segregated and only used for development of the Eclipse 400 Aircraft. The Complaint alleges that the Debtor acknowledged that obligation when it advised the Plaintiffs in September 2008 that their Deposits had not been used and were segregated. In fact, the Plaintiffs argue that the mere fact that the funds paid were called Deposits evidences a heightened duty by the Debtor to preserve them. *See, e.g., Stone & Webster,* 2009 WL 426118 at *4 (holding that escrow agreement can give rise to a fiduciary relationship). These allegations, the Plaintiffs contend, distinguish this case from the cases cited by the Noteholders. *See, e.g., Drexel Burnham,* 142 B.R. at 633 (no requirement that the funds be segregated or an unconditional right to a refund); *Faber's,* 360 F.Supp. at 946 (no requirement to segregate funds); *Greenbelt,* 1994 WL 592766 (finding no constructive trust because plaintiff alleged that funds had not been segregated but commingled and were not traceable).

The Court agrees with the Plaintiffs that the Complaint contains sufficient allegations that the Debtor was required to segregate and return the Deposits. Further, the Complaint contains allegations that the Debtor had a fiduciary duty to the Plaintiffs which it breached. If proven, that is sufficient under New Mexico law to warrant the imposition of a constructive trust. *See, e.g., Butt,* 477 F.3d at 1185 (remanding with instructions to impose constructive trust if trial court finds that bank wrongfully withheld profits it received that should have gone to beneficial owner); *Tartaglia,* 10 P.3d at 189 (noting that breach of fiduciary duty would support imposition of constructive trust).

c. *Res*

[7] The Noteholders argue that even if a trust or fiduciary relationship existed, no constructive trust can be imposed unless property is segregated from the rest of the settlor's property. *See, e.g., Morales,* 667 F.2d at 1071–72 (holding that even though the agreement was called a trust, there was only a debtor-creditor relationship because "in the absence of any provision requiring Morales to hold the funds in trust by keeping them separate, and otherwise restricting their use, the label 'trust' could ... have no legal effect."); *Shervin,* 112 B.R. at 734 (finding no constructive trust because "there is no indication that there was an identified res of money, put apart and held separately and for the benefit of another."). The Noteholders argue that the Agreements did not require that the Deposits be segregated by the Debtor. In fact, the Agreements acknowledge that the refund of the Deposits was generally to come from the Debtor's general account not from any escrow or deposit account. (Agreements at § 1.) *See, e.g., Sacred Heart Hosp.,* 175 B.R. at 553–54 (finding no trust in part because the debtor could repay the sums due from whatever source he chose); *Shervin,* 112 B.R. at 734 (same).

The Noteholders contend, therefore, that the count for imposition of a constructive trust must fail because the Complaint does not, and cannot, allege that there was a res on which the constructive trust could attach. The Noteholders argue further that where the alleged trust funds have been commingled, as they allege they have been in this case, the Plaintiffs must identify and trace the trust funds in order to prevail. *See, e.g., Goldberg v. New Jersey Lawyers' Fund for Client Protection,* 932 F.2d 273, 280 (3d Cir.1991) (holding that plaintiff must "identify and trace the trust funds if they are commingled"); ***519** *PKR,* 220 B.R. at 118 (holding that

to show entitlement to constructive trust, plaintiff must "be able to trace the wrongfully-held property.").

In addition, the Noteholders assert that the funds which the estate currently holds are not traceable to the Deposits but are the proceeds of the sale of the Debtor's hard assets. (Sale Order ¶ 7.) Therefore, the Noteholders contend the constructive trust count of the Complaint must be dismissed. *See, e.g., Greenbelt Road,* 1994 WL 592766, at *4 (affirming bankruptcy court's dismissal of complaint seeking imposition of constructive trust because complaint acknowledged that funds were not segregated and thus could not be traced).

The Plaintiffs respond that the Complaint does identify a res. The Complaint asserts that the Debtor represented to the Plaintiffs in September 2008 that their Deposits had not been used and were segregated. That identifies a res: the Deposits themselves that the Debtor was holding. The Plaintiffs further assert that they need trace the funds only if the Deposits were not segregated, a fact that is not alleged in the Complaint and which has yet to be established. The Plaintiffs contend, however, that even if the funds were commingled, they would be able to trace their funds by use of the lowest intermediate balance test. *See, e.g., In re Columbia Gas Sys., Inc.,* 997 F.2d 1039, 1063 (3d Cir.1993) ("The lowest intermediate balance rule ... allows trust beneficiaries to assume that trust funds are withdrawn last from a commingled account.... Therefore, the lowest intermediate balance in a commingled account represents trust funds that have never been dissipated and which are reasonably identifiable."); *Goldberg,* 932 F.2d at 280 (holding that plaintiff must "identify and trace the trust funds if they are commingled"). The Plaintiffs assert that the allegations of the Complaint (that Deposits in increments of $100,000 were made by the Plaintiffs in June and July 2008) are sufficient to allow for a tracing if it becomes necessary.

The Court concludes that on the face of the Complaint (which it must accept as the facts), the Plaintiffs have identified a res (the Deposits paid by them to the Debtor) which the Debtor acknowledged was segregated as late as September 2008, shortly before the Debtor filed its bankruptcy petition in November 2008. Thus the Plaintiffs have stated sufficient facts to identify a res and to state a facially plausible count for a constructive trust and the Court will not dismiss that count.

3. *Priority of Noteholders' Liens*

The Noteholders assert that they hold valid and perfected liens on substantially all of the Debtor's assets, which liens attached to the proceeds of the sale, including the funds currently held in escrow. (Cash Collateral Order ¶¶ E–G; Sale Order ¶¶ K, 7a.) The Noteholders contend that because there is no identifiable and traceable res, a constructive trust may not supersede their perfected security interests in the proceeds of the sale of the Debtor's assets. *See, e.g., In re Lehigh & New England Ry. Co.,* 657 F.2d 570, 582 (3d Cir.1981) ("trust fund claimants, who are unable to identify the funds set aside for them, may not invade a secured bondholder's interest."); *In re U.S. Lan Sys. Corp.,* 235 B.R. 847, 855 (Bankr.E.D.Va.1998) ("a constructive trust—if allowable at all—can attach only to those proceeds from the sale of the debtor's assets that are unencumbered.").

However, as noted above, the Court has found that the Plaintiffs have alleged a res on which their constructive trust attached: the Deposits which the Debtor had represented were still segregated shortly before the bankruptcy petition was filed. The ***520** cases cited by the Noteholders are, therefore, distinguishable. *Lehigh & New England Ry. Co.,* 657 F.2d at 578 (the proceeds had been commingled and all had been dissipated); *U.S. Lan Sys.,* 235 B.R. at 849 (fund on which employees sought to impose constructive trust had never been segregated). *Cf. In re General Coffee Corp.,* 828 F.2d 699, 706 (11th Cir.1987) (concluding that under Florida law "a constructive trust beneficiary should have the same rights to the trust assets that a beneficiary of an express trust would have. An express trust beneficiary clearly has priority to trust assets over a judicial lienholder or execution creditor.").

IV. *CONCLUSION*

For the foregoing reasons, the Court concludes that the Noteholders' Motion to dismiss will be denied.

An appropriate Order is attached.

ORDER

AND NOW, this **9th** day of **APRIL, 2010,** after consideration of the Motion of the Noteholders to dismiss counts 4 and 5 of the Plaintiffs' Complaint and the Plaintiffs' opposition thereto, it is hereby,

ORDERED that the Motion to Dismiss is **DENIED.**

cc: Steven M. Yoder, Esquire[1]

All Citations

426 B.R. 511, 53 Bankr.Ct.Dec. 18

Footnotes

1 In this Memorandum Opinion, the Court makes no findings of fact and conclusions of law. Fed. R. Bankr.P. 7052 (applying Fed.R.Civ.P. 52(a) which provides that "[f]indings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12...."). The facts recited are those alleged in the Complaint or reflected in the docket of this adversary proceeding and the bankruptcy case.

2 The Noteholders are Kings Road Investments, Ltd., Citadel Investment Group, L.L.C., and HBK Master Fund, L.P., who assert a secured claim against substantially all the assets of the Debtor.

3 The Plaintiffs are Over And Out, Inc.; Louisiana, N400EA; Ocala Bedrock, Inc.; The Kenneth and Shair Meyer Trust; The Gray Oil & Gas Co.; Michael T. Flynn; Richard A. Smith; James Frisbie; Team Aircraft, Inc.; Max J. Cohen; Joseph J. Rusin/Northwest Ohio Int'l, LLC; Shaun Hughes; Henry Orlosky; Peter Riechers; Michael Osborne Peter Schultz; Management Tech, LLC; Robert H. Yarbrough; Linde Int'l, Inc.; Davis Air, LLC; Julian Macqueen; Richard Ryan; Jeff Reynolds; K2 Jet, LLC; James Teng; Black Falcon Aviation & Consulting, LLC; Gulfstream Nautical; Dan Mudge; and Gray & Co., Inc.

4 The Agreements are governed by New Mexico law. (Agreements at § 6.)

1 Counsel is to serve a copy of this Memorandum Opinion and Order on all interested parties and file a Certificate of Service with the Court.

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2018 WL 6191949
Only the Westlaw citation is currently available.
United States Bankruptcy Court, D. Delaware.

IN RE: GREEN FIELD ENERGY SERVICES, INC., et al., Debtors.
Alan Halperin, as Trustee of the GFES Liquidation Trust, Plaintiff,
v.
Michel B. Moreno; MOR MGH Holdings, LLC; Frac Rentals, LLC; Turbine Generation Services, LLC; Aerodynamic, LLC; Casafin II, LLC, Defendants.

Case No. 13-12783(KG)
|
Adv. Pro. No. 15-50262(KG)
|
Signed 11/28/2018

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Chapter 11

KEVIN GROSS, U.S.B.J.

Re D.I. No. 474

OPINION AND FINDINGS OF FACT AND CONCLUSIONS OF LAW

I. INTRODUCTION[1]

***1** This Opinion follows the trial in the adversary proceeding on March 19-23, 2018, and May 1-2, 2018. The parties are plaintiff Alan Halperin, as Trustee of the GFES Liquidation Trust ("Trustee" or "Plaintiff"), and defendants Michel B. Moreno ("Moreno"), MOR MGH Holdings, LLC ("MGH Holdings"), Frac Rentals, LLC ("Frac Rentals"), Aerodynamic, LLC ("Aerodynamic"), Casafin II, LLC ("Casafin"), and Turbine Generation Services, LLC ("TGS" and together with Moreno, MGH Holdings, Frac Rentals, Aerodynamic, and Casafin, "Defendants"). At trial, the Court heard live testimony from Moreno, Ted McIntyre ("McIntyre"), former officer and director Enrique Fontova ("Fontova"), former director Charles Kilgore ("Kilgore"), and the experts presented by both parties, Christopher J. Kearns ("Kearns") (for the Trustee) and Rodney W. Sowards ("Sowards") (for Defendants). The Court also considered extensive stipulated facts, and reviewed prior deposition testimony from both live witnesses and witnesses who were outside the district and had not volunteered to testify at trial.[2]

The Trustee filed this adversary proceeding on April 6, 2015, following confirmation of the plan of liquidation of debtors Green Field Energy Services, Inc., *et al.* (the "Debtor" or "Green Field"). Before its bankruptcy in 2013 and ultimate liquidation in 2014, Debtor was an oil services business. It differentiated itself by using frac pressure pumps powered by aero-derivative turbine engines. The use of this technology allowed Green Field to operate and compete on a smaller footprint with more fuel flexibility, including natural gas or field gas, as opposed to diesel fuel traditionally used by competitors.

Within months of closing on a high-yield bond offering in 2011, and in the midst of Green Field's ramp up, the demand for frac services declined, causing liquidity problems and creating the need for Debtor to find alternative sources of capital. Moreno's search for capital led him to General Electric Company and its affiliate GE Oil & Gas, LLC

("GEOG" and, collectively with General Electric Company, "GE"), which expressed interest in an even newer start-up joint venture under which Moreno or Green Field would produce turbine-powered power generator units (instead of turbine-powered frac pumps) to be leased to the same producers targeted by Debtor for its traditional oil services.

The Trustee's Complaint[3] originally pleaded 35 counts in four broad categories: (1) Counts 1-10 related to the transfer of the so-called power generation business ("PowerGen" or "power generation") opportunity; (2) Counts 11-14 related to the two share purchase agreements; (3) Counts 15-26 related to various alleged preferential and/or fraudulent transfers; and (4) Counts 27-35 sought disallowance and/or subordination of various administrative claims and proofs of claim filed by Moreno and/or entities he controls.

***2** The Trustee has settled and dismissed Causes of Action ("Count") 9, and 10, against all Director Defendants. The Trustee also settled Counts 11 and 33 as against one of Debtor's former shareholders— Moody, Moreno and Rucks, LLC ("MMR"), which was dismissed from this proceeding. The Trustee also voluntarily withdrew Counts 4, 5, 13, 15, 16, 17, 18, 20, 22, 25, and 26.

On January 24, 2018, the Court entered a Memorandum Opinion and Order on the parties' cross motions for partial summary judgment (D.I 463, 464) (the "SJ Opinion"), resolving Counts 19, 23, 24, 30, 31, 34, and 35. As a result of the Court's partial ruling in the SJ Opinion, the Trustee voluntarily withdrew Count 21.

By two subsequent orders on both parties' motions to reconsider and to amend (Memorandum Order Denying Motion to Reconsider, D.I. 473; Memorandum Order re Motion to Amend, D.I. 476), the Court clarified its SJ Opinion concerning the share purchase agreement theories under Counts 11 and 12, and the Court narrowed issues for trial on Moreno's alleged "transfer beneficiary" liability which the Trustee asserts under 11 U.S.C. § 550(a)(1) in Counts 19, 23 and 24.

Accordingly, the issues presented for trial included:

1) Counts 1, 2, 3, 6 and 7 – fraudulent transfer, breach of fiduciary duty and corporate waste claims against Moreno and TGS related to the alleged transfer or waiver of the power generation business;[4]

2) Counts 11, 12 and 14 – breach of contract, breach of fiduciary duty and tortious interference claims against MGH Holdings and Moreno related to the alleged breaches of the two SPA contracts between Debtor and MGH Holdings; and

3) Counts 19, 23 and 24 – Moreno's personal liability for any avoidable transfers under the "transfer beneficiary" theory of 11 U.S.C. § 550(a)(1).

II. BASIS FOR JURISDICTION

The Trustee and Defendants have agreed that counts 1, 2, 19, 23 and 24 are statutorily "core" claims within the meaning of 28 U.S.C. § 157(b)(2). They have also agreed that counts 3, 6, 7 and 14 are "non-core" claims. *See* D.I. 288. The Trustee and Defendants dispute whether Counts 11 and 12 are core claims. MGH Holdings has not filed a claim in Green Field's bankruptcy case. Therefore, the Court finds that the Trustee's claims against MGH Holdings for pre-petition breaches of two pre-petition contracts are not "core" claims under 28 U.S.C. § 157(b)(2).

The Trustee consents to the Court's entry of final orders or judgments in connection with this adversary proceeding. The Trustee also asserts that the Court has statutory and constitutional authority to enter final orders or judgments with respect to the core claims at issue in this case. 28 U.S. C. § 157(b)(2); *In re Millennium Lab Holdings II, LLC*, 575 B.R. 252, 261–62 (Bankr. D. Del. 2017) (holding that *Stern v. Marshall,* 564 U.S. 462, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011), does not prevent a bankruptcy judge from entering final orders in statutorily core proceedings).

***3** Defendants do not consent to the Court's entry of final orders or judgments with respect to the non-core claims in this adversary proceeding. Defendants have not consented to the Court's constitutional authority to enter final judgment in this matter. They have expressly reserved such rights since Defendants' initial filings in this proceeding. The Court will enter judgment on the core claims and will issue proposed findings of fact and conclusions of law for the non-core claims.

The Court finds that it has both statutory and constitutional authority to enter final orders or judgments with respect to the statutorily core claims at issue in this case. 28 U.S.C. § 157(b)(2); *Burtch v. Seaport Capital, LLC (In re Direct Response*

Media, Inc.), 466 B.R. 626, 644 (Bankr. D. Del. 2012) (adopting the "narrow interpretation" of *Stern v. Marshall*, 564 U.S. 462, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011), holding that Stern "only removed a non-Article III court's authority to finally adjudicate one type of core matter, a debtor's state law counterclaim asserted under § 157(b)(2)(C)"). With respect to the non-core claims, these Findings of Fact and Conclusions of Law will constitute proposed findings of fact and conclusions of law under 28 U.S.C. § 157(c)(1) and Federal Rule of Bankruptcy Procedure 9033(a).

III. FINDINGS OF FACT

A. Background

Moreno served as Chief Executive Officer for Dynamic Industries for approximately 10 years, until 2007, when he sold his majority interest to a third-party investor. Trial Tr. 489-92. When he first acquired Dynamic Industries, it performed offshore welding and maintenance on offshore rigs. *Id.* The business evolved into a full-service fabrication, integration and maintenance business that built, installed and commissioned large-scaled floating production storage and off-loading units all over the world. *Id.* Thereafter, Moreno transitioned out of his management of Dynamic and formed MMR with two business partners and invested in various businesses in the energy industry. Stipulation No. 11.[5] One such investment was Hub City Industries, L.L.C ("Hub City").

B. Formation of Green Field

1. Hub City to Green Field

Hub City was a traditional oil and gas well-related service company that was originally formed in 1969. Stipulation Nos. 28-31. Such traditional services included cementing, coiled tubing, pressure pumping, acidizing, nitrogen and other pumping services. Stipulation No. 30. Prior to Moreno's involvement with Hub City, the company had begun working with inventor McIntyre on a new technology that would utilize used turbine engines to power various pumping technologies. Trial Tr. 1517:16 – 1519:24. In December 2010, Hub City began offering hydraulic fracturing services to its customer base. Stipulation No. 31.

Moreno first began investing in Hub City with two of his partners through MMR in 2005 or 2006, when McIntyre first began developing his turbine-powered frac pump. Trial Tr. 1517:16 – 1519:24. At the time, Moreno was still working with Dynamic Industries and had no direct involvement in Hub City's operations or management. Trial Tr. 507-08. Also during this period, McIntyre, an expert in unconventional applications for aero derivative turbine engines, was working with Hub City on an application of the aero derivative turbines to power Hub City's newer pressure pumping operations. Trial Tr. at 503-05. McIntyre later obtained a trademark on his pressure pumping technology under the mark "Frac Stack Pack."[6] He also sought but was denied a patent on the use of turbine engines to power and control frac pumps. Trial Tr. 1552:6-11.

***4** A recapitalization and buyout of Hub City's members began in May 2011 and in September 2011, Hub City changed its name to Green Field Energy Services, LLC. Stip. Facts ¶ 32. Upon conversion to a Delaware corporation in October 2011, the LLC changed its name to Green Field Energy Services, Inc. Stip. Facts ¶ 36. The recapitalization and buyout resulted in MOR MGH Holdings, LLC ("MOR MGH") owning 88.9% of Green Field's common stock and MMR, an entity owned 33.3% by Moreno, owning 11.1% of Green Field's common stock. Stip. Facts ¶¶ 32- 33; PX 142 at p. 5.

Moreno became the Chairman of the Board of Directors of Green Field and Chief Executive Officer in October 2011 and remained Chairman and CEO until Green Field's liquidation. Stip. Facts ¶ 37. Fontova became the President of Green Field and a director in October 2011 and remained in those positions until approximately October 2013. Stip. Facts ¶ 39. Earl Blackwell ("Blackwell") was Chief Financial Officer of Green Field from 2009 until Green Field's liquidation. Stip. Facts ¶ 40. Kilgore and Mark Knight ("Knight") also became directors of Green Field in October 2011 and remained directors until October 2013. Stip. Facts ¶¶ 41, 42.

2. Partnership with McIntyre and TPT

McIntyre is the President and Chief Operating Officer of Marine Turbine Technologies, LLC ("Marine Turbine"), as well as the manager of TPT. Trial Tr. 1497:3-24. TPT is a 50-50 joint venture between Green Field and McIntyre, which McIntyre holds through another entity, MTT Properties, LLC ("MTT Properties"). Trial Tr. 1498:2-10. Marine Turbine was incorporated in 1990 and is owned solely by McIntyre through MTT Properties. Trial Tr. 1497:19 – 1498:10.

As it relates to Green Field and the frac pump business, McIntyre's work began as early as 2004 when a company

contacted Marine Turbine about producing a frac pump with a turbine engine on top. Trial Tr. 1500:2-12; McIntyre Depo. Tr. 9:9 – 10:5. This led to McIntyre starting to develop his frac pump in 2006 and 2007 within a new entity called Turbine Stimulation Technologies ("TST"), which, at the time, was jointly owned by McIntyre and the previous owners of Hub City. Trial Tr. 1507:22 – 1508:21; McIntyre Depo. Tr. 9:9 – 11:4.

McIntyre simultaneously entered into a Capital Contribution/ Assignment Agreement, dated September 22, 2011, pursuant to which MTT Properties assigned to TPT its right, title, and interest in and to the "Invention." PX 102. An Amended and Restated Assignment Agreement executed less than a month later on October 17, 2011, modified the assignment to make it more inclusive and expansive by adding MTT Manufacturing, LLC, another entity owned by McIntyre. JX 7. The Amended and Restated Assignment Agreement assigned to MTT Properties all rights, title and interest in and to the Invention as well as an additional assignment of all rights, title and interest in and to any Intellectual Property relating to the Frac Stack Pack Technology. JX 7; Trial Tr. 1555:18- 1556:18.

When Moreno took over Hub City (now Green Field) in 2011, there were discussions about Green Field simply purchasing McIntyre's entire Marine Turbine business. Trial Tr. 1510:11 – 1512:22. However, Moreno and McIntyre could not agree on a value for McIntyre's unrelated intellectual property portfolio, which included firefighting, boats, motor vehicles and power generation. *Id.* Thus, as a compromise, they formed TPT as a joint venture. Trial Tr. 1510:11 – 1512:22, 127:14 – 128:11, 511-13. TPT was thus formed in September of 2011, with McIntyre being appointed as the manager. JX 6. In exchange for Green Field's agreement to fund TPT's overhead and expenses (JX 6, Trial Tr. 1523:11-20), McIntyre agreed to contribute his Frac Stack Pack technology and assign all interests in the Frac Stack Pack technology to TPT. JX 7, JX 8; Trial Tr. 1510:11 – 1512:22, 127:14 – 128:11. The contribution and assignment agreements to TPT in September of 2011 are specific. They are limited to McIntyre's Frac Stack Pack pressure pumping invention. There is no mention in those documents of power generation or any other technology developed by McIntyre or his company, Marine Turbine.

***5** Contemporaneously with the formation of TPT, and McIntyre's assignment of the Frac Stack Pack technology into TPT, TPT granted Green Field a 5-year license to use the Frack Stack Pack pressure pumping technology. PX 103, Trial Tr. 511-13. At the end of the 5-year license term, McIntyre would have been allowed to sell his pressure pumping technology in the open market. *Id.*

In addition to holding the intellectual property, TPT was the entity that manufactured and built the frac pumps for Green Field. McIntyre testified at trial that TPT exclusively built frac pumps for Green Field and that Green Field received an exclusive and perpetual license to the fracking technology. Trial Tr. 1509:23-1510:10, 1511:6-21. Pursuant to the TPT Operating Agreement, TPT was the sole manufacturer of Green Field's turbine powered fracking pumps and Green Field was TPT's sole customer, sole source of revenue and sole source of funding for TPT's operations. Stip. Facts ¶¶ 54-56; JX 6; McIntyre Dep. 56:14-18. Moreno acknowledged that "Green Field was funding TPT. TPT had no way to fund itself. Green Field was responsible for every employee at TPT. Their rent, their overhead, everything." Trial Tr. 906:23-907:2.

Green Field also provided employees to assist TPT, including Green Field project managers, such as David Kinnaird, who created "schedules, procurement, to help the supply chain, because the way that arrangement worked was Green Field was actually paying all the expenses associated with the building out of the equipment." Trial Tr. 1294:12-24, 1566:1-20; PX 243. As Fontova testified, Green Field "would procure the equipment, and then it would be assembled at TPT, primarily with TPT employees, but we had Green Field, some technicians, some schedulers and some project managers helping." Trial Tr. 1295:4-10.

Moreno repeatedly testified at trial that he treated TPT and Green Field as one company. Trial Tr. 123:14-25; 125:11-126:9; 184:13-185:5. Indeed, because of Green Field's control over TPT, Green Field was considered the primary beneficiary of the TPT venture, and TPT met the definition of a "variable interest entity," such that Green Field consolidated TPT's operating results with Green Field's in its financial statements. PX 226 at p. 57 (MORE_00036699); PX 142 at p. 65 (GFES014956).

3. The Green Field Start-Up

When Moreno began Green Field, the company was doing very little pressure pumping. Trial Tr. 1290-91. The initial plan in 2011 was to maintain these profitable "legacy services" and build a fleet to expand the company's pressure pumping horse power capabilities. *Id.* At the time of Moreno's takeover in 2011, Hub City had about a 24,000 horsepower

pumping capacity—*i.e.,* less than the capacity of one full frac spread. Trial Tr. 1293.

A full frac spread includes more than just pressure pumps. Trial Tr. 1291:20 – 1293:13, 1520:3-17. A complete frac spread includes trailers, man camps, water trucks, wireline, blenders, data vans, Sandkings and other equipment. *Id.* Depending on the formation where the fracking is being done, a spread may require approximately 35,000 horsepower as well, which could require anywhere from 20 to 30 pumps. *Id.*

The business plan was to build six to seven frac spreads over time. Trial Tr. 537-38; 1292-94. At the time, the rough cost to build each spread was between $35 and $50 million. Trial Tr. 1292-95, 1520:14-17. To raise this capital, Moreno and his management team searched for an "anchor" customer. Trial Tr. 533-37. After five years of serving Green Field's equipment in the field, the company's goal was to begin selling the equipment directly to other servicing companies. Trial Tr. 537-38. However, to finance its early startup operations during the period from May 2011 through September 2011, Green Field borrowed $53 million under a bridge loan (the "Bridge Loan") from Jefferies & Company. Stipulation No. 60. Green Field intended the Bridge Loan to finance working capital needs, fund the manufacture of the first operational fleet of Frac Stack Pack pressure pumps, sustain Green Field to an eventual note issuance, and to refinance its obligations under a then-existing credit agreement with JP Morgan. *Id.*

***6** Within months of entering into the market, Green Field entered into a "Contract for High Pressure Fracturing Services" (the "Shell Contract") with SWEPI, LP, the successor to Shell Western Exploration and Production, Inc. (collectively with its affiliates and subsidiaries, "Shell"). Stipulation No. 61. At all relevant times, Shell remained Green Field's most significant customer, representing up to 79% of all its revenues. *Id.* The Shell Contract committed $600 million in future revenue to Green Field, which became part of Green Field's business plan. Trial Tr. 542-43. In the Shell Contract, Green Field agreed to furnish certain fracking spreads at Shell drilling sites and service such sites at a discounted rate. In return, Shell agreed to provide up to an aggregate amount of $100 million in senior secured term loans (the "Prepayment Funding"). Stipulation No. 62.

On November 15, 2011, Green Field engaged in a bond issuance (the "Bond Issuance") and raised an additional $250 million through high interest secured notes from public markets. Stipulation No. 63. The Bond Issuance was memorialized on November 15, 2011, by an indenture (the "Indenture") between Green Field and Wilmington Trust, National Association, as trustee and collateral agent (the "Indenture Trustee"). *Id.*

The funds from the Bond Issuance were used primarily to repay both the Bridge Loan with Jeffries and the initial $42.5 million of Prepayment Funding due under the Shell Contract. The remainder amount was made available for the manufacturing of McIntyre's Frac Stack Pack pressure pumps and general operating cash needs. Stipulation No. 64. In other words, the $250 million proceeds from the Bond Issuance was not enough to fully fund Green Field's business plan.[7]

Shortly after the Bond Issuance, the oil and gas industry experienced a significant decline in natural gas prices, which in turn impacted the fracking industry. Stip. Facts ¶ 65. The decline in the oil and gas industry negatively impacted Green Field's operating results in 2012. Thus, Green Field sought additional financing from Shell in April 2012. *Id.* Green Field and Shell agreed to revise the structure of the Shell Contract, replacing the interest free Prepayment Funding with a $30 million revolving senior credit facility for up to an aggregate amount of $100 million (the "Shell Senior Credit Facility"). *Id.* Due to a limitation on debt set forth in Section 4.08 of the Indenture, the Shell Senior Credit Facility was limited to additional debt of no more than $30 million. *Id.*

In May 2012, Green Field fully drew the $30 million from the Shell Senior Credit Facility, but this proved still insufficient to satisfy their cash requirements. Stip. Facts ¶ 66. Shell therefore agreed to amend the Shell Senior Credit Facility and agreed to provide the remaining $70 million in funding (the "Shell Amended Senior Credit Facility"). *Id.* The Shell Contract, as amended, provided that the $100 million Shell loaned to Green Field was to be paid back according to a payment schedule requiring monthly $2 million payments until November 2013 (at which point they increased to $4 million and then $7.5 million in May 2014). JX 5 at MORE_00571025-26. Green Field defaulted on those payments in June, July, and August 2013 and reported those defaults in its quarterly report for the period ended June 30, 2013. PX 174 at pp. 8, 30; Stip. Facts ¶¶ 79, 83.

***7** In order to obtain the additional borrowing under the Shell Amended Senior Credit Facility, Moreno approached the bondholders with a consent solicitation (the "Consent Solicitation") that proposed to modify Section 4.08 of the

to permit a "one-time incurrence of up to $95.0 million in senior term loans secured by a first priority security interest in all of the company's motor vehicles and equipment under a credit agreement with one of [Green Field's] key customers, [Shell]...." Stip. Facts ¶ 67. As consideration for the bondholder consent, on October 24, 2012, MOR MGH and MMR (the Green Field shareholders) agreed to provide additional equity investments into Green Field under a share purchase agreement (the "2012 SPA"). Stip. Facts ¶ 68.

Section 2.01(a) of the 2012 SPA established that MOR MGH and MMR would purchase $10 million of Green Field preferred stock at execution, and up to an additional $15 million on a quarterly basis. Stip. Facts ¶ 69. The formula in the 2012 SPA required the quarterly increments to bridge the gap between actual cash on hand at quarter's end and $10 million (e.g., if cash on hand at quarter's end equaled $9 million, the required purchase by MOR MGH and MMR would be $1 million). *Id.*

C. Moreno and the Various "Moreno Entities"

Before further discussing Moreno's search for new capital to help Green Field during the 2012 downturn, the Court must address the various entities either owned and/or controlled by Moreno. The Trustee alleges that Moreno and a "web of affiliated companies under his control ... engaged in a concerted campaign" to strip Green Field of valuable assets. Second Amended Complaint ¶ 1. Moreno acted as manager for several entities that played various roles in Green Field's business, but the evidence does not support the Trustee's allegations of a "concerted campaign" against Green Field or its creditors. On the whole, the Court finds that the following entities were formed, or otherwise managed by Moreno, and often supported by Moreno voluntarily pledging his personal assets.

1. The Grantor Retained Annuity Trusts and Related Holding Companies

Moreno began forming grantor retained annuity trusts ("GRATs") in 2009, as part of an estate planning measure following the 2008 financial crisis. Trial Tr. 494. Moreno and his wife each is a settlor of his or her respective GRAT, neither one is a beneficiary of the GRATs, and neither one is trustee of the GRATs. Trial Tr. 496-99. Each GRAT is "seeded" with assets, whether it is cash or stock in a privately held company. *Id.* The assets are valued by a third-party at the time of contribution. *Id.* The primary purpose for the GRAT structure is to leave the beneficiary with the anticipated increased value of the contributed assets, but without the tax burden on the growth. Trial Tr. 498. In general, the trusts take on the obligation to repay the settlors their seed capital through annuity payments over a defined period of time, 10-15 years typically. *Id.* Sometimes the trusts lack the liquidity to make the required annuity payments. *Id.* Moreno testified that the annuity repayment is flexible—the payments may be deferred if the trusts are short on cash; the trusts may also give loans to the settlors (as they did in some instances) against future annuity payments, if cash is available. *Id.* While Moreno is a manager for some of the GRATs, he testified that he was not involved in the day-to-day finances of the GRATs, instead relying upon his family office accounting staff to ensure regulatory and accounting compliance. Trial Tr. 829:12-23.

In 2011, Moreno and his wife formed two new GRATs called the MBM 2011 MGH Grantor Retained Annuity Trust and the TCM 2011 MGH Grantor Retained Annuity Trust (collectively the "MGH GRATs"). Stipulation No. 9. As with the other GRATs, their daughter was (and still is) the sole beneficiary of the MGH GRATs. Trial Tr. 496.

***8** The sole asset of the MGH GRAT was an equal share of a newly formed company called MGH Holdings. Stipulation No. 9; PX 96, PX 97. MGH Holdings was established as a special purpose limited liability company registered in the state of Delaware. Stipulation No. 6. Its sole asset was stock in Green Field. As of October 17, 2011, MGH Holdings owned 88.9% of Green Field's common stock. Stipulation No. 7. At all relevant times, Moreno was a manager of MGH Holdings. Stipulation No. 8.

Also in 2011, Moreno and his wife established two other GRATS called the MBM 2011 DOH Grantor Retained Annuity Trust and the TCM 2011 DOH Grantor Retained Annuity Trust (collectively the "DOH GRATs"). PX 98, PX 99. The terms of the DOH GRATs are substantially the same as those of the MGH GRATs. Trial Tr. 68.

The schedule of annuity payments listed in the DOH GRAT agreements were tied to the value of Dynamic Offshore Holdings. Trial Tr. 495; PX 98, 99. That entity is not related to Dynamic Industries. Trial Tr. 495. After selling his interest in Dynamic Industries, Moreno started an offshore exploration business called Dynamic Offshore Holdings, but that entity had no affiliation to Dynamic Industries or its construction and fabrications businesses. *Id.*

The sole asset of each DOH GRAT was an equal share of an entity called MOR DOH Holdings, LLC ("DOH Holdings"). Trial Tr. 68. DOH Holdings eventually came to own three different entities that did business with Green Field— Frac Rentals, Shale Support Services and TGS. This structure is relevant to the "ultimate beneficiary" analysis discussed below.

Moreno's family office maintained separate records for the GRATs and their assets. In this regard, Moreno's accounting staff never treated obligations of MGH Holdings as an obligation of DOH Holdings, or vice-versa. Trial Tr. 92:13-21. Before forming TGS in May of 2013, from time to time, Moreno borrowed against his future annuity payments due from the DOH GRATs. PX 158; Trial Tr. 76:3-80:1; Trial Tr. CONFIDENTIAL Mar. 20, 2018 at 1-2:22. Such borrowing transactions were memorialized by notes issued in favor of DOH Holdings. *Id.* In May, 2013, at the request of GE, DOH Holdings transferred its interests in those notes and other non-TGS entities to a separate entity called MOR 2013 Holdings, LLC. *Id.* This transaction left DOH Holdings owning nothing but TGS. *Id.*

2. Moody Moreno and Rucks, LLC

MMR is one of the two primary owners of Green Field. Its membership interests are owned by TMC Investment, L.L.C. (33.3% equity interest), Elle Investments, L.L.C. (33.3% equity interest), and Rucks Family Limited Partnership (33.3% equity interest). Stipulation No. 11. At all relevant times, MMR owned 11.1% of the Green Field common stock. Stipulation No. 10. While the Trustee initially asserted claims against MMR under the 2012 SPA, those claims were settled well before trial for $100,000. Stipulation No. 12.

3. Turbine Powered Technology, LLC

TPT is a Louisiana limited liability company established on September 22, 2011 by its members, Green Field and MTT Properties, LLC ("MTT Properties"). Stipulation No. 24. Green Field and MTT Properties each owned 50% of TPT. Stipulation No. 26. TPT is not a named defendant in this action. Stipulation No. 27.

As discussed above, TPT was formed to hold McIntyre's Frac Stack Pack intellectual property so that it could be licensed to Green Field for use in its pressure pumping and other traditional well services. Trial Tr. 127:14-128:11. Initially, Moreno considered acquiring McIntyre's entire business and intellectual property portfolio, but the parties could not agree on a valuation for McIntyre's *other* intellectual property—*i.e.,* the inventions beyond the Frac Stack Pack technology. *Id.* Thus, the parties reached a compromise to "co-own the manufacturing component of the startup" through TPT. *Id.*

4. The Preference Defendants

***9** In its SJ Opinion on the parties cross motions for partial summary judgment, the Court discussed Aerodynamic, Casafin and Frac Rentals (collectively, the "Preference Defendants"). *See* Memo Op., D.I. 463 at 14-17. The issues surrounding the Preference Defendants were largely undisputed, and the Court has resolved most of them through summary judgment.

Aerodynamic and Casafin were special purpose entities established or otherwise utilized to assist Green Field in its aggressive plan to scale up the company's operations to remote areas where there was little or no infrastructure or large commercial airports. *See* Memo Op., D.I. 463 at 14-17, Trial Tr. 549-50, Blackwell Depo. at 156:12 – 157:22, 159:2-24.

Frac Rentals was established to rent additional equipment to Green Field because the company was unable to raise additional capital or borrow additional funds under the existing Indenture. Trial Tr. 552, Blackwell Depo. 142:13-20. Debtor's CFO testified that it was fairly commonplace in the industry to rent peripheral equipment with short-term utility. Blackwell Depo. 168:6-9. In Green Field's business judgment, ownership and maintenance of such peripheral equipment was "a capital investment, and it [was] really better to let somebody else provide that capital and just pay a day rate on using the equipment." Blackwell Depo. at 168:13-18.

Frac Rentals was established and funded by its owners—initially 80% owned by DOH Holdings, and 20% by a third-party investor Michael J. Smith—with Moreno acting as manager for the entity. Memo Op., D.I. 463 at 16; Blackwell Depo. 143:22-144:3, 170:9-13.

While Michel Moreno served as the Manager for the entity, it was operated by his brother, Jesus Moreno and a group of experienced operators of fracking related equipment. *Id.* In the Court's SJ Order (D.I. 464), the Court entered summary judgment on the following counts, in the following amounts:

- Count 19 – Frac Rentals: $69,137.97;
- Count 23 – Aerodynamic: $110,000.00; and

• Count 24 – Casafin: $466,414.94.

However, it was undisputed that all three Preference Defendants are no longer in business, have sold or otherwise disposed of their respective assets, and cannot satisfy a judgment. At trial, Moreno's stated that he received no salaries or distributions from any of the Preference Defendants, Trial Tr. 552-553. Also all money that Green Field paid to the Preference Defendants was generally used to satisfy the Preference Defendants' own expenses and obligations, such as fuel, maintenance, pilot fees, and the like. Trial Tr. 551-53.

5. Turbine Generation Services, LLC

The last entity alleged to fall within a "web of affiliated companies" is TGS. The undisputed evidence demonstrates that TGS was formed as a subsidiary of DOH Holdings in March of 2013. Moreno testified that he created TGS as a place-holder for a potential joint venture with GE, "not knowing where it was going to land" given his ongoing and fluid negotiations with GE. Trial Tr. 293-295, 312:6-14; JX 27, PX 136, PX 152. Moreno further testified, without being controverted by other witnesses or evidence introduced by the Trustee, that the formation of TGS was GE's mandate. GE was concerned about Green Field's finances. JX 30, Trial Tr. 291-93. Moreno testified that he did not have control over the process when it came to negotiations with GE over the direction of its power generation investment. Trial Tr. 588:4-7, 697:24-368:7, 782:3-19. Thus, at GE's insistence, Moreno formed TGS outside of Green Field. PX 157, Trial Tr. 785-87.[8] Moreno's credible testimony on this point was entirely consistent with all other evidence showing Moreno's ongoing discussions with GE over this period of time, as well as Moreno's disclosures to bondholders, as discussed in detail below. The Court finds that, consistent with the other entities set up by Moreno to support Green Field's operations, Moreno established TGS for legitimate business reasons aimed to support Green Field, not to harm Green Field or create an unfair opportunity for Moreno.

D. The Decline of the Fracking Market and Transition to Power Generation

1. PowerGen

***10** By the fall of 2012, Green Field was suffering significant losses and began looking for opportunities, investments or lines of business, to help prop it up. Trial Tr. 1416:22- 1417:15. As Moreno testified, one of the characteristics of drilling for oil is that the oil fields are sometimes in remote locations that do not have accessible power or a power grid. Trial Tr. 171:17-25; 191:10-15. For companies to drill in these remote locations, they must either connect to the power grid or bring in portable power. Trial Tr. 172:1-9. Because connecting to the power grid could be extremely expensive, portable power is used by the industry to a substantial degree. Trial Tr. 172:7-13.

As of November 2012, Moreno believed there was a market for power generation and that Green Field could participate in that market. Trial Tr. 188:15-189:4. McIntyre testified at trial that the power generation idea arose because Moreno realized that lack of electricity was a barrier for fracking companies. Trial Tr. 1530:11- 1531:12. Specifically, Moreno's understanding of the power generation market arose from discussions with potential Green Field fracking customers, including SandRidge Exploration and Production, LLC ("SandRidge"). Trial Tr. 558:6-8; PX 121 at p. 24. On a call with Green Field bondholders on November 21, 2012, Moreno touted to bondholders the exciting business opportunity provided to Green Field by the PowerGen business. He explained that there was a "big need for power" at well sites in North America and that operators had "to use portable power, 1-meg machine, 350kw machines and they go through the traditional suppliers, like Aggreko and Caterpillar. They're mostly diesel-driven units of portable power so there's a tremendous demand for power." PX 121 at p. 24. Moreno described the "significant" demand in the market, stating that "the demand for power is very nearly similar to what it was for fracing a year and a half ago" and emphasized that the demand was coming from existing customers. PX 121 p. 24. Moreno also told bondholders that given the tight margin profiles for fracking at the time, the power generation business could be "a great hedge and balance for us." PX 121 at p. 25. Moreno explained that PowerGen had a "dramatically better" margin profile. PX 121 at p. 25.

On the call with Green Field bondholders on November 21, 2012, Moreno also touted to bondholders the commitments it already had for PowerGen, including from Apache and Sandridge. PX 121 pp. 3, 20; Trial Tr. 158:6-17, 178:13-179:4, 182:11-183:6. At the time of the November 21, 2012 bondholder call, TPT was actively building a prototype power generation unit for SandRidge, which was completed in December 2012 and paid for by Green Field. Trial Tr. 178:2-8, 213:13-24, 222:20-223:8, 1452:24-1453:11, 1531:16- 1532:11; PX 243. At trial, Moreno testified that

SandRidge became a customer of Green Field for purposes of a power generation pilot program. Trial Tr. 219:24-221:20. He testified that if the pilot program with SandRidge was successful "it could morph into them starting to buy equipment from Green Field" rather than others. Trial Tr. 219:24-221:20.

Furthermore, Moreno's trial testimony and the November 21, 2012 bondholder call make clear that Green Field was taking the same dual fuel system, developed for Green Field's fracking operations, and applying it to PowerGen units. Trial Tr. 158:18-159:6; PX 121 at pp. 24-25. The turbine engine, adapted to accommodate multiple fuel sources, and thus able to run on both diesel and natural gas, including natural gas from the well-site, as used in Green Field's fracking operations, was technology translatable directly from fracking to power generation. PX 121 at pp. 24-25; Trial Tr. 198:22-202:4. Moreno explained to the bondholders in November 2012 the simplicity of transitioning Green Field's technology to power generation. PX 121 at pp. 24-25; *see also* PX 121 p. 20 ("[I]t's the turbine and the ability to use multiple fuel sources that makes this really work.").

2. 2012 SPA Obligations

***11** Pursuant to the 2012 SPA, on October 24, 2012, the day of its execution, MOR MGH and MMR were required to purchase $10 million of Green Field's preferred stock, and they did in fact make that purchase. D.I. 219, at ¶ 56. The obligations to make additional purchases of preferred stock arose thereafter on a quarterly basis as determined by the formula that required purchase in an amount "equal to the amount by which $10,000,000.00 exceeds the Cash or, if applicable, cash equivalents of the company ... as of the last Business Day of such fiscal quarter." PX 119. On February 13, 2013, while Green Field's was transitioning into the power generation market and negotiating with GE, the payment for the fourth quarter of 2012 became due. PX 132; Trial Tr. 381:3-382:20. Blackwell sent a notice to Moreno, Moody, and Rucks that the payment for the fourth quarter of 2012 was due. PX 132; Trial Tr. 381:3-382:20. These payments were, in fact, made by MOR MGH and MMR. Trial Tr. 381:17-382:23; D.I. 219 at ¶ 58; Blackwell Dep. 31:13-32:18.

On May 2, 2013, Blackwell again sent notice to Messrs. Moreno, Moody, and Rucks in connection with the payment due following the close of Q1 2013. PX 147. MOR MGH was responsible for $3,968,606 and MMR was responsible for $496,020. Stip. Facts ¶ 71. Payment was requested on or before May 15, 2013. PX 147. As explained below, on May 13, 2013, Moreno orchestrated Green Field's waiver of the PowerGen Business in favor of himself personally and Moreno caused TGS to enter into the $25M loan with GE. On May 15, 2013, two days after the Waiver, Moreno caused MOR MGH and MMR to breach their obligations under the 2012 SPA for the first quarter of 2013. Stip. Facts ¶¶ 71, 72. Moreno caused MOR MGH's breach despite the fact that Moreno was the CEO of Green Field, had a fiduciary obligation to Green Field, and MOR MGH's only asset was its stock ownership in Green Field. Trial Tr. 847:9-21.

On August 19, 2013, pursuant to the 2012 SPA, MOR MGH was responsible for funding $1,993,317 to Green Field and MMR was responsible for funding $249,138 to Green Field for the second quarter of 2013. Stip. Facts ¶ 73. Again, neither MOR MGH nor MMR made those payments. Stip. Facts ¶ 74.

During the bankruptcy proceedings, Moreno's financial consultant, Mesirow Financial, prepared a document summarizing the transactions between Moreno and other entities he controlled and Green Field. Trial Tr. Conf. 3/20 at 5:16-6:8; JX 3. The chart lists approximately $48 million in turbine sales ($23M) and deposits ($25M) that involved both TGS and Green Field. JX 3; DX 221; Trial Tr. 844:11-846:10. Putting aside Moreno's characterization of those transactions as purported contributions to Green Field,[9] of the $85M borrowed, $37M was either used by Moreno for his personal interest (i.e. $10M to purchase his Dallas house) or was otherwise unaccounted for. Trial Tr. 844:20-846:10; JX 3; DX 221. Accordingly, Moreno had additional funds on hand that would have allowed him to permit MOR MGH to satisfy its obligations under the 2012 SPA or the 2013 SPA (discussed and defined below). Moreno conceded at trial that "[i]t would have been beneficial for Green Field to have every dollar it could find." Trial Tr. 469:17-19. He also acknowledged that the absence of cash "is absolutely the kiss of death" to a company. Trial Tr. 478:12-17. Despite these acknowledgments, he chose to cause MOR MGH to fail to provide necessary cash to Green Field, even though he had funds on hand.

***12** For the payments due for each of the first two quarters of 2013 under the 2012 SPA, Blackwell, at the direction of Moreno, informed Moreno's fellow members in MMR, Moody and Rucks, that Moreno was intending to make the payments, even though Moreno ultimately did not make them. Blackwell Dep. 42:11-44:16, 55:7-12; PX 148. Moreno was aware that if he did not cause MOR MGH to make the payments, and he did not contribute his one-third share

of MMR's obligations, then his partners in MMR would likewise not arrange for the remaining two-thirds of MMR's obligations to be fulfilled. Trial Tr. 388:2-392:14; PX 148; PX 149. Blackwell, who was responsible for sending the notices to the Green Field shareholders and was responsible for the company's finances, testified that Rucks and Moody informed him that they would not pay their funding obligations unless Moreno paid his. Blackwell Dep. 55:13-17.

In total, MOR MGH's breaches of the 2012 SPA totaled $5,961,923. MMR's breaches totaled $645,158. Both are exclusive of pre-judgment interest.

3. Goldman Sachs Loans and the 2013 SPA

Moreno personally borrowed funds from Goldman Sachs in May and July of 2013, totaling $40 million. Trial Tr. 396:19-397:9. The first tranche for $25 million was dated May 15, 2013, i.e. two days after the Waiver Date. PX 156. The specified purpose of the personal loan was to make an "equity investment in Green Field which shall be used as working capital to fulfill equipment orders and to make and [sp] equity investment in Turbine Generation Services, L.L.C." PX 156 at GS0002950. The second tranche for $15 million was dated July 5, 2013. Trial Tr. 417:5-20; PX 166. Moreno put none of this money into Green Field.

On June 28, 2013, Green Field and MOR MGH executed a new share purchase agreement (the "2013 SPA," together with the 2012 SPA, the "SPAs"). Stip. Facts ¶ 75; PX 162. The 2013 SPA was a condition of Goldman Sachs loaning the second tranche of $15 million to Moreno personally and it required Moreno to purchase additional preferred stock in Green Field and then pledge that stock to Goldman Sachs as security for the personal loan. Trial Tr. 397:20-398:3; PX 160. Goldman Sachs required that Moreno provide a written certification once the stock had been purchased. Trial Tr. 400:12-402:19; PX 165.

MOR MGH did not buy the $10 million of Green Field preferred stock as required by the 2013 SPA. Stip. Facts ¶ 78. Despite not purchasing the required preferred stock under the 2013 SPA, Moreno provided a written certification to Goldman Sachs that the stock had in fact been purchased. Trial Tr. 403:11-404:20; PX 165. The certification detailed the specific accounts into which the money was allegedly deposited. PX 165. Moreno signed the certification on behalf of both Green Field and MOR MGH. Trial Tr. 404:17-20. The certification was false. Instead of funding his 2013 SPA obligation, Moreno admitted at trial that he used the $10 million to purchase his residential home in Dallas. Trial Tr. 411:24-420:12; PX 168. The Court observes that Moreno initially denied that he used the proceeds to purchase a home. Trial Tr. 411:18-23. However, when confronted with a document from his estate planning professionals (PX 168), he then admitted it. Trial Tr. 411:24-420:12; PX 168. Moreno also testified that the loan documents allowed him to use the loan proceeds to purchase personal real estate. Trial Tr. 416:4-417:2. The loan agreement, however, expressly precluded such use. Trial Tr. 417:5-418:21; PX 166 at GS0003763 ("The Borrowers will not, directly or indirectly, use any part of such proceeds for the purpose of (a) purchasing, improving, or otherwise investing in residential real estate, whether a primary residence of the Borrowers or otherwise."). The Court finds that Moreno knowingly and intentionally lied to Goldman Sachs and intentionally diverted $10M earmarked for Green Field to his own personal use.

***13** Moreno testified that the payment was not accounted for properly and that he sent the money from MOR DOH who sent it to TGS who sent it to Green Field. Trial Tr. 403:11-405:23. However, the capital contribution chart shows the payments from TGS to Green Field and none of those monies are the $10 million owed under the 2013 SPA; those monies were deposits for TPT or turbine engine purchases. In October 2013, when Moreno's (and Green Field's) attorney Slavich inquired as to whether Moreno had caused Green Field to receive the $10 million due under the 2013 SPA, Moreno told Slavich that MOR DOH, not Green Field, received the money. PX 183. Blackwell also testified that Green Field never received the $10 million due under the 2013 SPA.[10] Trial Tr. 408:4-410:18; Blackwell Dep. at 68:3-15, 74:5-75:15; PX 187.

4. Deterioration of Green Field and SPA Defaults

Green Field failed to make its $2 million monthly payments to Shell under the Shell Contract, as amended, for each of June, July, and August 2013, a default totaling $6 million. Stip. Facts ¶ 79. Moreno testified that had the SPAs been fulfilled, Green Field would have been able to make the required interest payments under the Shell Contract. Trial Tr. 469:20-470:3. Green Field's failure to satisfy the requirements of the 2012 SPA forced Moreno to notify the Indenture Trustee of the defaults and publicly acknowledge the same in the Q2 2013 Quarterly Report. Stip. Facts ¶ 83. Moreno signed the letter to Wilmington Trust, the Indenture Trustee, notifying it that the 2012 SPA had been breached. Trial

Tr. 431:21-433:16; PX 171. That letter also stated that "the Company has failed to sell shares of preferred stock *or make arrangements for another form of capital contribution*." PX 171 (emphasis added). Moreno also signed the Quarterly Report, dated August 20, 2013, which stated that "[t]he Company's shareholders did not purchase, and the company did not issue, preferred stock to its shareholders when payment for such shares of preferred stock was due on May 15, 2013 and August 13, 2013, nor did the company make arrangements for another form of capital contribution." 435:17-437:8; PX 174 at p. 8. Moreno also notified Green Field's accountants, Ernst & Young, of the defaults on August 19, 2013. PX 173; Blackwell Dep. 51:25-52:19.

These public notifications triggered a cross-default under the Shell Amended Senior Credit Facility. Stip. Facts ¶ 83. Green Field's Corporate Family Rating, Probability of Default Rating and Senior Secured Notes Due 2016 rating were all downgraded. *Id.* Moody's Investor Services categorized the downgrades as follows: Corporate Family Rating, downgraded to Ca from Caa2; Probability of Default Rating, downgraded to Ca-PD/LD from Caa2-PD; and Senior Secured Notes Due 2016, downgraded to C (LGD 5 / 72%) from Caa2 (LGD 4 / 60%). *Id.* Shell issued a notice of default to Green Field on October 8, 2013. Stip. Facts ¶ 84. On September 6, 2013, Moreno admitted to the bondholders that he failed to make the equity commitments under the 2012 SPA because he was spending his personal capital on PowerGen, which at that point was owned entirely by TGS and outside of Green Field. Trial Tr. 440:1-441:14; PX 177 at p. 5. Moreno acknowledged his responsibility for the SPA obligations and promised to cure the defaults that quarter. Trial Tr. 445:10-446:7; PX 177 at p. 5 ("I do plan on (inaudible) that default this quarter ... certainly I'll be in a position to cure this default in this quarter.").

As a result of the defaults under the SPAs, GE terminated its negotiations with Green Field (as discussed below). On September 13, 2013, Edoardo Padeletti ("Padeletti") responded to an internal GE email chain circulating a news article announcing Green Field's defaults and said: "We are working internally and with Moreno lawyers to understand properly the potential implications and (in a worst case scenario) how this could impact our JV." JX 50. Then, one week later, on September 20, 2013, GE circulated an email directing GE employees to "stop any work that is proceeding with regards to Project Cayenne." PX 215. Padeletti confirmed in his deposition that the Shell defaults contributed to GE's failure to consummate the joint venture for the PowerGen business. Padeletti Dep. 109:23-110:6, 118:8-23.

***14** Green Field filed a voluntary petition for Chapter 11 bankruptcy relief on October 27, 2013. Stip. Facts ¶ 4.

E. GE Negotiations

In the fall of 2012, while Moreno was discussing the power generation business with the Green Field bondholders and TPT was building the prototype unit, Moreno was looking to generate capital for Green Field and had discussions with several capital sources, ultimately beginning negotiations with GE. Trial Tr. 212:20-213:12.

In October 2012, Green Field entered into a nondisclosure agreement with GE Energy Financial Services for the exchange of proprietary information, including both the fracking and power generation technology. PX 120; Trial Tr. 251:22-253:18. Green Field then entered into a second nondisclosure agreement with the Aero Energy and Oil & Gas businesses of GE in December 2012 which also involved the fracking and power generation technology. PX 127.

Moreno testified that from the outset of his discussions with GE he sought a $100 million investment from GE for Green Field's fracking business, and when GE showed interest in power generation, he sought $200, with $100 million to go to fracking and $100 million for power generation. Trial Tr. 257:3-259:5. Moreno testified that he originally sought to have the power generation investment go directly into Green Field. Trial Tr. 259:6-10. Fontova testified that manufacturing of the PowerGen units would be done by TPT (the manufacturing business), and that the intent was to run the leasing business through Green Field. Trial Tr. 1452:9-20.

By March and April 2013, Green Field and Moreno were negotiating a joint venture for the leasing of PowerGen units. Moreno testified that the opportunity got passed around to various divisions of GE and GE repeatedly went back and forth about investing in power generation and fracking versus power generation only and whether the investment would be made directly into Green Field. Trial Tr. 684:6-685:9; 685:19-686:19. GE was concerned about Green Field's pre-existing senior debt as well as exposure to the environmental concerns with fracking. Trial Tr. 259:11-260:17.[11]

F. GE Was Interested in the Multi-Fuel Technology

GE indicated that it was interested in Green Field's power generation units because of the advantages of Green Field's multi-fuel technology originally developed for Green Field's fracking equipment and now deployed with its power generation units. On January 7, 2013, Green Field issued a press release announcing that it had signed a "global supplier agreement with GE Oil & Gas to deliver low-cost, cleaner burning power generation solutions to the oil and gas industry." PX 129; Trial Tr. 214:24-215:9. The press release also stated that Green Field would provide "its proprietary technology, including its bi-fuel capability developed for use on its Turbine Frac Pumps." PX 129. The press release stated that Green Field had "secured commitments with two customers to conduct pilot programs to test power generation of oil and gas equipment utilizing natural gas produced on site in the field." PX 129. These two commitments were for SandRidge and Apache. PX 129.

***15** In an executive summary circulated to GE from Green Field on March 20, 2013, Green Field described the power generation concept and specifically noted Green Field's "proprietary fuel control technology." JX 28 at GFES042781-82. The executive summary also provided that "[i]n addition to the advantages of less capital cost, greater ease in transport and fewer emissions, Green Field's turbine driven Power Generation units are capable of running on 'Field Gas'. This ability to run on Field Gas provides a significant savings to the end user in operating cost." JX 28 at GFES042785.

Moreno testified that he agreed with the statements written in the executive summary at the time. Trial Tr. 269:10-11; 269:20-21. Moreno also testified that GE was interested in the dual fuel technology that was developed for Green Field's hydraulic fracturing operations and paid for by Green Field. Trial Tr. 271:10-20. McIntyre similarly testified at trial that GE expressed interest in putting together a power generation rental fleet "[b]ecause no one at the time offered generators that could be dispatched into remote areas that could run on well gas, everything was diesel driven, liquid fuel." Trial Tr. 1536:13-22. Hosford testified at his deposition that one of the benefits of the Green Field engines was that "you could burn different fuels and you can switch fuels on the fly." Hosford Dep. 76:1-9.

As Moreno stated on a conference call with Green Field bondholders on April 19, 2013, GE and Green Field were working toward a joint venture and GE was interested in Green Field's dual fuel technology as it applied to power generation, which Moreno described as "fairly unique and even—and folks can't duplicate very quickly without our support." PX 143 at p. 7; Trial Tr. 264:18-265:22.

G. The PowerGen Opportunity

On May 13, 2013, the shareholders and board of directors of Green Field executed the Consent Solicitation. Stipulation No. 91, JX 61. That same day, GE advanced $25 million to TGS in exchange for the Senior Secured Note (the "GEOG Note") executed by TGS as borrower, and Moreno, as guarantor, in favor of GEOG, as lender. Stipulation No. 93, JX 49. The GEOG Note contained two critical attachments, which are discussed below. First, Annex A to the GEOG Note is a list of engines and equipment to be purchased from Green Field. Second, Annex B is a Term Sheet titled Project Cayenne, Summary of Principal Terms (the "Term Sheet"). JX 49.

The Trustee alleges that this date of May 13, 2013, was critical. Central to the fraudulent transfer, breach of fiduciary duty and corporate waste theories asserted in the Second Amended Complaint is the allegation that the so-called PowerGen business idea belonged to Green Field and was transferred to TGS as a result of the Consent Solicitation on May 13, 2013. To understand the merits of this highly critical issue, the Court must first consider the circumstances surrounding how the PowerGen business idea came to be, and what really happened on May 13, 2013.

1. Early Contact with Private Equity Groups and Bondholders

The reduction in fracking demand in addition to increased operating costs in 2012 challenged Green Field's early business plan to expand its frac spread fleet at the pace originally designed. While the company was performing according to plan from an operational perspective, the reduced margins and demand put a strain on the company's liquidity, preventing Green Field from continuing its planned capital expenditure outlays. JX 15, Trial Tr. 588. During a bondholder call on November 21, 2012, Moreno advised bondholders that he and Green Field were doing two things to improve liquidity—raise more equity where ever possible, and reduce capital expenditures until Green Field had more customers in place. *Id.* As Moreno testified at trial, Green Field suddenly had "a huge hole in [its] business plan." Trial Tr. 589-90. Because Moreno still believed in the company and its technology, he was motivated to go back into the

marketplace and find more money to survive the economic downturn. *Id.*

***16** Moreno started meeting with prospective investors in the fall of 2012 to help fill Green Field's capital needs. Trial Tr. 562-65. He started with his contacts at Jeffries —the firm that helped underwrite the Bond Issuance—in hopes that his contacts could connect him to private equity groups interested in investing in Green Field. *Id.* These contacts led to meetings with Goldman Sachs Private Equity, Cerberus Capital, Emigrant Bank, Solace Capital, BP Capital and at least a dozen other potential investors. *Id.*, Trial Tr. 1355:13 – 1356:9. Many of these firms were already existing bondholders. Trial Tr. 562-65, 567-70, 912-915, 943-945, PX 143, DX 47 at pg. 4. In all, Moreno testified that he met with "dozens of private equity sources," none of whom was interested in funding Green Field. Trial Tr. 567:9-12. The few investors that expressed interest in investing were only interested in investing alongside a larger strategic investor, like GE. Trial Tr. 1355:13 – 1356:9.

While Moreno's capital search began as an effort to find investments for Green Field's pressure pumping operations, he remained open to the possibility of expanding into a new power generation business—as long as the new venture helped Green Field's core business plan. Trial Tr. 567-68, 560-62. On this point, Moreno testified that a power generator business would constitute a whole new business line for Green Field, and that he did not want to start a new business line or business venture while he already had his hands full with the Green Field start-up. Trial Tr. 560-62, 578:1-22. Moreno began warming to the idea of starting a power generator business after he sold an interest in one of his unrelated businesses to the founder of SandRidge in 2012, during which transaction the principal of SandRidge indicated willingness for SandRidge to participate in a pilot program for turbine powered generators. Trial. Tr. 557- 58.

At the time, Moreno knew that Green Field lacked the intellectual property rights and know-how to develop power generators from its turbine stock. Trial Tr. 559-6. Moreno testified that there was no effective way to negotiate a deal involving power generators without giving McIntyre some economic benefit. Trial Tr. 205:15-206:15, 227:11-228:4. However, Moreno believed that McIntyre would be willing to contribute his know-how to a future venture, and Moreno further viewed a potential power generator business as "a catalyst to help [Moreno] raise money for Green Field." Trial Tr. 523, 559-60. Moreno testified that he stopped meeting with potential investors in Green Field only after he received a communication from GE that Jeff Immelt, then CEO of GE, had approved a substantial investment into a future joint venture with Green Field. JX 25, DX 109, 260, Trial Tr. 574-75, 681.

2. Negotiations with GE[12]

Moreno was ultimately unsuccessful in attracting new investments in Green Field. Trial Tr. 1355:13 – 1356:9, 1358:1-22. However, one of the many private equity groups that Moreno contacted during this process—Cerberus Capital —led him down a different path. Through the course of meeting with potential investors, Moreno met Bob Nardelli ("Nardelli"), who was then serving on the investment committee for Cerberus Capital. Trial Tr. 564-66. Moreno testified that his initial meetings with Cerberus Capital were intended to raise $100 million of new capital for Green Field, which Moreno hoped to use to complete Green Field's business plan of building additional frac spreads. Trial Tr. 568:6-24. Although Cerberus Capital was not interested in investing in Green Field, Nardelli connected Moreno with Nardelli's former colleagues at GE. Trial Tr. 566:7-13, 569:20-570:11.

***17** Moreno's initial discussions with GE began in September 2012, initially with an effort to get GE to infuse capital on Green Field's balance sheet through its fracking business. Trial Tr. 250:6-18. Over time, however, those discussions changed. Moreno testified that he did not initially pitch the idea of a power generator business. Trial Tr. 257:17-258:17. In October 2012, the parties executed a non-disclosure agreement containing a very broad definition of "well services." PX 120. While the Trustee highlighted the inclusion of "power generation" in the definition of "well services," Moreno testified that, at the time, Green Field was not in the business of power generation or many other enumerated items in the definition of well services. Tr. 252-53. Moreno testified that the early discussions with GE centered on GE's interest in extending the life of GE's retired turbine engines for uses like frac pumps or power generators, as McIntyre had done with the retired Honeywell engines deployed in Green Field's operations. DX 264, 266, Trial Tr. 255:8-256:24, Tr. 260:22-262:22, 937:24-938:11. As late as March 30, 2013—several months into the negotiations — representatives of GE acknowledged that GE's primary interests involved: (a) getting working knowledge of the above ground oilfield services business; (b) developing a power offering that is cost competitive in the power-to-lift

space; and (c) creating optionality for GE in buying out any partnership with Moreno or Green Field. DX 264. For GE, a partnership with Green Field and McIntyre offered the opportunity for GE to expedite the process of putting its used turbine engines back into the market for secondary uses. DX 264, DX 266, Trial Tr. 265:23-266:15, Trial Tr. 937:24-938:11.

On December 21, 2012, Green Field signed a Memorandum of Understanding with GE under which the parties contemplated a supply agreement. Green Field would start using GE components to build future products. DX 181, Trial Tr. 606-09. After that date, discussions with GE evolved. Trial Tr. 621-26.

On January 7, 2013, Green Field announced a pilot program with SandRidge, an oilfield operator, where SandRidge would start using turbine power generator units to be built by Green Field. PX 129, Trial Tr. 219-20. Moreno testified that, before that announcement, SandRidge had never ordered any services from Green Field. Trial Tr. 219:9-220:24. Moreno, Fontova, and McIntyre also testified throughout trial that Green Field had no manufacturing capacity on its own—TPT, led by McIntyre, did all manufacturing for Green Field. Trial Tr. 1346:15-24, 1353:16-22, 1511:6 – 1512:9.

On February 1, 2013, Moreno exchanged e-mails with Lee Cooper at GE discussing deal points for "a GE financing plan for Greenfield," which included a $100 million equipment financing line backed by customer orders and guaranteed by Moreno. DX 183, Trial Tr. 611- 24. Under this proposal, Green Field would commit to ordering GE parts, and GE would consider converting its debt to equity in the future. *Id.*

Ten days later, on February 11, 2013, GE directed Moreno to meet with Josh Loftus as "the right guy to speak with" about a "line of credit for both frac packages and power packages." DX 258, Trial Tr. 661-65. The e-mail asked for a face-to-face meeting with Moreno to discuss partnership options as well. *Id.* On February 16, 2015—*i.e.,* the day after Moreno met with GE representatives—GE circulated an internal e-mail recapping the meeting with Moreno. (DX 257, Trial Tr. 632-39). According to GE's internal e-mail, the PowerGen leasing concept would be "a substantial third arm of Green Field (along with the Manufacturing arm and existing Ops arm)." *Id.* Moreno testified that the "Manufacturing arm" meant TPT, and the "Ops arm" meant Green Field. *Id.* He came away from the meeting with GE with an impression that GE would invest in Green Field and allow Green Field to control the PowerGen leasing company. *Id.*

One week later, on February 23, 2013, GE sent Moreno a list of terms based on their meeting from February 15, 2013. DX 258, Trial Tr. 665-68. Moreno responded to the e-mail by thanking the GE representative and indicating that the details could be worked out that same week. *Id.* The reason for the urgency was that Moreno understood that GE's investment committee meeting would be convening on March 8, 2013, and that this prospective investment would be presented to GE's CEO, Jeff Immelt, for his approval. Trial Tr. 665-66. Moreno's meetings with various GE representatives, including Mike Hosford, a representative of GEOG, and Lee Cooper, a member of GE's investment committee, had left Moreno with the impression that Jeff Immelt was likely to approve an investment of $100 million into Green Field. *Id.*

***18** In anticipation of the March 8 presentation to Jeff Immelt, Moreno formed TGS on March 7, 2013. PX 136. The initial member of TGS was DOH Holdings. PX 136, Trial Tr. 293-95. Moreno testified that he placed it under DOH Holdings "as a placeholder, not knowing where it was going to land." Trial Tr. 312:6-14.

Immelt ultimately did approve a $100 million investment through a joint venture with Green Field "on the spot" during the March 8 review. DX 109, Trial Tr. 674-79. Immelt instructed GE to "get [Moreno] $25M by end of the week to help both sides of the business." DX 197, Hosford Depo Tr. 95:1-25, 97:23 – 98:15.[13] Having been informed of Immelt's approval, Moreno immediately stopped discussions with private equity investors in reliance on Immelt's approval and instructions. *Id.* On March 13, 2013, Mike Hosford at GEOG sent Moreno and others in Green Field's management an invitation to a conference call on March 15, 2013, to discuss "what [Green Field] will bring to the NewCo and also what GE is thinking." DX 260, Trial Tr. 679-81. Moreno insisted at that meeting and following that meeting that whatever funds GE was willing to invest in the joint venture had to be used to complete Green Field's overall business plan. *Id.* On March 17, 2013, following Moreno's calls and communications with GE representatives, Moreno changed the name of TGS to Green Field Power Generation Services, LLC. JX 27.[14]

During the course of negotiations with GE, Moreno had a dinner meeting with Immelt on March 25, 2013. Trail Tr. 689-98. In preparing Immelt for the dinner meeting, a

GE representative told Immelt about Green Field's pressure pumping business and Moreno's newest exploration of the power generation business through a potential joint venture with GE. JX 30. According to this e-mail, and as confirmed by Moreno at trial, Moreno was seeking a total of $200 million from GE—$100 million each for Green Field's business plan and for the new PowerGen start-up. JX 30, Trial Tr. 689-98. At the time, GE was receptive to both.

However, on March 26, 2013, two weeks after Immelt's initial approval of the investment, GE sent around an internal e-mail demonstrating their own struggle to execute on Immelt's initial demands. DX 262, Trial Tr. 698-701. Moreno had the impression from the amount of time GE was investing in him, a relatively small entrepreneur, that it demonstrated GE's commitment to him and the potential partnership. Trial Tr. 698-701.

Three days later, consistent with GE's prior briefing to Immelt, Moreno continued to request that GE invest $100 million directly into Green Field, separate and apart from the $100 million already authorized for the PowerGen business venture. DX 264, Trial Tr. 701-14. GE's internal e-mails summarized Moreno's request and indicated a willingness to provide the additional funding, if for no other reason than to prevent Moreno from seeking the additional funding from private equity investors. *Id.* Of course, as Moreno testified, he stopped meeting with private equity groups in early March when GE advised him that Immelt had approved the investment. Trial Tr. 719-20. GE's internal e-mails indicate that, even within GE, certain representatives were growing concerned about misleading Moreno "regarding the size of our investment." DX 264, Trial Tr. 719-20.

***19** On April 3, 2013, Moreno flew to Schenectady, New York to meet with Colleen Calhoun, one of his primary points of contact at GE, and others to discuss deal points for the joint venture. Trial Tr. 720-21. The next day, on April 4, 2013, Calhoun sent Moreno a detailed e-mail with the deal points discussed in Schenectady. JX 31, Trial Tr. 313-23, 727:7-14. Those deal points included a total $200 million capital infusion into Green Field, but required that the PowerGen entity be held outside of Green Field. *Id.* Moreno testified that the $200 million investment would have solved Green Field's liquidity problems, but GE changed its mind within weeks of Calhoun's e-mail. Trial Tr. 723-27.

Later the same day, on April 4, 2013, Calhoun e-mailed Beth Comstock at GE to report that she had "an outline of a deal," with $50 million going "out the door" first, followed by three additional installments of $50 million each "based on milestones." DX 265, Trial Tr. 740. She advised her colleagues at GE that the GE team would be meeting in Houston to "get aligned" and that the next few days would be critical. *Id.*

The next day, on April 5, 2013, Calhoun raised an issue with Moreno concerning the ownership of the PowerGen intellectual property. JX 32, Trial Tr. 728-31. Specifically, GE recognized that McIntyre controlled the intellectual property surrounding the PowerGen business, and Moreno discussed with Calhoun how to treat McIntyre in a manner that would entice him to cooperate with GE and Green Field on their potential joint venture. JX 32, Trial Tr. 732:15-733:9.

> Ted is the sole owners of MTT .... and so, you know, [PowerGen] is Ted's baby. And I'm trying to use the potential opportunity to benefit Green Field and the joint-owned company TPT that Ted and I had, or Green Field and Ted had... I needed Ted to be a partner. I couldn't force it. You know, I couldn't just mandate it.

Trial Tr. 732:15-733:9.

In the midst of this uncertainty over how Green Field could contribute McIntyre's intellectual property into the potential joint venture, Moreno flew to Houston on April 8 and 9, 2013, to meet again with GE's executive team. DX 266, Trial Tr. 745-49. On April 10, 2013, Calhoun e-mailed her superiors at GE with the "big points" discussed during the meetings with Moreno. *Id.* The outline of the deal continued to contemplate a $200 million investment, but Calhoun's internal e-mail recognized the uncertainty for the form of investment, the approval process and timeline for investments, and the business unit at GE that would own the investment. *Id.* Throughout these meetings, Moreno continued to insist that the money invested by GE needed to be used to pay for Green Field's pressure pumping equipment expansion. *Id.*

One week later, the uncertainty over which GE unit would own the venture bubbled to the surface. DX 268. On April 17, 2013, John Flannery—now the CEO of GE, but then the Senior Vice President of Corporate Business Development—e-mailed Calhoun to warn her that he was "not having much luck yet finding a 'sponsor' " for the power generation joint venture business. *Id.* Flannery indicated that GE "really need[ed] someone to show more interest" than Flannery was seeing at the time "to warrant taking any financial risk on this." DX 268. Moreno was unaware of this struggle within GE. Trial Tr. 751:9 – 752:16, 753:8 – 754:4.

That same day, on April 17, 2013, Calhoun sent additional e-mails internally to her colleagues at GE, recognizing that "we've done a 180 degree turn in the last 5 days," and that she did not know how to interact with Moreno given GE's sudden change in position. DX 268, Trial Tr. 754-55. She suggested that "[a]t the very least[,] we need to get him the $25MM loan and help him unwind what we've been discussing." *Id.* Another five days later, on April 22, 2013, internal e-mails within GE show that Calhoun was still trying to find a business unit to take ownership of the PowerGen business venture. DX 270, Trial Tr. 760.

***20** Then, on April 23, 2013, Calhoun provided an update to her GE colleagues, recognizing that GE was still only "50/50 on doing the deal." DX 111, Trial Tr. 755-60. The update recognized that John Flannery was convening a meeting of potential business unit sponsors on April 24, 2013, and that there remained a chance that GE would not approve the contemplated $200 million investment. *Id.* Calhoun lobbied her colleagues to remain supportive of a smaller $25 million loan if the larger investment did not get approved, explaining that "we've put Mike in a tough spot financially as he has waited for GE." *Id.*

Flannery held his meeting on April 24, 2013, and contemporaneous e-mails characterized those meetings as being "like an episode of 24." *Id.* Apparently, a faction within GE had agreed to invest in PowerGen, but conditioned on the money not being used toward Green Field's existing business. DX 271, Trial Tr. 764-65. While, GE was internally opposed to its money being used toward Green Field's pressure pumping business, Moreno was apparently unaware of this internal debate and continued to assume that the joint venture would support Green Field's business. *Id.*

One week later, on May 1, 2013, showing his frustration with the lack of movement by GE, Mike Hosford at GEOG sent an e-mail to Lee Cooper and Beth Comstock at GE to detail his perspective of the six-month history between Moreno and GE. DX 197, Trial Tr. 769-77, Hosford Depo Tr. 94:2-16. The e-mail details how GE continued to change its position with Moreno, and had moved from what was supposed to be a partnership relationship into "more of a transaction feel only." *Id.*

Hosford contemporaneously sent a copy of his e-mail to Moreno to show Moreno that there were some factions within GE still fighting for him. *Id.* While Comstock and Cooper defended GE by suggesting that Hosford was unaware of the lack of support in some key areas, Comstock acknowledged to Cooper that GE's behavior over the past six months was "embarrassing" and that she was "not sure [Hosford] is wrong" in his characterization. *Id.* Hosford concluded his e-mail by suggesting that GE should advance $25 million to Moreno immediately, with some going to the PowerGen joint venture and some going to Green Field to "allow him to complete at least frac spread 5." *Id.*

3. The GE Term Sheet and Related Transactions

As GE continued to struggle internally, Green Field was under time pressure. By May 17, 2013, Green Field needed to make a $17 million semi-annual interest payment under the Bond Indenture. Trial Tr. 799:7-12. As of May 2, 2013—*i.e.,* weeks before the semi-annual bond interest payment was due—Green Field did not have the liquidity to honor the semi-annual interest payment. PX 147, Trial Tr. 386:15 – 387:18. Under the circumstances, GE represented Green Field's best chance for avoiding an immediate default under the Indenture. Trial Tr. 1358:1-22.

Moreno fought hard to get cash from GE to help Green Field. While his discussions with GE had led him to believe that GE would fund its investment through Green Field by March or April of 2013, GE was slow to move on Immelt's orders to get Moreno money. Instead, Moreno was able to procure a short-term $25 million loan under the GEOG Note, which Moreno personally guaranteed. JX 49, Tr. 804-08. On May 13, 2013, Moreno and TGS executed a senior secured loan with GE for $25 million, which included the Project Cayenne Term Sheet as an attachment to the note. JX 49.

Moreno continued fighting to get concessions from GE in the Term Sheet annexed to the GEOG Note. First, Moreno negotiated to ensure that TPT would be the contract manufacturer for TGS. JX 49, Tr. 804-08. The term ultimately led to the execution, on June 21, 2013, of the Agreement for the Manufacture and Sale of Turbine Powered Generators (the "Tri-Party Agreement"), which was executed by Green Field, TPT and TGS. Stipulation No. 94.

***21** Moreno also negotiated for the inclusion of a provision in the Term Sheet to ensure that TPT earned a 25% mark-up on all equipment manufactured for TGS. JX 49, Tr. 804-08. Requiring TGS to order units from TPT benefited Green Field in two critical ways: (1) it gave half of the profit directly to Green Field, through its 50% ownership of TPT; and (2) it allowed TPT to operate profitably so that Green Field

would not have to fund its operations and overhead costs, saving Green Field substantial costs. *Id.* Moreno also fought to ensure that Green Field bondholders could exercise options to buy into the joint venture. *Id.*

While GE wavered on whether to allow an investment in Green Field directly, the Term Sheet contemplated the use of GE's initial $50 million investment to: (a) buy Green Field's unused engine inventory; and (b) build additional power pumping equipment to be leased to Green Field. JX 49, Trial Tr. 939-42.

Upon executing the GEOG Note, GE funded the $25 million loan to TGS. JX 49. Moreno characterized this transaction as "an elegant solution that GE signed off that said, yes, we understand that the timing of building this inventory at TGS is maybe a little sooner than necessary, but we see the value of going ahead and allowing you to buy the inventory, which would indirectly create some liquidity for Green Field." JX 3, Trial Tr., Mar. 20, 2018 at 9:17 – 11:13, 15:10 – 16:3. According to Moreno, Green Field could not have sold the turbine engines to just anyone for these values. Trial Tr., Mar. 20, 2018 at 11:4-20. GE provided a crucial joint venture partner to be a customer for TPT's manufacturing end-user product, which did not exist before GE advanced money to TGS. *Id.*

On May 14, 2013, TGS used nearly $20 million of those loan proceeds to purchase unused turbine inventory from Green Field. JX 3. Green Field had purchased those turbines from Honeywell at approximately $135,000.00 each. Trial Tr. 1582-83. There was no application or use for the turbines at the time, because Green Field lacked the liquidity to continue its capex expansion on its frac spread fleet. *Id.* Yet, despite the lack of a market or use for Green Field turbine inventory, Moreno negotiated with GE to purchase the engines from Green Field at approximately $500,000.00 per unit, totaling nearly $20 million, and constituting an almost 300% mark-up. *Id.*

While the Trustee's expert considered this transaction "fair value" because neither GE nor Powermeister, LP (discussed below) "cried foul," Trial Tr. 1086, 1758, 1085, the Court is not persuaded by that evaluation. Powermeister is the investment arm of Mt. Vernon, a bondholder with an existing investment in Green Field. A substantial mark-up that benefitted Green Field would give Powermeister no reason to "cry foul." Further, the circumstances leading up to GE's willingness to provide a $25 million short-term loan demonstrates that the use of these funds was anything but "fair value." This was an accommodation by GE, because GE had placed Moreno in a difficult position. DX 111, Trial Tr. 755-60. The Court agrees with Soward, Defendants' expert, that this transaction meets the definition of "extraordinary consideration," at least as it relates to the turbines. Trial Tr. 1764.

Further, the cash received from the inventory sales gave Green Field the liquidity it needed to satisfy its interest payment obligations due under the Indenture. Trial Tr. 1385. The loan proceeds from the GEOG Note also allowed TGS to reimburse Green Field over $1 million for the time Green Field's employees spent trying to develop the PowerGen business within Green Field before it became clear to Green Field that GE would not invest directly in Green Field. JX 1; Padaletti Depo. Tr. 97:13 – 98:6. The Court finds that this payment provided additional consideration to Green Field, which would not have been possible but for Moreno's continuous negotiations with GE and extensive efforts to find capital to save Green Field.

H. Transparency with Bondholders and Board Members

***22** Through the Second Amended Complaint and at trial, the Trustee questioned Moreno's openness and truthfulness. Based on the extensive record presented by Defendants, the Court finds that although there were areas of testimony that were not open and truthful, Moreno was credible concerning his communications with bondholders and Green Field's Board members.

1. The Board of Directors

The Court considers the circumstances surrounding the execution of the Consent Solicitation. Specifically, the Trustee alleges that Green Field's board of directors failed to inform themselves. Second Amended Complaint ¶ 31. Having considered the evidence presented at trial, including the extensive e-mails, notes, deposition testimony and live testimony, the Court agrees that the other members of the board were informed of Green Field's business and the circumstances necessary to make decisions, they acted prudently and independently.

Green Field's board was initially comprised of four individuals: Moreno, Fontova, Kilgore and Goodson. Stipulation Nos. 37, 39, 41, 42, 43 & 44. The board later added Mark Knight. Stipulation No. 42. Collectively, the board was

an engaged group of successful businessmen, each with his own experience, opinions and ego. Trial Tr. 1593:6-12.

While Fontova had worked at Dynamic Industries prior to joining Moreno at Green Field, he had decades of experience in senior management of large, public companies in the energy industry such as Shell and its affiliates. Trial Tr. 1278:2–1279:22. Fontova worked for other businesses not controlled by Moreno both before and after joining Green Field. *Id.* During his time working at Dynamic Industries and Green Field, Fontova felt free to disagree with Moreno and never felt as though he might be fired for disagreeing with Moreno. Trial Tr. 1284:18–1285:6.

Kilgore was appointed based on his past experience serving on the board of Dynamic Industries for 10 years, during which period the company saw a large expansion in its business and the ultimate successful sale of ownership to a private investment group. Trial Tr. 526-27, 1589:15-23. Moreno came to know Kilgore in the time before Moreno acquired Dynamic Industries and asked Kilgore to join the board of Dynamic Industries based on Kilgore's experience in the offshore market. Trial Tr. 1589:7-14. Kilgore is independently successful having founded and operated his supply boat business that delivers equipment to oil rigs and platforms in the Gulf of Mexico. Trial Tr. 1586:7–1587:17. Kilgore did not rely on Moreno for employment, nor did he rely on any of Moreno's businesses to support his own businesses. Trial Tr. 1589:24 – 1590:4. Kilgore was never paid to serve on the board of Dynamic or Green Field; he served voluntarily but took the appointments seriously. Trial Tr. 1591:1-14.

Goodson was the CEO of PetroQuest Energy, a publicly held oil and gas company focused on exploration and production. Trial Tr. 1591:17-19, 525. Moreno had known Goodson for 15-20 years prior to his joining the Green Field board. Trial Tr. 525. Goodson resigned from the Green Field board in May of 2012 to avoid any potential conflicts when his company began considering Green Field as a vendor for PetroQuest. Stipulation No. 44, Trial Tr. 525. Mark Knight was added to the board when Goodson resigned. Trial Tr. 528–29. Knight had a good reputation in the community and industry, and he was the CEO of his family company, Knight Oil Tools, which was one of the largest private companies in the industry. Trial Tr. 528-29, 1592:12–1593:5, 1591:20-22, 1592:4-11. He was also well-regarded for his involvement in the Lafayette, Louisiana community, which involved service on many boards and philanthropic endeavors. Trial Tr. 1592:12–1593:5. As with Kilgore, Knight was not compensated for his service Green Field's board. Trial Tr. 528. Rather, the board members were added to help Green Field grow as a young startup. *Id.*

***23** Once formed, the board met regularly to discuss Green Field matters. Fontova Depo. Tr. 15:1-13. While minutes were prepared to memorialize discussions, the meetings generally covered a broader array of topics than the agenda and minutes reflected. Fontova Depo. Tr. 15:1-13, Trial Tr. 1364:11–1366:3. The initial board meeting, in 2011, was held in person, but subsequent meetings were convened by phone, typically once per quarter. Trial Tr. 1593:13–1594:4. The meetings generally required a degree of formality, as all board members would receive an agenda in advance of the call, along with associated materials (e-mailed or shipped packages). Trial Tr. 1594:5–1595:1.

The Court finds that the board was apprised of the developments and the value of any potential PowerGen business opportunity. Both Kilgore and Fontova testified that they were well-aware of the many twists and turns that negotiations with GE had taken, and Fontova knew first-hand that GE would not allow a joint venture to be held within Green Field. Trial Tr. 1326:5219, 1598:4–1601:17. Kilgore was kept apprised of the developments through regular phone calls and meetings with Moreno and, on occasion, Fontova. Trial Tr. 532, 1596:1-25. Knight was told about Moreno's ongoing discussions with GE and had warned the other board members that GE was very difficult to work with and was not to be trusted. Trial Tr. 1599:14–1601:17, Knight Depo. Tr. 47:12–48:15, 49:1-50:6, Trial Tr. 1363:16–1364:8.

The board also understood that Green Field lacked the financial wherewithal to start a new line of business, particularly if GE was unwilling to invest in Green Field directly. JX 74, Trial Tr. 1616:6–1619:6. Thus, during the April 2013 board meeting and in prior meetings, the board discussed Green Field's need for new capital and GE emerging as Green Field's most likely (if not only) source. JX 74, Trial Tr. 1616:6–1619:6, 1489:19-1491:19. Because Moreno's discussions with GE remained fluid, no formal resolution was presented to the board and the board members did not believe any action was required because Green Field was not being asked to give anything away. Trial Tr. 1603:4–1605:25, 1607. However, the board members agreed that they would sign a consent if such a consent became necessary. Trial Tr. 1603:4–1605:25.

By May 13, 2013, GE was ready to advance money through a $25 million short-term convertible loan to TGS. As Moreno had negotiated with GE, the funds would be used to purchase Green Field's inventory, and Green Field would use those proceeds to make the semi- annual interest payment under the Indenture and resolve its short-term liquidity problems. Trial Tr. CONFIDENTIAL Mar. 20, 2018 at 11:4-20, Trial Tr. 1606:12 – 1608:12. Further, under the Term Sheet, TPT would execute a manufacturing agreement with TGS to begin building power generator units for TGS to lease to new customers. JX 49, Trial Tr. 1606:12 – 1608:12.

To assist in the transaction and satisfy a condition being imposed by GE's Padoletti, Green Field's corporate counsel at Latham & Watkins prepared the Consent Solicitation and circulated it through the company's CFO, Blackwell, who normally circulated materials to board members. Trial Tr. 1604:18–1605:25. The board members did not hold another meeting to deliberate execution of the Consent Solicitation. *Id.* Moreno executed it on behalf of himself and as manager for the two shareholders. *Id.* Fontova and Kilgore executed the Consent Solicitation without meeting, and Knight was not in his office on May 13, 2013, but executed the Consent Solicitation remotely. Trial Tr. Knight Depo. Tr. 51:18–53:14.

As such, the board signed the Consent Solicitation without meeting together and without receiving a fairness opinion. Despite this, the board members have all stated that the Consent Solicitation was a good move for Green Field. Short notice for the Consent Solicitation and the absence of a formal meeting or fairness opinion to deliberate the Consent Solicitation's terms casts some doubt on whether the board was adequately informed. The Court finds, however, that the record demonstrates that the Board was kept informed of Moreno's ongoing GE negotiations, had access to and considered adequate and accurate information in deciding whether to execute the Consent Solicitation and fully understood what Green Field would receive in exchange for its execution of the Consent Solicitation.

2. Bondholder Communications

***24** Under the Indenture, Green Field began holding quarterly bondholder conference calls in 2012 to discuss the company's quarterly financials and operations. Stipulation Nos. 88, 89. Those calls were held on June 5, 2012, August 22, 2012, November 21, 2012, April 19, 2013, May 22, 2013 and September 6, 2013. Stipulation No. 89. Each of those conference calls was transcribed. Stipulation No. 90, PX 111, PX 197, PX 217, PX 121, PX 143, PX 157, PX 177.

During these conference calls, Moreno typically gave a high-level update on business development, then the company's CFO, Blackwell, would give an update on the financial performance, followed by Fontova's update on the company's operations. PX 111, PX 197, PX 217, PX 121, PX 143, PX 157, PX 177; Trial Tr. 1298:21–1299:24. The call transcriptions clearly show that Fontova advised bondholders as to how the market reduction in 2012 impacted the company's margins and resulting ability to continue its planned operational expansion. PX 121, PX 143, Trial Tr. 1300, 1303:6-22, 1306-08.

Importantly, in all of Fontova's operational updates to bondholders, he never once mentioned PowerGen or attempted to give bondholders an update on Green Field's PowerGen business. Trial Tr. 1308:18–1309:5, 1314:24–1315:1. He explained that this was because Green Field never operated a PowerGen unit and, thus, there was never any update to give bondholders. *Id.* Of the hundreds of employees at Green Field, not a single employee was ever engaged in the PowerGen business; Green Field's operational efforts during this period were limited to "touching base with some of our customers to try and engage them and get feedback on their receptiveness about potentially PowerGen." Trial Tr. 1317:19–1318:4.

In addition to quarterly conference calls with all of Green Field's officers, Moreno also made it a point to keep in touch with the bondholders. Before the April 2013 conference call, Moreno invited many of the bondholders to visit Green Field and TPT's respective facilities in Louisiana to see and hear first-hand how Green Field's operations were developing—an offer that 80% of the bondholders accepted. Trial Tr. 315:21–317:5. In addition to this invitation, Moreno kept his more active bondholders apprised individually between quarterly calls. Trial Tr. 627:23 – 628:6.

Moreno made frequent calls to Green Field's larger bondholders, including one in particular—Wayne Teetsel of Stonehill Capital ("Teetsel"), which held at least $30 million of the total $250 million bonds issued. Teetsel Depo. Tr. 205:13-25. The Teetsel calls were to him alone and not to all bondholders. The calls are important because Teetsel took contemporaneous handwritten notes of his conversations with Moreno, an undertaking that sheds light on the extent to which Moreno sought transparency with his investors. Teetsel Depo. Tr. 26:10-15, 43:11-14, 46:10-12, 126:2-13, 133:3-18, 174:15-22, 178:9-18. Based on the following history of

bondholder communications, the Court finds that Moreno did not intend to mislead or defraud Green Field or its creditors.

As early as November 7, 2012, Moreno informed Teetsel that GE was interested in making an equity investment into Green Field so that Green Field could form a new leasing company to build and lease power generation units. DX 42, Trial Tr. 579-83. On November 15, 2012, Moreno updated Teetsel that GE was contemplating a contribution of its Compressed Natural Gas technology into the joint venture, and that Green Field would agree to convert its "manufacturing capacity" from construction of frac pump equipment to power generation equipment. DX 44, Trial Tr. 583-86. At the time, in mid-November 2012, GE was contemplating a $25 million cash and $50 million in-kind contribution into the joint venture. *Id.* The Court finds that this representation was accurate at the time.

***25** One week later, on November 21, 2012, Green Field held its quarterly bondholder call. JX 15. According to Teetsel's contemporaneous handwritten call notes, Teetsel understood that Green Field's performance had been poor due, in part, to increased guar prices and lower energy prices. JX 15. Moreno advised bondholders that he was doing two things to increase liquidity. JX 15, Trial Tr. 588, Teetsel Depo. Tr. 134:4 – 135:17. First, he attempting an equity raise. *Id.* Second, he was pulling back capex spending until there were more customer contracts in place. *Id.* Operationally, Moreno advised bondholders that the company was performing as planned. *Id.* However, although Moreno had already told Teetsel and others about a potential GE investment in a new PowerGen leasing business venture, Teetsel knew that no such business existed. Teetsel Depo. Tr. 136:13-20.

Eight days after the bondholder conference call, on November 29, 2012, Moreno called Teetsel directly to provide an update on his capital raise efforts. DX 26, Trial Tr. 592-600. Moreno told Teetsel about the potential SandRidge pilot program and provided rough estimates of the capital costs and likely revenues realized from a potential leasing venture. *Id.* At the time, while Teetsel understood why Green Field was exploring the potential new PowerGen business venture, he believed that Green Field lacked the liquidity to expand into this new line of business. Teetsel Depo. Tr. 143:8–144:13. Teetsel knew that Moreno was only considering the PowerGen idea as a means to save Green Field. *Id.*

On December 20, 2012, Moreno provided Teetsel with another update describing the imminent execution of a memorandum of understanding and supply agreement between Green Field and GE. DX 178, DX 181, Trial Tr. 603-09. Under this arrangement, Green Field and TPT would begin commercializing GE products for use in their existing pressure pumping business. *Id.* While discussions were progressing on the supply agreement terms, Moreno believed discussions with GE would progress more quickly if GE simply provided a line of credit to Green Field in exchange for Green Field's commitment to purchase GE products. DX 179, Trial Tr. 603-06. These discussions failed, however, because GE was only willing to extend $10 million of credit to Green Field and only with a standby letter of credit and personal guaranty from Moreno. *Id.* Thus, Moreno continued negotiations with GE as a joint venture and equity partner. *Id.*

One month later, on January 18, 2013, Moreno provided Teetsel with another update that GE had committed to infusing Green Field with $15 million, which would be used to fund TPT's efforts to commercialize McIntyre's dual fuel technology on GE's equipment. DX 30, Trial Tr. 608-11. Importantly, also during this conversation, Moreno advised Teetsel that he was expecting a $200 million term sheet from GE any day. *Id.*

As the negotiations with GE began to shift, Moreno kept Teetsel and the bondholder group apprised of those shifts. The first example of this appears in Teetsel's notes from a call on February 6, 2013. JX 22. In the days before Moreno's call with Teetsel, Moreno had been in discussions with GE about the form of the joint venture or equity investment. Trial Tr. 611-24. According to e-mails between Moreno and individuals at GE, and GE internal communications responding to Moreno's communications, GE had not yet decided how to partner with Moreno and Green Field. DX 183, Trial Tr. 611-24. By the time Moreno provided his update to Teetsel on February 6, 2013, Moreno advised Teetsel that any money coming from GE would come "with strings." JX 22, Trial Tr. 626-29. Specifically, the $100 million contemplated as of early February 2013 might have to go into a special purpose entity outside of Green Field, and that Green Field's only interest in the PowerGen business might be as the contract manufacturer. *Id.* Moreno told bondholders that this structure would still provide Green Field with much needed liquidity. *Id.*

***26** Over the course of the next two weeks, Moreno was deeply engaged in discussions with GE over the form of GE's potential investment. On February 28, 2013, Moreno

provided Teetsel with an update about the private equity firms with whom Moreno had met. DX 49. Moreno met with private equity firms until GE confirmed that Immelt had approved GE's investment into Green Field on March 8, 2013. Trial Tr. 668-74. On February 15, 2013, Moreno met with GE in Irving, Texas. DX 257, DX 258, Trial Tr. 661-65. On February 28, 2013, once Moreno was comfortable that GE would approve an investment with Green Field, Moreno provided Teetsel the full update. JX 49, Trial Tr. 668-74. At the time, Moreno anticipated that GE would invest $100 million by the end of March 2013. *Id.*

On March 12, 2013, days after Immelt approved an immediate investment of at least $25 million, Moreno provided Teetsel with an update. JX 25, Trial Tr. 681. According to Teetsel's notes, "GE [was] working on getting Mike $25 [million] in the interim to kick-start the construction of power gen units ... $25 [million] would come into Green Field as a deposit on the 1st $100 [million] order." JX 25.

Nine days later, on March 21, 2013, Moreno provided Teetsel with another update. JX 25. According to Teetsel's notes, Immelt wanted the investment funded by the end of April. *Id.* Teetsel's notes also indicate that GE was willing to fund 100% of the capital for the joint venture, but "the JV must be an unrestricted subsidiary [of Green Field and] will require bondholder approval." *Id.* As Moreno warned Teetsel in February, GE's money comes "with strings." JX 22, Trial Tr. 262-26, 682-86. More specifically, in order for Green Field to benefit from GE's investments, the bondholders were going to have to consent to the creation of a new subsidiary of Green Field that was "unrestricted" - meaning that the new venture would not be subject to the $250 million bondholder debt. *Id.* While Green Field never formally solicited bondholder consent on this issue, the Court finds that such efforts would have proven futile for at least a couple of reasons. First, the bondholders had made clear to Moreno that they would only consent to a structure where the joint venture was a restricted subsidiary of Green Field. Teetsel Depo. Tr. 198:23 -199:3. Additionally, GE could not get comfortable that its potential investment in a subsidiary of Green Field—restricted or unrestricted—would be sufficiently protected from Green Field's bondholders. Trial Tr. 588:4-7, 637:24 – 638:7, 782:3 - 19.

On March 25, 2013, *i.e.*, the same day that Moreno dined with Immelt to discuss the future partnership—Teetsel's notes reflect that GE "seems to be" willing to invest in the power generation business "as a division of Green Field" and fund CapEx needs for both the PowerGen start-up and Green Field's existing pressure pumping business through "an upsized investment in the Power Gen JV." JX 29. Moreno advised Teetsel again that GE had committed to advance $25 million immediately, with the remainder of the investment to come by the end of April. JX 29, JX 30, Trial Tr. 686-89. Moreno's update to his largest bondholder remained true to GE's position at the time.

Moreno's next critical update to Teetsel was on April 5, 2013. JX 33. As discussed above, Moreno had made significant progress with GE prior to this date—e.g., Moreno flew to Schenectady, New York on April 3 to meet with Calhoun and her team, Calhoun e-mailed an outline of the deal points to Moreno, then raised the issue over who owned the PowerGen intellectual property, and started to convene "critical" meetings in Houston, Texas to "get aligned" on the various moving parts. JX 32, DX 265, Trial Tr. 728-31, 740. According to Teetsel's April 5 notes, GE was willing to contribute up to $200 million to the joint venture, and the joint venture would provide Green Field with $400 million of consistent revenue over the next three years, with 25% margins. JX 33, Trial Tr. 736-40. Moreno was still committed to using those revenues from the PowerGen joint venture to complete Green Field's frac spread construction. *Id.* Once again, Teetsel's notes, based on Moreno's disclosures to him, remain consistent with the transaction that GE was contemplating at the time. JX 32, DX 265, Trial Tr. 728-31, 740.

***27** Five days later, on April 10, 2013, Moreno provided Teetsel with another update. DX 45. Teetsel's notes provide that Green Field had lined up two new customers for its frac services. DX 45, Trial Tr. 742-43. This demonstrates that Green Field had not pivoted from its core fracking business, even in the midst of Moreno's negotiations with GE. *Id.*

On April 18, 2013, Moreno updated Teetsel again. DX 45. According to Teetsel's notes, GE was still contemplating a $200 million investment, of which $25 million would be made by the end of the month, and $100 million would be used to fund the construction of two frac spreads for Green Field. DX 45, Trial Tr. 744-46. Teetsel also noted Moreno's ongoing negotiations with GE to ensure that bondholders would receive warrants for non-voting shares in the joint venture with GE. *Id.* As discussed above, this term made it into the ultimate Term Sheet annexed to the GEOG Note. JX 49.

On May 14, 2013, Moreno provided another update to Teetsel. DX 35. According to Teetsel's notes from this call, Moreno advised Teetsel that he closed on the initial GE loan on the previous day, and that Moreno would be closing on a personal loan with Goldman Sachs the next day. DX 35, Trial Tr. 778-81. Moreno told Teetsel that the two loans would provide Green Field with up to $50 million in liquidity. *Id.* In other words, even though the PowerGen leasing company was being held outside of Green Field, Moreno assured Teetsel that he was able to help Green Field by keeping it outside. *Id.*

As discussed above, Green Field actually benefited from the GE loan. As soon as GE funded the loan, Moreno caused the vast majority of the funds to be transferred to Green Field to purchase Green Field's stale turbine inventory, at a substantial mark-up. JX 3; Trial Tr. 829:12- 23, 830:3 – 832:8. This transaction allowed Green Field to make its semi-annual interest payment to the Indenture Trustee—something that, but for Moreno's willingness to personally guarantee loans for non-debtor entities, Green Field would not otherwise have been able to do.

While Teetsel was the only bondholder to keep contemporaneous handwritten notes memorializing his phone conversations with Moreno, there is evidence that Teetsel was not the only bondholder with whom Moreno communicated during this period. Moreno testified that he communicated with many of his bondholders, and there is evidence to corroborate this testimony. Trial Tr. 782:10-19. For example, Jacob Rothman, a representative of another bondholder called Beach Point Capital, testified that Moreno had been updating him on his efforts to raise capital for Green Field, and that Rothman believed that Moreno might actually be able to raise the equity needed to keep Green Field in business. Rothman Depo. Tr. 80:19–81:21. Another bondholder, Mount Vernon Investments, actively negotiated with Moreno and ultimately made a qualified investment in TGS (through its affiliate Powermeister), knowing that the PowerGen leasing business would be held outside of Green Field and believing that a well-capitalized PowerGen business would benefit Green Field and, by extension, its bondholders. DX 137, DX 140, DX 141; Merrick Depo. Tr. 15:20–16:20, 86:9–87:16, 87:22-88:10. Moreno testified that he also worked closely with another bondholder, BP Capital, who considered but decided not to make a similar loan or qualified investment. Trial Tr. 564:6–565:16.

***28** Considering the weight of evidence, the Court finds that Moreno was open and transparent with Green Field's creditors, and that the Trustee has not presented sufficient evidence—direct or circumstantial—to demonstrate that Moreno intended to defraud or otherwise harm Green Field or its creditors. On the contrary, the evidence suggests, and the Court finds, that Moreno was dealing with a very fluid situation during the course of his negotiations with GE, and as time ran out on Green Field's liquidity, Moreno did his best to keep Green Field's creditors apprised of how GE's ever-changing investment might impact Green Field and its ongoing business.

3. Ownership of the PowerGen Idea

The Trustee sought to paint PowerGen as a natural extension of Green Field's Frac Stack Pack license. The Court is not so persuaded, and McIntyre, the inventor and expert in the field of aero-derivative turbine applications, himself disagreed with this proposition. McIntyre Depo. Tr. 32:23 – 34:15. As discussed above, the Frac Stack Pack invention was one of many applications of aero-derivative turbines that McIntyre developed and deployed. McIntyre had also developed fire suppression systems for the oil and gas industry as well as engines for boats and motor vehicles—none of which the Trustee contends to be a natural extension of the Frac Stack Pack technology.

As Moreno's search for capital led him into discussions with GE over a PowerGen business, Moreno involved McIntyre from the beginning. McIntyre Depo. Tr. 39:1–40:18, 49:22–51:17. Before that time, TPT was not engaged in manufacturing power generators—it only built TFPs for Green Field's pressure pumping business. McIntyre Depo. Tr. 61:12-64:1. Only after Moreno convinced his counterparts at SandRidge to run a pilot program for power generator units in January 2013 (PX 129; Trial Tr. 219:9–220:24) and after GE's engineers spent enough time with McIntyre's staff working on design specifications for the power generation units, did McIntyre use Marine Turbine assets and trade credit to build power generator units in February 2013. Trial Tr. 1530:11–1533:22; McIntyre Depo. 64:19–66:15. Construction was at TPT's facility, which McIntyre owned and which he had also used for Marine Turbine's business. Trial Tr. 1516:14-22.

While McIntyre's staff built TPUs for the SandRidge pilot in early 2013, neither Green Field nor TPT supplied any technology or know-how toward the construction. Trial Tr. 1533:10–1534:15. McIntyre only considered allowing his PowerGen opportunity to be manufactured through TPT instead of Marine Turbine because Moreno convinced him that "it was the right thing" to do, and because Moreno could

bring an industry titan, like GE, to the table as a potential customer. Trial Tr. 1537:7–1538:23, 1541:25–1542:12.

I. Valuing the PowerGen Startup

1. The Parties' Expert Witnesses

In an effort to prove (and disprove) damages, the Trustee and Defendants each presented an expert witness to opine on the value of the PowerGen startup as of the time of the alleged transfer. The Trustee contends, and his expert Kearns, assumed that the date of the transfer and, thus, the critical date for valuation was May 13, 2013, the date Green Field's board of directors executed the consent, waiving the opportunity to participate in the leasing side of the PowerGen business and permitting Moreno to continue negotiations with GE through TGS. Trial Tr. 997:15-18. Defendants dispute that anything was actually transferred on that date or as a result of the Consent Solicitation, but their expert Sowards also provided his analysis of the potential value of the PowerGen startup as of May 13, 2013.

***29** Both Kearns and Sowards were qualified as expert witnesses for purpose of evaluating the value of the PowerGen startup. Trial Tr. 1252:13–1254:25, 1674:15–1675:3, 1794:4-17, 1841:16-23.

2. Methodology and Areas of Disputes

Kearns testified that he used a "Venture Capital Approach" which involved five steps. Trial Tr. 1031. Because PowerGen did not have any operating history and, thus, no ability to consider past performance, step one was to determine the development stage of the company. Trial Tr. 1031. Step two was to "evaluate potential range of outcomes ... and those outcomes can include a single, to a home run, to a strikeout." Trial Tr. 1051. Step three was to "probability weight" those potential outcomes. Step four was to determine the value of the enterprise. Trial Tr. 1051. Lastly, step five was to take the value and allocate it among the participants in the venture. Trial Tr. 1032.

Kearns did not create, conduct or rely upon his own financial projections or market analysis as a basis for determining the value of PowerGen common equity. Trial Tr. 1108. Rather, he relied entirely upon GE's financial projections and market studies (discussed *infra*). Trial Tr. 1108. Fur t h e r, beyond relying on the documents produced in this case, Kearns acknowledged that he lacked direct personal knowledge to verify the assumptions for any of the financial projections. Trial Tr. 1164.

Kearns identified AICPA guidelines on the valuation of equity securities for privately held companies to describe the methodology he relied upon. PX 213. The methodology he used is known as the "Probability Weighted Equity Return Model" ("PWERM") methodology. Kearns directed the Court to Chapter 6 of the AICPA guidelines which describes "probability weighting analysis." Kearns noted that "in this case you have a range of potential outcomes, going from, as you will see, management's view to zero. And how from a valuation perspective those outcomes have to be weighted from a probability perspective to come to a value conclusion." (PX 213; Trial Tr. 1033-34). In general, Sowards, Defendants' expert, did not disagree with the general methodology described by Kearns and as outlined in the AICPA guidelines. Sowards did, however, have significant disagreement concerning the correct application of the methodology, as well as whether Kearns relied upon the appropriate data when applying the PWERM methodology. Trial Tr. 1742:21–1744:13, 1745:18–1746:2.

As a threshold matter, Sowards testified that there were actually a fair number of points on which he agreed with Kearns's methodology. Trial Tr. 1684:16–1685:24. Specifically, Sowards and Kearns agreed that, without seed capital of $100 million, there was no PowerGen business or opportunity to value. Trial Tr. 1685:1-6. Sowards also agreed that GE's financial model was useful to try to ascribe value to common equity for the PowerGen startup opportunity given its lack of operating history. Trial Tr. 1685:7-11. Sowards and Kearns also agreed on the discount rates applied for the premium and the delay period. Trial Tr. 1685:11-14. Lastly, they agreed that an EBITDA multiple of six to eight was reasonable for determining an enterprise value. Trial Tr. 1685:15-19.

***30** The differences in the experts' valuation opinions centered around four principal "critiques," as presented by Sowards. First, Sowards testified that Scenario 4—not Scenario 3—is the appropriate "GE Model" that could be used as a "base case" for determining a value. DX 311, Slides 1-6; Trial Tr. 1687:10 – 1688:13, 1689:17 – 1730:5. Second, Sowards testified that the value ascribed to Green Field under the Tri-Party Agreement, which would not have existed but for Moreno's work to negotiate the Term Sheet with GE, should be taken into account. DX 311, Slides 7-9; Trial Tr. 1731:8 – 1742:20. Third, Sowards opined

that Kearns' analysis failed to account for the risk that the $100 million capital infusion, which was necessary for the PowerGen startup, would not be obtained. DX 311, Slides 10-11; Trial Tr. 1742:21 – 1757:8. Finally, Sowards testified that Kearns' analysis failed to take into account the profit Green Field obtained from TGS by selling its unused turbines. DX 311, Slides 12-13; Trial Tr. 1757:9–1765:17. While Kearns attributes $26.9 million in value to the PowerGen opportunity, Sowards explained that, if these four adjustments are taken into account, the value of PowerGen is less than $0. DX 311, Slides 14-15; Trial Tr. 1775:12–1787:3. Sowards further explained that if Kearns had used Scenario 4, instead of Scenario 3, and made none of the other three adjustments he describes, the valuation of the PowerGen opportunity using Kearns' methodology would be $6.8 million. *Id.* The effect of each of the adjustments described by Sowards on the value of the PowerGen common equity is demonstrated in DX 311. Each of the four points are addressed below.

3. Selection of a "Base Case" for Valuation—Use of Scenario 3 or Scenario 4

A significant amount of trial time was spent discussing the various "scenarios" of the "GE Sensitivity," which were GE's PowerGen financial models. Trial Tr. 971-1254 [Kearns]; Trial Tr. 1661-1842 [Sowards]; JX 39 [GE Sensitivity]. The GE Sensitivity was considered by GE Corporate in May, 2013 with regard to the PowerGen opportunity, and it consists of four "scenarios," containing different assumptions and inputs. By "sensitivity," the Court understood that GE made assumptions based on its own observations as well as those provided by Green Field's management, and made various different adjustments for utilization of power generation units, speed of deployment of the units, capital costs and the like. Trial Tr. 1052-53. On or about May 2, 2013, management for Green Field sent individuals at GE a detailed Microsoft Excel file with what purports to be management's financial projections, assuming $100 million equity from GE and "maximum production of units with available cash received from GE plus cash generated from operations." JX 36. GE then prepared its own model, which sensitized management's projections and considered GE's own different assumptions. JX 39, JX 40. The same models were forwarded to GEOG's representative, Padaletti, on May 15, 2013. JX 59. For purposes of the GE sensitivity analysis, Green Field's projections are in Scenarios 1 and 2, and GE's sensitized projections are in Scenarios 3 and 4. JX 39, JX 40.

Kearns did not conduct an independent financial analysis or projection of the PowerGen startup, but, instead, relied on the GE Sensitivity. Trial Tr. 1108. The first critique offered by Sowards was over Kearns's selection of Scenario 3 as the "base case" for determining value. DX 311, Slides 1-6. Kearns concluded that the Green Field management's projections, which were contained in Scenarios 1 and 2, were unreliable, and, thus, chose not to use the Green Field projections in his valuation analysis. Trial Tr. 988:7-14. Sowards agreed with Kearns that Green Field management projections were unreliable as a base case and should not be used in an analysis of the value of common equity of the PowerGen Opportunity. Trial Tr. 1730:12 – 1731:7.

Kearns and Sowards disagreed as to whether Scenario 3 or Scenario 4 provides the more reliable base case for valuation of the common stock of a PowerGen joint venture. For his base case, Kearns relied upon Scenario 3, describing it as the "GE PowerGen Sensitivity" in his trial testimony. Trial Tr. 1149-50; Kearns demonstrative Slides 24 and 25. Sowards contended that Scenario 3 is not GE's model because it does not contain all of the key assumptions made by GE during its analysis of the financial projections and that Scenario 4, which does contain all of GE's key assumptions, is therefore the most reliable base case and should have been used for the financial analysis/determination of valuation and damages, if any. As described below, the Court agrees with Sowards' contention that Scenario 4 is the most reliable base case and should have been used for the financial analysis/determination of valuation and damages, if any.

***31** In a document titled "Project Cayenne Financial Model Overview" (the "GE Model Overview"), dated May 21, 2013, GE described and compared the "Green Field Model" and the "GE Model." JX 40. This GE Model Overview is informative, as it describes the differences in the Scenarios in the GE Sensitivity. Kearns relied on the GE Model Overview in conducting his analysis. Trial Tr. 1147. He cited the same document as the basis for stating that the EBITDA he relied upon (which came from Scenario 3) was forecasted following GE's adjustments of "several key assumptions." Kearns acknowledged that on Slide 6 of the GE Model Overview, GE listed its "key assumptions" as compared against Green Field's model. Trial Tr. 1150. Kearns opined that GE "sensitized several key assumptions" and that following those adjustments, the GE PowerGen Sensitivity forecasted revenues of $87.3 million for 2015 and EBITDA of $48.3 million. Trial Tr. 1147:25–1149:24. These amounts come from Scenario 3. Trial Tr. 1163:1-18. Kearns also testified that the $48.3 million of EBITDA used in his

analysis resulted from a GE analysis which contained GE's key assumptions. Trial Tr. 1147:25 – 1149:24.

Scenarios 1 and 2 of the GE Sensitivity Analysis, which are the Green Field management's models, projected the total number of power generation units to be manufactured and deployed as 265 units. JX 36; DX 311, slide 4; Trial Tr. 1156. In the GE Model Overview, GE described Green Field management's assumptions regarding the number of units to be manufactured and deployed (265 units) as follows: "Unit deployments based on capacity of TPT, not a bottom's up commercial schedule – only 40 MW under contract to date." JX 40, p. 2. On the same slide of the GE Model Overview, GE described Green Field management's model as "High Growth, high margin, high CAPEX model." JX 40, p. 2. Slide 6 of the GE Model Overview, which contains a bold heading of "GE MODEL," explains the following differences between the GE model and the Green Field management model scenarios:

- Similar construct with a few key differences
- Doubled Variable Cost assumptions to 10/12/6% of sales
- Increased fixed monthly cost to 500k and 6%
- Reduced Utilization to 65%
- Increased equipment costs to $630k for 1 MW unit
- Slower ramp in unit sales after 40 MW has been commercialized
- Balance Sheet capitalized with $100M from Day 1

JX 40, p. 6. Scenario 3 does not contain all of GE's key assumptions, as indicated on Slide 6 of the GE Model Overview. JX 40. Only Scenario 4 lines up with GE's own description of the "GE Model." Specifically, Scenario 3 contains a projected total number of units to be manufactured and deployed that remains at 265 units—the same as Green Field management projections in Scenarios 1 and 2. JX 36, DX 311 slide 4; Trial Tr. 1055, 1158-59, 1165. Scenario 4, which includes GE's assumption of the manufacture and leasing of 191 units, is significantly different. Only Scenario 4 contains the "slower ramp in unit sales" and increased equipment cost. JX 36, DX 311 slide 4. Scenario 4 also slows the rate of deployment of the units. JX 40 p. 7. These are key assumptions by GE that were known or knowable as of May 13, 2013. Trial Tr. 1774:11–1775:11. Accordingly, Scenario 4 utilizes the same assumptions as those listed in the GE Model Overview and self-described by GE as the "GE Model." JX 40, Slides 6-7. As such, the Court finds that Scenario 4 is the more reliable and appropriate base case for an analysis of the value of PowerGen common equity.

As Sowards explained, the projected financial results using Scenario 3 as the base case for the valuation analysis rather than Scenario 4 are significantly different. JX 40, Slide 6-7; Trial Tr. 1723:4 – 1724:22, 1701:12-25, 1707:3–1708:2, 1713:2–1716:20. Scenario 3 generates EBITDA of $48.3 million in 2015 while Scenario 4 generates EBITDA of $29.9 million in 2015. JX 39, DX 311, Slide 6; Trial Tr. 1692:17–1697:13. Kearns agreed that if he had used Scenario 4 his valuation of the common equity would have been "lower." Trial Tr. 1171.

Kearns claimed that he used GE's projections of revenue and EBITDA. Trial Tr. 1148-49. However, his analysis was based upon projected EBITDA from Scenario 3 which contained management's original assumption of 265 units to be manufactured based solely upon manufacturing capacity rather than the market driven assumption used by GE in Scenario 4, which, again, assumes 191 units to be manufactured. *Id.* Kearns testified that he used Scenario 3 as the basis for his valuation, and that he "considered" but did not use Scenario 4 because it was a "downside" or "stress case" that was not informative for valuation purposes. Trial Tr. 1052, 1056, 1102. Sowards testified, and this Court agrees, that the selective use of GE's key assumptions for a base case diminishes the usefulness and reliability of Kearns' valuation opinions. Trial Tr. 1724:7-22. Kearns admitted that his report(s) did not disclose the existence of Scenario 4 and that he should have at least noted it in a footnote. Trial Tr. 1165:7-17. There was no testimony or evidence indicating that, as suggested by Kearns, GE considered Scenario 4 to be a downside case or that they considered it of no value in a valuation analysis. Trial Tr. 1171:19–1172:7. On the contrary, the evidence indicates that Scenario 4 is GE's more complete financial sensitivity analysis. In addition to the references in the GE Model Overview (JX40), indicating that the GE Scenario 4 contained all the key assumptions and was the "GE model," Kearns admitted that the Project Cayenne Overview (JX40) supports GE's use of the lower number of projected units. Tr. 1187. Other evidence also supports the conclusion that GE was concerned that the potential market for PowerGen units might be smaller than GE originally thought, a concern that supports financial projections forecasting production of fewer units and supports a conclusion that Scenario 4 was both the "GE model" and a more appropriate base case.[15]

***32** Kearns also refers to the "September reforecast," which is an incomplete draft forecast prepared by GEOG in September 2013. PX 212. The earlier model, prepared by GE in May 2013, was prepared by a different GE group and then presented to management at GEOG for completion. Padaletti Depo. Tr. 157:22–162:6. GEOG began to prepare its own financial model for the PowerGen opportunity, but never completed its modeling before deciding to withdraw from negotiations all together. *Id.* For this reason, the so-called September reforecast is not a reliable indication of value or what was known or knowable in May 2013. Trial Tr. 1770:3–1775:11. However, the Court notes that the figures in the subsequent GEOG draft model in September 2012 projected the same number of units (191) that were contained within Scenario 4 of the May 2013 model. PX212, Tr. 1055, 1060. The use by GE of a lower projected number of units supports Sowards' assertion that GE assumed a smaller number of PowerGen units would be manufactured and leased in the oil and gas market and this is a more reliable assumption.

Also supporting this conclusion is an email dated April 23, 2013, from a GE officer, Robert Duffey, to John Flannery and Duncan O'Brien. DX 288. In this e-mail, Duffey gave his comments after reviewing a draft business plan for the anticipated joint venture. Among other comments, he notes that he saw there are a lot of uncertainties in the business plan that he saw that the assumptions on market share might not be achievable by a business with no personnel today, that the oil and gas industry's slow adoption of new technologies, and that other competitors such as Caterpillar were also "doing pilots today as well." *Id.* Duffey also notes that the business plan "assumes that the infrastructure is in place to remotely produce and deliver the gas needed for fuel in the field." Trial Tr. 1189-91. The absence of infrastructure to deliver "field gas" to the PowerGen turbine units would again deprive the turbine PowerGen leasing operation its most significant claimed competitive advantage—the ability to operate on field gas available at the well site—and could also have caused GE to be more conservative in estimating the number of units which could be manufactured and leased. DX 288.

Kearns also testified that PowerGen was in the early part of the growth-stage opportunity; that PowerGen had no track record of profits. Trial Tr. 1123:3 – 1131:25. All of the factors cited point to the use of Scenario 4 as a more reliable basis for valuing the common equity in PowerGen. Kearns relied on the assumption by Green Field management, GE and its outside consultants with respect to the market and costs and did not independently verify any of their assumptions. Trial Tr. 1142. Separate and apart from the documents, he could not give opinions as to the number of PowerGen units that could be built or leased. Trial Tr. 1144. Moreover, Kearns specifically identified the GE Model Overview as a document that would support GE's use of a lower projected number of units. Tr. 1187.

The testimony of Kearns raises another issue regarding Kearns' opinions on valuation and damages. As noted, he dismissed Scenario 4 as a stress case, a downside case and as not instructive as to common equity valuation. He did so in spite of his testimony that the "second step" of his valuation methodology was to "evaluate a potential range of outcomes...and the outcome can include a single to a homerun, to a strikeout," Trial Tr. 1031; and his testimony that you have a range of potential outcomes "from management's view to zero, Trial Tr. 1040, that from a valuation perspective must be weighted from a probability perspective to come to a value conclusion. Even if the Court could conclude that Scenario 3 was a more reliable base case than Scenario 4, Kearns testified that he "probably weighted" Scenario 3 only against the management Scenarios 1 and 2 and against the GE September forecast draft. Trial Tr. 1077-78. None of Scenarios 1 or 2 or the September reforecast take into account the probability of a strike out.

***33** The Court believes that Kearns' methodology was generally reliable; however, his reliance on Scenario 3 and the exclusion of Scenario 4 from his analysis reduces the usefulness of his valuation analysis and opinions. Kearns chose to rely entirely on the analysis conducted by GE and its consultants and testified that he had no independent knowledge or experience to give opinions regarding the number of PowerGen units that could or would be manufactured and leased for use in the oil and gas industry. Trial Tr. 1108, 1142-45. Thus, there is no basis to support the selection of an EBITDA from a scenario that does not contain all of the information identified as key assumptions, which are contained in another scenario. The evidence shows that in spring 2013, GE was expressing concerns about the market for turbine powered generation in the oil and gas industry. Scenario 4 recognized that concern, while Scenario 3 did not. Moreover, Kearns admitted that the assumptions in the GE Model Overview, which included GE's lower utilization rates and slower deployment of units, were present only in Scenario 4 of GE's analysis. Based on all of the evidence the Court concludes that Scenario 4 provides a more reliable basis for evaluation of the common equity attributed to the PowerGen

opportunity and that Scenario 3 does not reflect all of the conditions that were known or knowable in May 2013.

The more reliable base case for valuing the common stock in the PowerGen opportunity is Scenario 4. Under Scenario 4, GE projected 2015 EBITDA of $29.9 million. Accepting and applying Kearns' methodology to EBITDA of $29.9 million results in a total common equity value of $39.6 million. Dem Ex. D311, slide 6. Further applying Kearns' methodology to then find the Green Field interest in PowerGen (49.9%), and deducting the net TGS deposit (which Kearns testified is "undisputed mitigation") results in a damage amount of $6.8 million before making any of the additional three adjustments suggested by Sowards. Applying the adjustments recommended by Sowards to the calculations using Scenario 4, as discussed below, further reduces damages significantly —to a figure below zero. DX 311, slide 6 and 14; Trial Tr. 1775:12 – 1788:6.

4. The Tri-Party Agreement and Value to Green Field

The second critique offered by Sowards was Kearns's failure to include the value added by the Tri-Party Agreement as mitigation. JX 42, DX 311, slides 7-9; Trial Tr. 1731:11–1742:20. As discussed above, the Tri-Party Agreement was an agreement between TPT and TGS under which TGS agreed to order its TPUs from TPT at a 25% profit margin. JX 42. This was one of the terms negotiated by Moreno for the benefit of Green Field that was included in the GE Term Sheet. JX 49. Before the execution of the Tri-Party Agreement, Green Field was responsible for paying all of TPT's overhead and expenses. In other words, TPT was a cost center to Green Field. Following the execution of the Tri-Party Agreement, TGS would be paying all of TPT's expenses, plus a 25% profit margin on all units produced. This converted TPT from a cost center into a profit center for Green Field. Trial Tr. 1732:7–1733:20.

Green Field stood to benefit from its 50% ownership of TPT and the 25% profit built into the Tri-Party Agreement. Trial Tr. 1733:24 – 1742:20. As TPT built power generation units, it would be paid a 25% profit on each unit, and Green Field would own 50% of that. Specifically, depending on the Scenario adopted and the number of units produced over the operative period, by Sowards' calculation, Green Field stood to benefit from the Tri-Party Agreement between $6.5 million (for Scenario 4) and $9.1 million (for Scenario 3). JX 42, DX 51, DX 311, Slide 9; Trial Tr. 1733:23–1742:20. Kearns offered no explanation for why this profit that Green Field would receive under the Tri-Party Agreement (and the change from TPT as a cost center to TPT as a profit center) was not valuable to Green Field and should not be taken into account. The Court thus agrees with Sowards that the profit attributable to Green Field's ownership of TPT should be factored into any damage model as mitigation. Accordingly, the Court accepts Sowards' critique on this point and will reduce any damages accordingly. Applying the projected profit under the Tri-Party Agreement as mitigation of damages to the potential value of Green Field's common equity in PowerGen under Scenario 4 reduces the alleged damages from $6.8 million to $300,000. *See* DX 311.

5. The Trustee's Valuation and the Risk of No Funding

***34** The third critique offered by Sowards was that Kearns failed to account for the risk that no funding for the PowerGen opportunity would be obtained. DX 311, Slide 10; Trial Tr. 1742:21–1757:8. On this issue, Kearns agreed that PowerGen needed initial funding of $100 million. Kearns' entire valuation and damages scenario assumed access to $100 million in capital, and Kearns acknowledged that, without capital, there would be no opportunity to value. Trial Tr. 1205, 1208, 1210. Kearns also agreed that there was a risk that PowerGen would never be funded. Trial Tr. 1134-35. He also agreed that if there was a 50% chance that the opportunity could not be financed, a valuation of the opportunity should take that risk into account. Trial Tr. 1135.

When directly asked if he took into account that PowerGen could never obtain the necessary seed funding, Kearns explained: ".... I testified that I took into account there was a possibility that PowerGen ultimately could yield little or no value." Trial Tr. 1209. However, that failed to address the question. Instead, Kearns testified that the risk was "baked into" the 35% discount rate already applied for the execution risk of the business. Trial Tr. 1209:3-12. Sowards also explained that the 35% execution risk applied by Kearns did not include the risk of "no funding." Trial Tr. 1743:6 – 1744:13. On the contrary, the "execution risk" assumed that there would be funding, even if the funding was delayed for a period. Trial Tr. 1744:19 – 1746:2. But Kearns's analysis did not properly consider the risk that no investor(s) would come forward with the $100 million seed capital necessary to give the business the opportunity to develop, or not.

Sowards' opinion that there was a risk that funding would not be obtained is supported by the evidence. According to an April 23, 2012, e-mail from Colleen Calhoun, she had advised Moreno that GE was about "50/50" on consummating its investments with Green Field and/or TGS. DX 111;

Calhoun Depo. Tr. 126:13–127:15, 128:8–129:16, 130:9–132:9. Within the same e-mail, Calhoun suggested that, even if GE decided not to invest in a joint venture, GE should consider making a $25 million short-term loan to Moreno given the amount of time that had passed since GE initially advised Moreno that GE's CEO had approved the investment. *Id.* Even after May 13, 2013, when GEOG advanced the initial $25 million as contemplated in Calhoun's April 2012 e-mail, GEOG's corporate representative, Padaletti, testified that GEOG was not yet committed to a long-term deal. Trial Tr. 1756; Padaletti Depo. Tr. 105:1-7, 107:18 – 108:4.

Kearns acknowledged that when TGS executed the GEOG Note in May 13, 2013, it remained unknown if GE would convert the loan to equity and fund the remaining amounts contemplated under the Term Sheet. Trial Tr. 1208. The Court finds that the 35% execution risk does not account for the actual risk of no funding, as of May 13, 2013, that is, that GE or any other investor might not have invested in the PowerGen opportunity. Accordingly, the Court will reduce the valuation and damage model by 50% to account for this risk. *See* DX 311.

6. The Trustee Fails to Account for Profit

Sowards' final critique was that Kearns failed to account for the "extraordinary consideration" provided to Green Field from the sale of turbines to TGS using the proceeds of the loan from GEOG to TGS. DX 311, Slides 12-13; Trial Tr. 1757:9–1765:17. According to Green Field's account records, the turbine inventory had a book value of approximately $8,727,082.54. DX 227, Trial Tr. 1759:24–1763:2. Moreno caused TGS to pay Green Field $23,091,345.00 for these same turbines, demonstrating a profit of $14,363,262.46. *Id.* The profit is extraordinary based on the book value, alone. But the Court heard testimony from Moreno, Kilgore and McIntyre that these turbines had no readily available market and no real use other than as proposed by Green Field or TGS. Trial Tr. CONFIDENTIAL Mar. 20, 2018 at 11:4-20; Trial Tr. 1582:5–1583:7, 1597:16–1598: 10, 1603:4-19, 1626:2-8. Sowards disagreed with Kearns' proposition that the $23 million paid for Green Field's turbines was an even exchange of value for value. Given the significant increase in cash price over the book values, as well as the uncontroverted testimony regarding the absence of an available market for the turbines, the Court agrees that the sale of turbines to TGS was more than an even exchange of value for value.

***35** The Court also agrees that the increased sale price on the inventory was not the only benefit to Green Field. The sales provided much-needed liquidity for Green Field that allowed Green Field to make payments on its senior secured notes and maintain a level of liquidity through the end of the month. Accordingly, the profit of $14,363,262.46 to Green Field on the sale of the turbines to TGS must be taken into account as mitigation of damages.

7. Conclusions as to Value

For the reasons discussed above, the Court finds that the PowerGen business had little or no value as of May 13, 2013, and Green Field received much more than it gave up as the result of the May 13 Consent Solicitation. While the financial models demonstrated that the potential PowerGen leasing business may have had value in the future, GE's own models indicated that the business was worth no more than $6.8 million. DX 311, Slide 14. However, this assumes that an investor was actually willing to invest $100 million of seed capital to help the business get off the ground. As of May 13, 2013, there was a 50% chance that no such investor would surface. The value, therefore, needs to be reduced by 50%. Further, the $14.4 million of "extraordinary consideration" from the sale of Green Field's stale turbine inventory provided Green Field with needed liquidity and is a mitigation of damages. Finally, Green Field stood to benefit by up to $6.5 million in future profits under the terms of the Tri-Party Agreement. Thus, the Court finds that, even if there had been a transfer of the PowerGen business, or even if Moreno had breached his fiduciary duties to Green Field by causing the opportunity to be transferred to TGS, Green Field benefited from the transaction. In other words, the Trustee has failed to carry his burden of proving damages as a result of the Consent Solicitation, dated May 13, 2013, and subsequent transactions.

CONCLUSIONS OF LAW

I. FIDUCIARY DUTY

A. Ultimate Beneficiary

In the SJ Opinion and order (Memo Op., D.I. 463, 464), the Court granted partial summary judgment on three of the Trustee's preference counts against Aerodynamic, Casafin and Frac Rentals. Specifically, the Court held that, of the $3.7 million alleged preferential transfers made to Aerodynamic, Casafin, Frac Rentals and TGS, only the following amounts (totaling $645,552.91) could be recovered by the Trustee as preferential transfers:

Count 19 (Frac Rentals Transfers): $69,137.97;

Count 23 (Aerodynamic Transfers):	$110,000.00; and
Count 24 (Casafin Transfers):	$466,414.94.[16]

The Court subsequently clarified in its *Memorandum Order Regarding Defendants' Motion to Amend Opinion and Order Regarding Cross-Motions for Partial Summary Judgment* (Memorandum Order re Motion to Amend, D.I. 476) (the "Clarifying Opinion"), that the Trustee had not demonstrated, as a matter of law, that Moreno was the "ultimate beneficiary" of the foregoing transfers such that the Trustee could recover the foregoing amounts from Moreno under 11 U.S.C. § 550(a). Thus, at trial, it was the Trustee's burden to prove the elements of section 550(a).

***36** Because the only property transferred to Aerodynamic, Casafin and Frac Rentals was cash from Green Field, the Court held that the Trustee need not quantify the value of the transfers. Clarifying Opinion at 5-6. The issues for trial were, thus, whether: (1) Moreno received an actual benefit from the transfers; and (2) Moreno had access to the property transferred. *Id.*

Under Section 550(a)(1) of the Code, a party may recover an avoidable transfer from "the initial transferee of such transfer or the entity for whose benefit such transfer was made." The Trustee alleges that Moreno, through his ownership of and activity in Aerodynamic, Casafin and Frac Rentals, is a party for whose benefit the avoidable transfers were made, making him an ultimate beneficiary.

In *McCook Metals*, Chief Judge Eugene R. Wedoff outlined a three-part test to determine whether or not a party could be considered an ultimate beneficiary of a transfer. *See Baldi v. Lynch (In re McCook Metals, LLC),* 319 B.R. 570, 590-594 (Bankr. N.D. Ill. 2005); *see also Bonded Financial Services, Inc. v. European American Bank,* 838 F.2d 890 (7th Cir. 1988). To recover a transfer under Section 550(a)(1) from an ultimate beneficiary, a party must show: "(1) it must actually have been received by the beneficiary; (2) it must be quantifiable; and (3) it must be accessible to the beneficiary." *Id.* at 590.

In addressing the first element, the *McCook Metals* court stated that "an actual benefit rather than a merely intended one must be received in order for the beneficiary to be liable under § 550(a)(1)." *Id.* The *McCook Metals* court's reading of the Code is consistent with at least one other court's findings. *Id.* at 591 (citing *Bonded Financial,* 838 F.2d at 895). The Trustee relies principally on *Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Grp.* (*In re Buckhead Am. Corp.*), 178 B.R. 956 (D. Del. 1994), in support of his position that Moreno's ownership and control of Aerodynamic, Casafin and Frac Rentals is sufficient to make him the ultimate beneficiary for any transfers to those entities. In the Court's Clarifying Opinion, however, the Court explained why the Trustee's reliance on *Buckhead* was misplaced, and why a fact issue remained regarding whether Moreno actually benefitted from these three entities.

At trial, the Trustee relied on the same evidence that he did on summary judgment. Specifically, the Trustee argued that Moreno's position as manager for the three transferees, as well as his direct or indirect ownership of the entities, meant that he stood to benefit from any transfers to those entities. But the Trustee's evidence is insufficient. At trial, Moreno presented uncontroverted evidence that Aerodynamic, Casafin and Frac Rentals were all special purpose entities established to provide aircraft support and specialized equipment for Green Field. All equipment owned by those entities were financed through third-parties because Green Field lacked the credit to obtain the equipment for itself. Green Field's disinterested CFO, Blackwell, monitored the invoices of these entities to make sure the rates charged were within market, and the payments that Green Field made to the transferees ultimately paid for third-party expenses, such as financing costs, pilot fees, maintenance and fuel. The special purpose entities generated no profit, and there is no evidence that Moreno drew any form of a salary, dividend or distribution from any of them. On the record presented at trial, the Court concludes that the Trustee has not met this first element of demonstrating that Moreno received an actual benefit from the Aerodynamic Transfers, Frac Rental Transfers or Casafin transfers. As such, the Trustee may not recover any of these amounts from Moreno under 11 U.S.C. § 550(a).

***37** For the same reasons, and to complete the analysis, the Trustee has not demonstrated that Moreno had access to the transfers. As discussed in the Clarifying Opinion, "[c]ontrol of an entity is not enough to show access to the benefit. The party must show that there was actual access... Percentage interests and annual payments are not enough to show, as a legal conclusion, that Moreno had access to the transfers." Clarifying Opinion at 6 (citing *McCook,* 319 B.R.

at 592). As with the first element, the Trustee relied solely on the same record presented on summary judgment—*i.e.,* that Moreno was the 50% owner of Aerodynamic and Casafin, and was entitled to annuity payments from one of the DOH GRATs.[17] Even though Moreno was the manager for all three transferees, there was no evidence that he was employed by any of the entities, and Moreno testified credibly that he relied on his family office to manage the cash of these entities. The Court has no evidence that Moreno ever directed his family office to make payments from these three transferees. Thus, the Trustee has failed to demonstrate how Moreno had access to the funds transferred from Green Field. Because the Trustee has not carried his burden on the first and third elements of the *McCook* standard for establishing Moreno as an ultimate beneficiary under 11 U.S.C. § 550(a), the Court concludes that the Trustee may not recover any portions of the Aerodynamic Transfers, Frac Rental Transfers or Casafin Transfers from Moreno.

B. Claims Related to the PowerGen Business

The Trustee asserts three basic theories against Moreno based on the PowerGen transfer. First, the Trustee alleges that the transfer was fraudulent and that the value of the business may be recovered from Moreno personally. Second, the Trustee alleges that Moreno may be held liable for the transfer because Moreno breached his fiduciary duties in authorizing the transfer to occur, harming Green Field by depriving it of the value of the business. Third, the Trustee alleges that Moreno may be held liable for corporate waste. These theories are addressed in order below.

1. Fraudulent Transfer Theory

The Trustee first seeks a determination that the PowerGen Transfer was a fraudulent transfer, and asks the Court to award judgment against Moreno for the value of the PowerGen business. Under this theory, the Court must first decide the threshold question whether the Trustee has demonstrated a transfer of an interest in Debtor's property in a manner that may be avoidable—*i.e.,* constructive or actual fraud—under section 548 of the Bankruptcy Code or applicable state law. As a predicate to avoiding any transfer, the Trustee must first prove that Debtor held an interest in the property transferred. *Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003* (*In re Fruehauf Trailer Corp.*), 444 F.3d 203, 211 (3d Cir. 2006) (quoting *Mellon Bank, N.A. v. Metro Communications, Inc.,* 945 F.2d 635, 645 (3d Cir. 1991)) (citing 11 U.S.C. § 548(a)(1); *BFP v. Resolution Trust Corp.,* 511 U.S. 531, 535, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994)). As the party "bringing the fraudulent conveyance action," the Trustee "bears the burden of proving each of these elements [of fraudulent transfer] by a preponderance of the evidence." *In re Fruehauf Trailer Corp.,* 444 F.3d at 211 (citing *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L.* (*In re R.M.L.*), 92 F.3d 139, 144 (3d Cir. 1996)).

Even if the Trustee carries his burden on this threshold question, the Court must decide a second threshold question —whether Moreno is an "ultimate beneficiary" of the so-called PowerGen transfer—before assessing damages. That is, because the transfer went to TGS, not Moreno, the Trustee must also prove that Moreno was the "ultimate beneficiary" of the transfer under section 550(a)(1) of the Bankruptcy Code.

(a) PowerGen Was Not Property of Debtor.

"The Bankruptcy Code defines property interests broadly, encompassing 'all legal or equitable interests of the debtor in property.' " *In re Fruehauf Trailer Corp.,* 444 F.3d at 211 (quoting 11 U.S.C. § 541(a)(1)). The Third Circuit interprets "property of the debtor" broadly to include anything of "value." *See id.* (quoting *Segal v. Rochelle,* 382 U.S. 375, 379, 86 S.Ct. 511, 15 L.Ed.2d 428 (1966)); *cf. In re R.M.L.),* 92 F.3d at 148 ("We also agree that the mere 'opportunity' to receive an economic benefit in the future constitutes 'value' under the Code."). Nevertheless, at trial it was the Trustee's burden to prove that Green Field held a property interest in the so-called PowerGen business or opportunity. The Trustee did not carry his burden for the following reasons.

***38** First, the Trustee could never fully articulate what Debtor owned or transferred under the broad definition of PowerGen. Throughout trial, it remained unclear whether the Trustee was seeking to avoid the transfer of a business, an opportunity, the equipment related to the potential business opportunity or some combination of the foregoing. That issue remained unclear at trial. While the Trustee presented evidence that Green Field and its executives were aware of the potential value in the manufacturing and leasing of turbine power generator units, the mere awareness of such an opportunity does not render that opportunity an "asset" of Debtor under the Uniform Fraudulent Transfer Act. *See W. Oil & Gas J.V. v. Griffiths*, 2002 WL 32319043, *3 (N.D. Tex. Oct. 2002) (granting summary judgment for the defendant under the Texas Uniform Fraudulent Transfer Act, because the plaintiff could not prove that the defendant held a property

interest in an opportunity, even though the defendant knew of the opportunity and advised others of the potential value of the opportunity).

While bankruptcy courts construe "property of the debtor" broadly, the Delaware Supreme Court has held that a company's "precarious financial position" and restrictions imposed under loan covenants can prevent a company from claiming a right to a corporate opportunity. *See Broz v. Cellular Info. Sys.,* 673 A.2d 148, 155 (Del. 1996). Further, "for an opportunity to be deemed to belong to the fiduciary's corporation, the corporation must have an interest or expectancy in that opportunity." *Id.* at 156. A company's "articulated business plan" and recent divestment practices can demonstrate whether the opportunity belonged to the company. *Id.* (concluding that the company did *not* have an interest in the opportunity because the articulated business plan did not contemplate new acquisitions, and the company had been divesting similar assets).

Based on the extensive record described above, the Court is unable to conclude that Debtor had an interest or expectancy in the potential PowerGen business opportunity. There is no question that Green Field never actually operated a PowerGen business. Further, there is no dispute that Green Field lacked the capital necessary to begin a new PowerGen start-up business on its own. Indeed, the only reason Moreno was exploring the possibility of a separate PowerGen start-up was to fill a gap in capital to support Green Field's existing pressure pumping based business plan—to build out six or seven frac spreads and diversify Green Field's well services customer base. Green Field needed an investor like GE to provide the capital necessary to start any new business, and the most likely source of capital for such a business venture proved to be GE. While GE considered allowing Green Field to own the leasing venture, it ultimately concluded that the leasing company had to be held outside of Green Field. Nevertheless, Moreno negotiated with GE to ensure that TPT would be the leasing company's initial contract manufacturer, and that TPT would earn a 25% mark-up on all units produced. Under the circumstances, given GE's unfettered leverage over Moreno and Green Field, the Court concludes that Green Field never truly had an opportunity to establish a PowerGen leasing company. At the same time, however, by allowing Moreno and TPT to work directly with GE outside of Green Field, the board of directors for Green Field made sure that Green Field would still benefit from up to $400 million of revenue over the three-year manufacturing period. Based on this record, the Court concludes that Green Field never held an interest in the PowerGen leasing business opportunity and, consequently, the Trustee has failed to establish that anything of value was transferred to TGS.

This is also true from a technological perspective. The overwhelming evidence demonstrated to the Court that Green Field never owned an interest in McIntyre's intellectual property. This point was made clear from the very formation of TPT, which was a compromise between Green Field and McIntyre. Under the compromise, TPT would hold *only* McIntyre's Frac Stack Pack intellectual property, while McIntyre would retain all rights to his other intellectual property. Both Moreno and McIntyre testified that they could not agree on a value for McIntyre's other intellectual property. Thus, TPT was limited to the Frac Stack Pack technology.

***39** Moreno testified credibly that if he had tried to start a PowerGen business without McIntyre's consent, McIntyre would have had a valid claim against Green Field for stealing McIntyre's intellectual property. While Moreno went into deep discussions with GE before anyone at GE raised this issue with Moreno, it was always apparent from TPT's records that not even TPT owned the right and know-how to manufacture McIntyre's power generator units. TPT and Green Field could only acquire those rights and information if McIntyre was willing to contribute his PowerGen intellectual property and know-how into TPT. Ultimately, once GE demonstrated its willingness to advance money into TGS, Moreno convinced McIntyre to contribute his PowerGen intellectual property into TPT, but that did not occur until June, 2013— more than one month after the alleged PowerGen transfer occurred.

Thus, based on the record presented, the Court finds and concludes that the Trustee has failed to demonstrate the existence of a property interest of Green Field in the PowerGen technology or business. At all relevant times, the technology belonged to McIntyre, and Green Field never had an interest in the PowerGen leasing business opportunity.

(b) Any Transfers to TGS Were Not Actually or Constructively Fraudulent

Even if the Trustee could establish that Green Field held an interest in the so-called PowerGen business or opportunity, the transfer is not avoidable because there is insufficient evidence of actual or constructive fraud. To avoid a transfer as constructively fraudulent, a plaintiff must demonstrate: (i)

a transfer within the applicable time period; (ii) the debtor's insolvency; and (iii) a lack of reasonably equivalent value (or fair consideration). *See Charys Liq. Trust v. McMahan Sec. Co. L.P. (In re Charys Holding Co.),* 443 B.R. 628, 636 (Bankr. D. Del. 2010). Here, Debtor's insolvency is not in dispute. (Stipulation No. 92). Thus, the relevant issues for trial were: (a) whether and when the alleged transfer occurred, if ever; and (b) whether Green Field received reasonably equivalent value or fair consideration in exchange for any transfer.

The Trustee was required to prove that Green Field received less than reasonably equivalent value (or fair consideration) in exchange for the alleged transfer. *Mellon Bank, N.A. v. Metro Communications, Inc.,* 945 F.2d 635, 646 (3d Cir. 1991); 11 U.S.C. § 548(a)(2)(A). In determining whether a debtor received reasonably equivalent value, the Third Circuit applies a two-step analysis: (a) first, whether the debtor received *any* value from the transaction in question; and (b) whether that value was reasonably equivalent to the value transferred, considering a totality of circumstances. *See Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L. (In re R.M.L.),* 92 F.3d 139, 152 (3d Cir. 1996). The Trustee contends that the transfer occurred on May 13, 2013, the day that Green Field's shareholders and board of directors executed the Consent Solicitation agreeing to waive any potential PowerGen opportunity to allow Moreno, TGS and TPT to engage GE for the potential venture. Without reaching any conclusions over what was transferred on that date, the critical issue for the Court to decide is whether Debtor received reasonably equivalent value in exchange for what it gave up on May 13, 2013. On this issue, the Court concludes that the Trustee failed to carry his burden.

As a direct result of the consent executed on May 13, 2013, GE advanced $25 million to TGS. While Moreno personally guaranteed this obligation, Green Field was not required to sign the note or guaranty the obligation. Thus, Green Field took on no new debt on May 13, 2013. Instead, Moreno caused over $19 million of the GEOG Note proceeds to be used for inventory purchases at prices that Green Field could not have obtained in a true arm's length third-party sale. This inventory sale gave Green Field immediate liquidity in an amount that allowed the company to pay its semi-annual interest payment to bondholders and avoid payment defaults to its other creditors.

***40** Meanwhile, the Project Cayenne Term Sheet attached to the TGS note provided for TPT to become TGS's contract manufacturer. Ultimately, as a result of the deal negotiated by Moreno, TPT entered into the Tri-Party Agreement under which Debtor was effectively relieved of its ongoing obligations to pay TPT's overhead costs, and as the result of which Green Field became entitled to half of the profits generated by TPT. In other words, in exchange for a consent that gave up nothing on behalf of Green Field, Green Field received an immediate influx of over $20 million in cash and an agreement to earn up to $400 million in future revenues. On balance, the Court concludes that Green Field did receive reasonably equivalent value than it gave up on May 13, 2013. As such, the Court concludes that the so-called PowerGen transfer of May 13, 2013, is not avoidable as a constructive fraudulent transfer.

Nor can the Trustee avoid the PowerGen transfer as an actual fraudulent transfer. The proof required to show actual fraud is higher than that required to establish constructive fraud. To avoid a transaction under section 548(a)(1)(A) of the Bankruptcy Code, the Trustee must show that the transaction was made "with actual intent to hinder, delay or defraud" creditors. *Official Comm. of Unsecured Creditors of Fedders N. Am., Inc. v. Goldman Sachs Credit Partners L.P. (In re Fedders N. Am., Inc.),* 405 B.R. 527, 545 (Bankr. D. Del. 2009). Because direct evidence of an actual fraudulent transfer is often unavailable, courts generally rely on circumstantial evidence, or "badges of fraud," to infer the debtor's fraudulent intent. *See id.* (citing *In re Hechinger Inv. Co. of Del.*, 327 B.R. 537, 550-51 (D. Del. 2005); *Dobin v. Hill (In re Hill)*, 342 B.R. 183, 198 (Bankr. D. N.J. 2006)).

The "badges of fraud" considered by courts include, but are not limited to: (1) the relationship between the debtor and the transferee; (2) consideration for the conveyance; (3) insolvency or indebtedness of the debtors; (4) how much of the debtor's estate was transferred; (5) reservation of benefits, control or dominion by the debtor over the property transferred; and (6) secrecy or concealment of the transaction. *See id.*

The complete statutory list of factors to consider under DUFTA are as follows:

(1) The transfer or obligation was to an insider;

(2) The debtor retained possession or control of the property transferred after the transfer;

(3) The transfer or obligation was disclosed or concealed;

(4) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) The transfer was of substantially all the debtor's assets;

(6) The debtor absconded;

(7) The debtor removed or concealed assets;

(8) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) The transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Uniform Fraudulent Transfer Act, Del. C. § 1304(b).
In the Second Amended Complaint, the Trustee alleged only a handful of the foregoing factors—*i.e.,* that the PowerGen Transfer was made to or for the benefit of an insider; that Debtor received no value or less than reasonably equivalent value for the transfer; that Debtor was insolvent at the time of the transfer; and that the PowerGen business was valuable. No single factor is determinative, and the Court must consider the totality of circumstances. At summary judgment, the Trustee had asserted only a few badges, and, at trial, failed to prove anything beyond what Defendants stipulated before trial. Specifically, Defendants did not dispute that Green Field was insolvent and that the Consent Solicitation authorized Moreno to continue negotiations with TGS—an entity controlled by an insider of Green Field. At trial, the Trustee did not prove that anything had been concealed, and for the reasons discussed above, the Trustee did not carry his burden in proving that Green Field received less than reasonably equivalent value for what it gave up or transferred. Under the circumstances, the Court concludes that the Trustee has not carried his burden in proving that there has been a constructive or actual fraudulent transfer. *See In re Fedders N. Am., Inc.,* 405 B.R. at 545.

(c) Moreno Was Not the "Ultimate Beneficiary" of PowerGen.

***41** Even if the Trustee had demonstrated Green Field's interest in PowerGen, the Trustee cannot recover the value from Moreno, because the Trustee has failed to prove that Moreno was the beneficiary of any transfer to TGS. As discussed above, Moreno is the manager of TGS, but holds no ownership interest in the entity. He is the settlor of a GRAT that owns approximately 45% of DOH Holdings, the parent of TGS. He testified credibly and without being controverted that he received no distributions, dividends or salaries from TGS. Further, Moreno personally guaranteed the $25 million note to GE, and pledged his personal wealth to Goldman Sachs and Powermeister in order to borrow funds. Under the circumstances, the Trustee has not demonstrated that Moreno received any actual benefit from any transfer to TGS. Accordingly, Moreno cannot be held liable under section 550(a) for any avoidable transfer made to TGS.

2. Breach of Fiduciary Duty

The Delaware Supreme Court has held that directors and officers of a Delaware corporation owe the corporation and its shareholders a "triad" of duties. *See Malone v. Brincat,* 722 A.2d 5, 10 (Del. 1998); *In re Fedders N. Am., Inc.,* 405 B.R. at 539. "This triad is composed of the duty of care, the duty of loyalty, and the duty to act in good faith." *In re Fedders N. Am., Inc.,* 405 B.R. at 539 (citing *Malone,* 722 A.2d at 10).

A plaintiff cannot prove a breach of the duty of care without a showing of gross negligence. *See id.* (citing *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096, 1113 (Del. Ch. 2008)). Presentation to a board may not be required "where the opportunity is one that the corporation is incapable of exercising." *See Broz v. Cellular Info. Sys.,* 673 A.2d 148, 157-158 (Del. 1996); *see also Wolfensohn v. Madison Fund, Inc.*, 253 A.2d 72, 76 (1969).

In the present case, Moreno's duty of care is not in question. Rather, the Trustee asserts two claims for breach of loyalty and good faith (Counts 3 and 13) based on: (a) the alleged fraudulent transfer of the PowerGen business to TGS; and (b) Moreno's alleged conduct in preventing MGH Holdings from purchasing stock under the SPAs. As a threshold matter, these are alternative legal theories to the Trustee's fraudulent transfer theories (Counts 1 and 2) and the Trustee's tortious

interference theory (Count 14). The Court addresses the merits of each claim below.

Through Count 3, the Trustee asserts a claim directly against Moreno for conspiracy or aiding and abetting an alleged fraudulent transfer to TGS, which the Court has already addressed. "The authorities are ... clear that there is no such thing as liability for aiding and abetting a fraudulent conveyance or conspiracy to commit a fraudulent transfer as a matter of federal law under the Code." *In re Fedders N. Am., Inc.,* 405 B.R. at 549 (citations omitted). Even if the Trustee could have established that Green Field (through Moreno) defrauded its creditors by transferring a PowerGen business to TGS, the Trustee would still have been required to prove how Moreno benefited from the transfer under the "ultimate beneficiary" standards of section 550(a). *See generally In re McCook Metals LLC,* 319 B.R. 570, 591 (Bankr. N.D. Ill. 2005). For the reasons already discussed above, the Trustee failed to prove that the Consent Solicitation of May 13, 2013, constituted an actual or constructive fraudulent transfer. Further, the Trustee failed to demonstrate how Moreno, as the manager of TGS, received an actual benefit from the alleged transfer.

Nevertheless, in the interest of completeness and the record, the Court addresses the merits of the fiduciary duty claims. "A claim for breach of the duty of loyalty requires a showing that a fiduciary was on both sides of a transaction and that the transaction was not entirely fair to the company." *See In re Fedders N. Am., Inc.,* 405 B.R. at 540. "Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness. The business judgment rule is the default standard of review." *Reis v. Hazelett Strip-Casting Corp.,* 28 A.3d 442, 457 (Del. Ch. 2011).

***42** The Court concludes that the Trustee has not carried his burden in showing that Moreno was truly on both sides of the PowerGen transaction. While it is undisputed that Moreno was an officer and director of Green Field and was technically the manager of TGS, the overwhelming evidence presented at trial showed that Moreno was not negotiating with himself to transfer PowerGen to TGS. Rather, he was negotiating with GE extensively over the course of several months in an effort to entice GE to invest directly into Green Field, consistent with his fiduciary duties to Green Field. When GE finally decided that it would not invest in Green Field directly, Moreno found a way to bring liquidity to Green Field, monetize illiquid assets, and convert TPT from a cost-center into a profit-center for Green Field. The undisputed evidence demonstrated to the Court that Moreno negotiated these points, not with himself, but with GE over the course of several months. Accordingly, the Court concludes that Moreno was not really on both sides of the transaction that led to the PowerGen business being started up within TGS. Moreno negotiated with GE and acted in the best interests of Green Field in doing so. It follows then that the ordinary business judgment standard applies to Moreno's actions as an officer and director of Green Field.

(a) Moreno's Actions Were Consistent with His Fiduciary Duties.

The business judgment rule presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." *Reis,* 28 A.3d at 457 (quoting *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984)). The duty to act in good faith "is a subsidiary element of the duty of loyalty." *In re Fedders N. Am., Inc.,* 405 B.R. at 540 (citing *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).

> The Delaware Supreme Court has identified three examples of conduct that may establish a failure to act in good faith. First, it has held that such a failure may be shown where a director "intentionally acts with a purpose other than that of advancing the best interests of the corporation." [ ] Second, it has held that a failure may be proven where a director "acts with the intent to violate applicable positive law." [ ] Third, it has held that a failure may be shown where the director "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." [ ] The court noted, however, that this list of examples is not necessarily exclusive. More specifically, it said there "may be other examples of bad faith yet to be proven or alleged, but these three are the most salient." [ ]

Id. (quoting *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 67 (Del. 2006)).

Based on the evidence presented, the Court concludes that Moreno's actions as CEO and chairman of the board of Green Field were made in the best interests of Green Field, consistent with reasonable business judgment. In the present case, there was a legitimate reason to execute the Consent Solicitation on May 13, 2013—GE emerged as the only

source of capital sufficient to give Green Field the liquidity it needed to make interest payments under the Indenture and bring Green Field's business plan back on track, and GE was insisting on the execution of the Consent Solicitation before it would advance any funds. Moreno and other members of the board relied on advice of Green Field's corporate counsel, Latham & Watkins, to execute whatever documents were necessary to bring immediate liquidity into the company. By executing the Consent Solicitation, Moreno and the remaining board members did not believe they were giving up anything of value, because the PowerGen opportunity was unavailable without GE's seed capital, and GE was unwilling to invest in Green Field directly. On the other hand, Moreno and the other board members understood that, by executing the Consent Solicitation, GE would advance $25 million to TGS, which TGS then made available to Green Field to pay interest on its senior secured notes. Additionally, once the PowerGen leasing business was properly capitalized, TPT would start to earn 25% profits on each unit it manufactured and sold to TGS, allowing Green Field to realize positive cash flow from its 50% interest in the manufacturing subsidiary. The Court therefore finds that Moreno was motivated by his belief that his negotiations with GE would save Green Field, and the trial evidence corroborates Moreno's position. Under the circumstances, the Court concludes that Moreno did not breach his fiduciary duties to Green Field, as such actions were protected by the business judgment rule.

***43** The Court further concludes that, while inapplicable to the facts presented, Moreno's actions would have satisfied Delaware's heightened fiduciary duty standards. The Court provides the following analysis, for the sake of completeness, but concludes that neither heightened standard applies to the facts of this case.

(b) Moreno's Actions Satisfy the Enhanced Scrutiny Test.

Enhanced scrutiny is Delaware's intermediate standard of review. Framed generally, it requires that the defendant fiduciaries "bear the burden of persuasion to show that their motivations were proper and not selfish" and that "their actions were reasonable in relation to their legitimate objective." *Mercier v. Inter-Tel (Del.), Inc.,* 929 A.2d 786, 810 (Del. Ch. 2007).

Enhanced scrutiny applies when the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors. The *Unocal* case involves resistance to a hostile takeover, where there is an "omnipresent specter" that target directors may be influenced by and act to further their own interests or those of incumbent management, "rather than those of the corporation and its shareholders." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985). Tailored for this context, enhanced scrutiny requires that directors who take defensive action against a hostile takeover show (i) that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (ii) that the response selected was "reasonable in relation to the threat posed." *Reis,* 28 A.3d at 457 (quoting *Unocal*, 493 A.2d at 954-55).

In the present case, Moreno had reasonable grounds for believing that Debtor was facing a liquidity crisis. The undisputed evidence demonstrated that a slowdown in the fracking market left a hole in Green Field's operating cash flow, preventing it from completing its business plan to build out six or more frac spreads and expand its hydraulic fracturing customer base to be less reliant on Shell. Moreno spent most of the second half of 2012 and the entire first quarter of 2013 trying to raise new capital to get Green Field's business plan back on track.

While Kearns, the Trustee's expert, testified that he believed that Green Field could have found a willing investor had it maintained its PowerGen rights in bankruptcy, the overwhelming and uncontroverted evidence directly contradicts Kearns's uninformed beliefs. Not only did Green Field lack a contractual right to McIntyre's PowerGen intellectual property as of May 13, 2013, but Moreno and Green Field's management had been trying for months to raise the capital needed to start up the business with Green Field to no avail. Moreno's efforts included meetings with dozens of potential investors, existing bondholders and strategic investors like GE. After months of searching, the best Moreno could do was sign personal guarantees to borrow from GE (through TGS), Goldman Sachs (through the DOH GRATs) and Powermeister (through DOH Holdings). None of those lenders were willing to lend to or invest in Green Field directly. Only by taking those actions was Moreno able to insert approximately $50 million for the benefit of Green Field. Further, while McIntyre was aware of these negotiations, the earliest documentation of his purported contribution of PowerGen intellectual property into TPT came in June 2013, over a month after the execution of the Consent Solicitation. The Court does not accept the Trustee's suggestion that Green Field had other reasonable alternatives.

(c) Moreno's Dealings with Green Field Satisfy "Entire Fairness" Test.

***44** While the Trustee failed to prove that Moreno was on both sides of the transaction, the Court will consider whether the transaction satisfies the "entire fairness" standard, in the interest of completeness. *Miller v. McCown De Leeuw & Co., Inc*. (*In re The Brown Schools*), 386 B.R. 37, 47 (Bankr. D. Del. 2008). The "entire fairness" standard requires proof of both: (i) fair dealing and (ii) fair price, examined together as a whole. *Official Unsecured Creditors' Comm. of Broadstripe, LLC v. Highland Capital Mgmt., L.P*. (*In re Broadstripe, LLC*), 444 B.R. 51, 106 (Bankr. D. Del. 2010).

(i) "Fair dealing" involves elements such as (a) when the transaction was timed, (b) how it was initiated, (c) how it was structured, (d) how it was negotiated, (e) how it was disclosed to the directors, and (f) how the approvals of the directors and the stockholders were obtained.

(ii) "Fair price" includes such considerations as "economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."

Id. (citing *Weinberger v. Uop,* 457 A.2d 701, 710-11 (Del. 1983))

In the present case, the evidence presented by Moreno was sufficient to satisfy Moreno's burden under the "entire fairness" standard. Specifically, Moreno established that he dealt with Green Field in a fair manner. Negotiations with GE were initiated at least six months before the Green Field liquidity crises came to a head, and Moreno fought hard to get a transaction with GE to close in March, 2013, with two months to spare before interest payments came due. During this process, it appeared at various points in time as though GE was willing to invest directly in GE, but GE frequently changed its mind and ultimately withdrew from negotiations without consummating anything more than the GEOG Note with the Term Sheet attached. Moreno's efforts to raise capital were disclosed to bondholders and the board of directors as early as November, 2012, and Moreno continuously kept bondholders and outside directors apprised of his discussions with GE, both on quarterly conference calls as well as through frequent phone calls to Teetsel and Kilgore.

The Court is persuaded that the board approved the transaction in a reasonable manner and on an informed, real-time basis. As Kilgore testified, the board had followed Moreno's negotiations with GE since November of 2012 and deliberated the need for a formal consent in April, 2013. At the time, the board decided that no formal consent was necessary because the company was not giving anything up. When Green Field's corporate counsel (Latham & Watkins) advised the board that the Consent Solicitation would satisfy GE's lending conditions requiring Green Field to give any corporate assets away, the company's CFO, Blackwell, circulated the Consent Solicitation to each director. Each director executed the Consent Solicitation on the spot, having deliberated the matter in previous conference calls and fully understanding that Green Field was not giving anything up by "waiving" PowerGen. During their live testimony, Kilgore and Fontova both explained that Green Field was receiving far more from Moreno's negotiations with GE than Green Field was giving up—specifically, Green Field would receive most of the $25 million that GE was loaning to TGS and Moreno and a future source of revenue through its manufacturing subsidiary. Although a meeting of the Board, with discussion and exchanging thoughts and concerns was the preferable procedure, the Court concludes that Moreno dealt fairly in obtaining approval of the Consent Solicitation.

***45** The Court also concludes that Green Field received a "fair price" in exchange for waiving the PowerGen opportunity. As the board members testified, Green Field was not giving anything up, except the potential opportunity to participate in the leasing side of a PowerGen business, even though the record demonstrated that there was no funding available to Green Field to participate in that side of the business. Even if the Court accepts Kearns's $26.9 million assessment of the value for the leasing side of the PowerGen business, the Court agrees with Sowards that Green Field received far more in excess of this amount in exchange for its "waiver" of the opportunity. Specifically, but for the Consent Solicitation from the board, GE would not have advanced the first $25 million and negotiations would likely have ceased. With the Consent Solicitation, GE advanced funds to TGS, knowing that TGS would use the funds to "purchase" inventory from Green Field at a substantial mark-up—so substantial that it allowed Green Field to make its $17 million semi-annual interest payment to bondholders. In addition to the inventory sales, Green Field was reimbursed over $1 million for its executives' time trying to develop the business within Green Field, and TPT began producing PowerGen units to sell to TGS at a 25% profit margin, half of

which would supplement Green Field's cash flow. Under the circumstances, the Court concludes that Green Field received a "fair price" in exchange for the board's Consent Solicitation to allow Moreno and TPT to work with GE and TGS directly on the PowerGen business. As such, Moreno's actions would not constitute a breach of his fiduciary duties, even under the heightened "entire fairness" standard.

3. Corporate Waste

Delaware law recognizes a claim for corporate waste where the plaintiff establishes "particularized facts showing that the corporation, in essence, gave away assets for no consideration." *See Resnik v. Woertz,* 774 F.Supp.2d 614, 635 (D. Del. 2011) (quoting *Green v. Phillips,* C.A. No. 14436, 1996 WL 342093, at *5 (Del. Ch. June 19, 1996)). "Waste has been described as 'an exchange of corporate assets for consideration so disproportionally small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose.' " *In re USDigital, Inc.*, 443 B.R. 22, 47-48 (Bankr. D. Del. 2011) (quoting *Weiss v. Swanson*, 948 A.2d 433, 450 (Del.Ch. Mar.7, 2008)).

"The test for corporate waste is an 'extreme test, very rarely satisfied by shareholder plaintiff.' " *Id.* In *USDigital*, the Bankruptcy Court explained that a transaction could be considered corporate waste if the company decided to spin off a new venture that it had invested operating funds to develop without making arrangements for reimbursement. *See id.* at 48. In this case, however, Green Field made arrangements for TGS to reimburse Green Field over $1 million for executives' time and expenses incurred between November 2012 and June 2013. (JX 1, Stipulation No. 95). Further, both Fontova (an inside director) and Kilgore (an outside director) explained their understanding of what Green Field stood to gain by consenting to Moreno's continued negotiations with GE through the external entity TGS. Green Field stood to gain immediate liquidity from the sale of its stale and illiquid inventory, plus Green Field stood to receive future revenues from TPT which, under the terms of the Tri-Party Agreement, would no longer weigh down Green Field's balance sheet as a cost center. Even if the Court accepted Kearns's value for the PowerGen business, without discount, the Trustee has failed to prove that the Consent Solicitation gave away an asset for little or no consideration. The Consent Solicitation opened a door of liquidity for Green Field that was previously closed.

II. BREACHES OF THE SHARE PURCHASE AGREEMENTS

A. Liability of MOR MGH

The Trustee seeks damages for MOR MGH's breaches of the 2012 and 2013 SPAs, respectively. Under applicable New York law,[18] "an action for breach of contract requires proof of (1) a contract; (2) performance of the contract by one party; (3) breach by the other party; and (4) damages." *In re Delta Mills, Inc.*, 404 B.R. 95, 105 (Bankr. D. Del. 2009) (quoting *First Investors Corp. v. Liberty Mut. Ins. Co.*, 152 F.3d 162, 168 (2d Cir. 1998)). In its SJ Opinion, the Court determined that the first two elements were uncontested and that "the 2012 SPA was breached and that MOR MGH and MMR did not make their required purchases for each of the first two quarters of 2013." D.I. 463 at pp. 36-37, 39. The Court also found that "MOR MGH never made the $10,000,000 purchase under the 2013 SPA, as required." *Id.* at p. 39. Both in the SJ Opinion and its Reconsideration Order, the Court denied awarding judgment to the Trustee at that time on the basis that "[w]hether Green Field was or was not in the 'same economic position' that it would have been without the breach of contract is an issue that remains for trial." D.I. 473 at p. 4. With the trial record before it, the Court now finds that Green Field was damaged by MOR MGH's breaches of the SPAs.

***46** As the Court previously articulated in its SJ Opinion, "[u]nder New York law, the normal measure of damages for breach of contract is expectation damages - - the amount necessary to put the aggrieved party in as good a position as it would have been had the contract been fully performed." *McKinley Allsopp, Inc. v. Jetborne Int'l., Inc.*, No. 89 Civ. 1489 (PNL), 1990 WL 138959, at *8 (S.D.N.Y. Sept. 19, 1990); *see also Topps Co., Inc. v. Cadbury Stani S.A.I.C.*, 380 F.Supp.2d 250, 261 (S.D.N.Y. 2005) ("Damages for a breach of contract are normally limited to the amount necessary to put the plaintiff in the same economic position plaintiff would have occupied had the breaching party performed the contract."). At summary judgment, the Trustee asked the Court to follow those cases holding that "under New York law, where the breach of contract was a failure to pay money, the plaintiff is entitled to recover the unpaid amount due under the contract plus interest." *House of Diamonds v. Borgioni, LLC*, 737 F.Supp.2d 162, 172 (S.D.N.Y. 2010) (citing *Scavenger, Inc. v. GT Interactive Software Corp.*, 289 A.D.2d 58, 58-59, 734 N.Y.S.2d 141 (N.Y. App. Div. 2001)). The Court declined to do so out of concern that damages beyond failure to receive the amounts due under the contract needed to be established. Two cases aid in providing context. *See Stokoe v. E-Lionheart,*

LLC, 129 A.D.3d 703, 704, 11 N.Y.S.3d 199 (N.Y. App. Div. 2015) ("Thus, contrary to the conclusion of the Supreme Court, the plaintiffs are entitled to recover, as damages, the amounts due under the promissory notes and guarantees. The plaintiffs established, prima facie, the amounts that were due under the promissory notes and guarantees."); *cf. Bi-Economy Market, Inc. v. Harleysville Ins. Co. of N.Y.*, 10 N.Y.3d 187, 193, 856 N.Y.S.2d 505, 886 N.E.2d 127 (2008) ("With agreements to pay money ... the sole purpose of the contract is to pay for something given in exchange. In such cases, what the payee plans to do with the money is external and irrelevant to the contract itself."). The Court now holds that the Trustee has met his burden of proof of damages by establishing nonpayment of the amounts owed under the 2012 and 2013 SPAs.

The Court holds that Green Field would have been in a better economic position had MOR MGH complied with its SPA obligations. First, Moreno testified at trial that "[i]t would have been beneficial for Green Field to have every dollar it could find." Trial Tr. 469:17-19. He also testified that the absence of cash "is absolutely the kiss of death" to a company. Trial Tr. 478:12-17. Moreno also acknowledged that had the SPAs been fulfilled, Green Field would have been able to make the required interest payments under the Shell Contract. Trial Tr. 469:20-470:3. Green Field then would have avoided its cross-defaults under the Shell Contract and the Bond Indenture. *See* Stip. Facts ¶ 83. Accordingly, the Court holds that Green Field would have been in a better economic position had MOR MGH and MMR complied with the SPAs than it was as a result of the breach.

Furthermore, MOR MGH, through Moreno, had access to additional funds to make the payments, without impacting the ability of TGS to satisfy its obligations to TPT in connection with the manufacture of the PowerGen units. The evidence at trial established that Moreno or his entity MOR DOH, which owned TGS, borrowed at least $85 million from GE, Goldman Sachs and Powermeister between May and August 2013. Trial Tr. 843:7-844:19. Putting aside Moreno's characterization of certain transactions as "capital contributions," the evidence establishes that approximately $48 million of transactions between TGS and Green Field occurred during this time period in the form of turbine sales ($23M) and deposits ($25M). JX 3; DX 221; Trial Tr. 844:11-846:10. From the remaining $37 million of available funds, Moreno admitted—only after being confronted with a document from his estate planning professionals—that $10 million was improperly siphoned off to purchase his Dallas home. Trial Tr. 411:18-420:12, 844:11-19. The additional $27 million was completely unaccounted for. Trial Tr. 844:20-846:10; JX 3; DX 221. That $37 million was thus available to satisfy the $17 million in SPA obligations, without impacting in any way TGS' obligations to TPT. Further, Moreno could have borrowed additional money on behalf of MOR MGH in order to fulfill its obligations under the SPAs. Moreno acknowledged that whatever money either TGS or MOR MGH had in its possession was derived from money borrowed by Moreno. Trial Tr. 846:23-847:8. Indeed, all of the money that Defendants allege TGS paid to Green Field to satisfy the SPA obligations was either from Moreno's personal funds or money that he borrowed. Trial Tr. 817:14-24, 846:23-847:8.[19]

***47** At summary judgment, Moreno argued that he satisfied MOR MGH's obligations under the SPAs by contributing $66 million in funds to Green Field from other entities. At trial, Moreno again testified about these payments. Trial Tr. Conf. 3/20 at 5:16-6:8. The Court, in its earlier SJ Opinion, already rejected Moreno's argument that these payments constitute substitute performance for MOR MGH's breaches of the SPAs. D.I. 463 at pp. 38-39. Moreno now argues that those payments demonstrate his good faith effort to benefit Green Field.

Moreno also testified at trial that there was a material adverse change that relieved him of his obligations under the 2012 SPA. Trial Tr. 470:11-16. In none of his contemporaneous public disclosures disclosing the defaults did Moreno assert any potential material adverse change. PX 171; PX 174 at p. 8. Additionally, he promised to cure the defaults, demonstrating that he still believed he had an obligation that he needed to fulfill. Trial Tr. 445:10-446:7; PX 177 at p. 5. The Court has already determined that the SPAs were breached. D.I. 463 at p. 39. The Court finds that Moreno's argument is without merit.

Accordingly, the Trustee has proven that Green Field suffered damages in the amount of $15,961,923 due to MOR MGH's failure to honor its obligations under the 2012 and 2013 SPAs. The Trustee prevails on damages, plus applicable prejudgment interest. The New York legal interest rate is 9% per annum, N.Y. C.P.L.R. § 5004, and is calculated on a simple interest basis. *Marfia v. T.C. Ziraat Bankasi*, 147 F.3d 83, 90 (2d Cir. 1998). New York law provides that prejudgment interest must be computed

> from the earliest ascertainable date the cause of action existed, except that interest upon damages incurred

> thereafter shall be computed from the date incurred. Where such damages were incurred at various times, interest shall be computed upon each item from the date it was incurred or upon all of the damages from a single reasonable intermediate date.

N.Y. C.P.L.R. § 5001(b) (McKinney's 2016). The Trustee is therefore entitled to prejudgment interest of 9% from May 15, 2013 to present with respect to the first quarter 2013 required but unperformed purchase of $3,968,606; from August 19, 2013 to present with respect to second quarter 2013 required but unperformed purchase of $1,993,317; and from June 28, 2013 to present with respect to the required but unperformed $10 million purchase under the 2013 SPA. Pre-judgment interest in the amount of $7,208,235.50 has accrued through June 29, 2018, the date of the Trustee's filing. Prejudgment interest continues to accrue at the rate of $3,935.82 per day, until the date of judgment.

B. Moreno's Tortious Interference

The Trustee seeks damages against Moreno personally for his tortious interference with the obligations of MOR MGH and MMR under the SPAs. Under New York law, "[t]he elements of a tortious interference with contract claim are well established—the existence of a valid contract, the tortfeasor's knowledge of the contract and intentional interference with it, the resulting breach and damages." *Hoag v. Chancellor, Inc.*, 246 A.D.2d 224, 677 N.Y.S.2d 531, 533 (N.Y. App. Div. 1998). In the Court's SJ Opinion, the Court determined that the 2012 and 2013 SPAs were valid contracts, that Moreno had knowledge of those contracts, and that the contracts had been breached due to MOR MGH and MMR's nonpayments. D.I. 463 at pp. 36-39, 42. As described above, the Court finds that Green Field was damaged as a result of the breaches. Thus, the Court must decide whether Moreno interfered with MOR MGH and MMR's obligations under the SPAs and whether he acted with the requisite level of intent.

***48** The Court finds that Moreno intentionally interfered with the obligations of MOR MGH under the SPAs. Moreno was the manager of MOR MGH. Stip. Facts ¶ 8; Trial Tr. 62:2-12; PX 92 at § 3.2. MOR MGH, in turn, was owned by two grantor retained annuity trusts, collectively referred to as the MGH GRATs. Stip. Facts ¶ 9. Moreno was responsible for managing the assets and investments of the MGH GRATs. Trial Tr. 67:17-20, 75:13-76:2. Accordingly, Moreno exercised full control over MOR MGH and controlled whether or not it made payments in compliance with its obligations under the SPAs.

The Court also finds that Moreno interfered with MMR's obligations under the 2012 SPA. Moreno was aware that if he did not cause MOR MGH to make its payment and Moreno did not contribute his one-third share of MMR's obligations, then his partners in MMR would likewise not follow through with payment. Trial Tr. 388:2-392:14; PX 148; PX 149. Blackwell, who was responsible for sending the notices to the shareholders and was responsible for Green Field's finances, testified that Rucks and Moody were not going to make their funding calls unless Moreno made his. Blackwell Dep. 55:13-17. Even though Moreno directed Blackwell to represent to Moody and Rucks that Moreno was intending to make the payments, Moreno had no intention to perform, did not perform and, as a result, caused Moody and Rucks to breach the 2012 SPA. Blackwell Dep. 42:11-44:16; 55:7-12; PX 148. Moreno was thus responsible for interfering with MMR's obligations.

The Court also finds that Moreno acted with the requisite level of intent when he interfered with the obligations of MOR MGH and MMR under the SPAs. The traditional articulation of intentional interference is that the interfering party must be a stranger to the contract; a corporate representative acting in his corporate capacity is not typically deemed a "stranger."[20] *Rockland Exposition, Inc. v. Alliance of Auto. Serv. Providers of N.J.*, 894 F.Supp.2d 288, 336-37 (S.D.N.Y. 2012). However, where the corporate officer is acting with malice, that is, for his personal gain, rather than the corporate interests, liability from interference will be found. *Id.* at 338; *Hoag*, 677 N.Y.S.2d at 533-34; *Petkanas v. Kooyman*, 303 A.D.2d 303, 759 N.Y.S.2d 1, 2 (N.Y. App. Div. 2003). "New York courts have construed personal gain to mean that the challenged acts were undertaken with malice and were calculated to impair the plaintiff's business for the personal profit of the individual defendant." *Rockland*, 894 F.Supp.2d at 338 (internal quotation marks and citations omitted). In proving "malice," courts have held that merely showing that the defendant acted with the intent to procure personal gain is sufficient. *See, e.g., Albert v. Loksen*, 239 F.3d 256, 272-76 (2d Cir. 2001) (denying summary judgment to defendant because evidence that supervisor interfered with employee's employment contract in order to prevent employee from reporting his misconduct would be sufficient to prove malice); *See Zuckerwise v. Sorceron Inc.*, 289 A.D.2d 114, 735 N.Y.S.2d 100, 102 (N.Y. App. Div. 2001); *Hoag*, 677 N.Y.S.2d at 533-34. Indeed, "the malicious motive is inferred from the acts taken with knowledge of the contract." *Connell v. Weiss*, No. 84 Civ. 2660, 1985 WL 428, at *2 (S.D.N.Y.

Mar. 19, 1985) (citing *Campbell v. Gates*, 236 N.Y. 457, 460, 141 N.E. 914 (1923)).

The Court finds that Moreno acted with malicious intent in causing the breaches of the SPAs. MOR MGH's only asset was its ownership of the common shares of Green Field. Trial Tr. 847:9-21. By causing MOR MGH to breach its obligations under the 2012 and 2013 SPAs, Moreno deprived Green Field of $17 million of capital which Green Field needed in order to satisfy obligations to Shell and to continue its business. Trial Tr. 469:20-470:3.

***49** Further, the timing of the breaches of the 2012 SPA speaks to Moreno's intent. While Moreno caused MOR MGH to satisfy the initial $10 million payment obligation and the payment obligation for the fourth quarter of 2012 required under the 2012 SPA, that performance occurred before the transfer of the PowerGen opportunity. Trial Tr. 381:17-382:23; D.I. 219 at ¶ 58; Blackwell Dep. 31:13-32:18. The first breach of the 2012 SPA occurred on May 15, 2013, just two days after Green Field waived the PowerGen opportunity in favor of Moreno personally. *See* Stip. Facts ¶ 71; JX 61. In other words, Moreno made the decision to stop complying with the obligations of the 2012 SPA as soon as he knew that he would no longer be pursuing the PowerGen business opportunity in Green Field. He was thus willing to let Green Field suffer and, as he put it, give it the "kiss of death" by denying it needed funds and instead putting the money towards a business that he now personally owned outside of Green Field. Trial Tr. 478:12-17. Indeed, Moreno admitted to Green Field bondholders on a quarterly conference call that the very reason for his default was because he was devoting his personal capital to PowerGen, which he had intentionally seuqestered outside of Green Field. Trial Tr. 440:1-441:14; PX 177 at p. 5.

Moreno also knew that MOR MGH breaching the SPAs would cause Green Field to fail to make its interest payments to Shell, which would cause a cross-default under the Bond Indenture, which would then send Green Field into a downward spiral towards bankruptcy. Green Field's failure to satisfy the requirements of the 2012 SPA forced Moreno to notify the Indenture Trustee of the defaults and publicly acknowledge the same in the second quarter 2013 Quarterly Report. Stip. Facts ¶ 83. These public notifications triggered a cross-default under the Shell Amended Senior Credit Facility. *Id.* As a result, Green Field's Corporate Family Rating, Probability of Default Rating and Senior Secured Notes Due 2016 rating were all downgraded. *Id.* Shell then issued a notice of default to Green Field on October 8, 2013. Stip. Facts ¶ 84. Moreno testified that had the SPAs been fulfilled, Green Field would have been able to make the required interest payments under the Shell contract. Trial Tr. 469:20-470:3. Moreno also knew that causing harm to Green Field was not in MOR MGH's best interest because MOR MGH owned no assets other than Green Field stock. Trial Tr. 847:9-21. Accordingly, Moreno knew that by causing the breaches of the SPAs, Green Field would default on the Shell Contract and cross-default on the Bond Indenture, which would have negative implications for the company which, in turn, would harm MOR MGH.

Moreno falsely testified that "Green Field received every dollar that TGS ended up getting." Trial Tr. 424:9-10. However, no monies went into Green Field other than in fair market value transactions (i.e., turbine sales) (Trial Tr. 1085:20-1086:23, 1091:7-1092:3, 1820:11-19, 1824:20-1825:1) or as deposits required to be held in trust. Trial Tr. 466:2-6, 837:12-840:24; Trial Tr. Conf. 3/20 at 16:4-8. Moreno acknowledged that these payments were distinct and unrelated to the SPAs. Trial Tr. 468:9-469:12, 846:11-22. Moreover, even under Moreno's accounting, there was at least $35 million on hand that he borrowed either personally or through TGS, which either went to Moreno personally or was unaccounted for. Trial Tr. 844:20-846:10; JX 3; DX 221.

The most egregious evidence of Moreno's malicious intent was his diversion of $10 million from the second tranche of the Goldman Sachs loan. Moreno secured the loan by promising Goldman Sachs that he would cause MOR MGH to use $10 million of the funds to purchase additional preferred stock in Green Field which he would then pledge to Goldman Sachs. Trial Tr. 397:20-398:3; PX 160. Goldman Sachs required Moreno to certify in writing that the purchase did in fact occur. Trial Tr. 400:12-402:19; PX 165. Moreno, in turn, provided Goldman Sachs with the written certification, which he signed on behalf of both MOR MGH and Green Field. Trial Tr. 403:11-404:20; PX 165. The certificate, as previously stated, was untrue. Instead, Moreno took that same $10 million and used it to purchase his Dallas home. Trial Tr. 411:18-420:12; PX 168. Moreno testified that he was allowed under the loan agreement to use the funds for personal real estate purposes. Trial Tr. 416:4-417:2. But his testimony is flatly contradicted by the terms of the loan agreement itself. PX 166 at GS0003763; Trial Tr. 417:5-418:21. Moreno's lies at trial only underscore his malicious intent and desire to avoid liability. There can be no question that spending

available funds on one's personal residence in direct violation of the terms of the loan agreement, rather than fulfilling obligations to the company, constitutes placing one's personal interests ahead of the company's.

***50** Moreno testified that the payment was not accounted for properly and that he sent the money to MOR DOH which sent it to TGS which sent it to Green Field. Trial Tr. 403:11-405:23. The Court rejected this argument at summary judgment. D.I. 463 at pp. 38-39. In any event, the capital contribution chart shows the payments from TGS to Green Field, and none of those monies are the $10 million owed under the 2013 SPA; rather, those monies were deposits held for TPT or turbine engine purchases. JX 3. Additionally, in October 2013, Moreno told his (and Green Field's) attorney, Slavich, that MOR DOH, not Green Field, received the money. PX 183. Blackwell, who Fontova agreed would know most about the financial affairs of Green Field, also testified that Green Field never received the $10 million due under the 2013 SPA. Trial Tr. 408:4-410:18; Blackwell Dep. at 68:3-15, 74:5-75:15, 209:23-210:3; Fontova Dep. 120:9-17; PX 187.

Accordingly, the Trustee has proven that Green Field is entitled to damages from Moreno in the amount of the $16,607,081,[21] plus applicable prejudgment interest at 9%, due to Moreno's tortious interference. N.Y. C.P.L.R. § 5001(a) ("Interest shall be recovered upon a sum awarded ... because of an act or omission depriving or otherwise interfering with title to, or possession or enjoyment of, property ...."); *N. Main St. Bagel Corp. Duncan*, 831 N.Y.S.2d 239, 242–43 (N.Y. App. Div. 2007). The only difference in damages under this count is that Moreno is also liable for the additional amounts not funded by MMR, plus pre-judgment interest thereon, net of the amounts acquired in settlement. This amount equals an additional $645,158, before the accrual of prejudgment interest. As of June 29, 2018, prejudgment interest has accrued in the amount of $7,546,111.12, and continues to accrue at a rate of $4,119.55 per day.

C. The Trustee is Entitled to a Constructive Trust on Moreno's Dallas Home

Alternatively, the Court finds that these facts justify the remedy of a constructive trust against Moreno's Dallas home.[22] Under Delaware law, "a constructive trust is an equitable remedy of great flexibility and generality. A constructive trust is proper when a defendant's fraudulent, unfair or unconscionable conduct causes him to be unjustly enriched at the expense of another to whom he owed some duty." *Ruggerio v. Estate of Poppiti*, No. CIV.A. 18961-NC, 2005 WL 517967, at *3 (Del. Ch. Feb. 23, 2005); *In re Opus E.*, 528 B.R. at 106 ("The imposition of a constructive trust is also appropriate where a defendant has been unjustly enriched."). Thus, courts analyze the same elements for a constructive trust as they do for an unjust enrichment claim. "To prevail on a claim for unjust enrichment or imposition of a constructive trust[,] the Trustee must allege sufficient facts to plausibly show that (i) there was an enrichment; (ii) an impoverishment; (iii) a relation between the enrichment and the impoverishment; (iv) the absence of justification; and (v) the absence of a remedy provided by law." *In re Direct Response Media, Inc.*, 466 B.R. 626, 661 (Bankr. D. Del. 2012).

***51** Courts have found that a successful tortious interference claim can give rise to a constructive trust. *See GHK Assocs. v. Mayer Grp., Inc.*, 224 Cal.App.3d 856, 274 Cal.Rptr. 168, 182 (Cal. Ct. App. 1990) ("A breach of contract or intentional interference with [a] contract can make the offending party a constructive trustee."); *Scymanski v. Dufault*, 80 Wash.2d 77, 491 P.2d 1050, 1057 (Wash. 1971) ("We have here a defendant who has intentionally interfered with another's business relationship and as a result of such interference has acquired the property that was the subject of that relationship. A constructive trust ... is the appropriate remedy.").

Courts have also imposed a constructive trust on a home when it is clear that the proceeds that were wrongfully taken from the plaintiff were used to purchase that home. *See In re Lee*, 574 B.R. 286, 294 (Bankr. M.D. Fla. 2017) ("Here, Defendants have been unjustly enriched by the receipt of the fraudulent transfers that they invested in their home. Under the constructive trust doctrine, the rightful owner of misappropriated trust property may trace whatever has been bought with the trust proceeds to the extent such property can be substantially identified as having been acquired with the misappropriated property or funds."); *Zobrist v. Bennison*, 268 Ga. 245, 486 S.E.2d 815, 817 (Ga. 1997) ("In its grant of partial summary judgment to Bennison, the trial court concluded that the money used to pay down Zobrist's mortgage actually belonged to Bennison's children. That conclusion, applied to the principle stated above, authorized the imposition of the trust."); *Benson v. Richardson*, 537 N.W.2d 748, 760 (Iowa 1995) ("A party in whose favor a constructive trust has been established may trace the property to where it is held and reach whatever has been obtained through the use of it.").[23]

As explained above, $10 million of the funds Moreno borrowed from Goldman Sachs, which were to be used to purchase stock in Green Field, was instead used to purchase his Dallas home, in violation of the express terms of the loan agreement. Trial Tr. 411:18-420:12; PX 168. Moreno then lied to Goldman Sachs about the stock purchase. Trial Tr. 403:11- 404:20; PX 165. Moreno signed the Goldman Sachs certification on behalf of both MOR MGH and Green Field, thus concealing the fraud from Green Field. PX 165. This is the type of fraudulent, unfair and unconscionable conduct that justifies imposition of a constructive trust. Moreno was enriched by using $10 million to buy a home, and Green Field was impoverished because it was deprived of $10 million of funding. The impoverishment is directly related to the enrichment, and there is no justification for Moreno's actions. Further, there is no adequate remedy at law to be able to recover the $10 million spent on the home. Accordingly, the Court finds that all of the elements of a constructive trust are satisfied.

III. *THE PROOFS OF CLAIM OF AERODYNAMIC, CASAFIN, AND FRAC RENTALS*

There is an inconsistency in the Court's SJ Opinion that it shall now correct. Despite having awarded judgment to the Trustee on the three preferences claims (Aerodynamic, Casafin and Frac Rentals), the Court declined to disallow the corresponding proofs of claim filed by those defendants under Section 502(d). In the SJ Opinion, the Court stated:

> ***52** The Trustee argues against Moreno's preference claims pertaining to TGS, Aerodynamic, Casafin and Frac Rentals. Under Section 502(d), summary judgment for the Trustee can only be granted if the Trustee is successful in his motion to deny those specific preference claims. As discussed above, the Court did not grant the Trustee summary judgment on his preference claim, and thus summary judgment on count 29 is denied.

DI. 463 at pp. 45-46. However, it was the Trustee, not Moreno, who brought the preference claims, and the Court did, in fact, award judgment to the Trustee on his preference claims against Aerodynamic, Casafin and Frac Rentals. D.I. 463 at p. 46. As a result, the Trustee argued against the proofs of claim by Aerodynamic, Casafin and Frac Rentals against Debtor. Because the Trustee was successful on his preference claims, pursuant to Section 502(d) of the Bankruptcy Code, all proofs of claim against Debtor by Aerodynamic, Casafin and Frac Rentals must be disallowed until such time that those entities return the preferential transfers to the estate. 11 U.S.C. § 502(d) (emphasis added) ("[T]he court *shall* disallow any claim of any entity ... that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable ...."); *See, e.g.*, *In re Pardee*, 218 B.R. 916, 930 (B.A.P. 9th Cir. 1998) ("Every claim of an entity that is a transferee of an avoidable transfer, such as a preference, or that holds property that should be turned over to the trustee is automatically disallowed until the property is turned over or the liability is paid in full."). At trial, Moreno testified that Aerodynamic, Casafin and Frac Rentals have not paid the judgments against them. Trial Tr. Conf. 3/19 at 5:16-23; Trial Tr. 89:15-90:4, 91:7-14. The Court thus finds in favor of the Trustee on Count 29.

IV. CONCLUSION

The Court has found in favor of Moreno and Defendants and against the Trustee on the Trustee's claims arising from the waiver of the PowerGen business for constructive fraudulent transfer, actual fraudulent transfers, breach of fiduciary duty and corporate waste. The Court has also found in TGS's favor on the claim against TGS for aiding and abetting Moreno's breach of fiduciary duty. The Court therefore finds that there are no damages for each of these causes of action.

The Court has found in favor of the Trustee on his claims relating to the two SPAs. The Court has found that MOR MGH breached the 2012 SPA and 2013 SPA, damaging Green Field in the amount of $15,961,923 plus interest, for 2012 and 2013 respectively. Additionally, the Court has found that Moreno intentionally and tortuously interfered with the obligations of MOR MGH and MMR under the SPAs, damaging Green Field in the amount of $16,607,081. The damages for tortious interference are duplicative of the damages for breach of contract, but include an additional $645,158, before the accrual of prejudgment interest. Accordingly, the Court finds that the Trustee is entitled to recover $16,607,081, plus prejudgment interest from Moreno personally. The Court alternatively finds that because Moreno tortiously interfered with the 2013 SPA and used $10 million to purchase his personal residence in Dallas, the Trustee is entitled to a constructive trust over that property in the amount of $10 million.

***53** Further, the Court has found that the Trustee can recover the judgments previously awarded to him for his preferential transfer claims against Aerodynamic, Casafin and

Frac Rentals against Moreno personally as the entity for whose benefit the transfers have been made. Accordingly, the Court finds that the Trustee may recover a total of $645,552.91 from Moreno for those claims, plus applicable prejudgment interest. The Court also finds that the proofs of claim filed by Aerodynamic, Casafin and Frac Rentals against Debtor are disallowed until Moreno pays those judgments to Debtor pursuant to 11 U.S.C. § 502(d) of the Bankruptcy Code.

The Trustee, through his attorneys, is directed to confer with Defendants' attorneys on an appropriate form of Order consistent with this Opinion and Findings of Fact and Conclusions of Law to be submitted to the Court. If the parties cannot agree they may submit alternative forms of Order.

(Jointly Administered)

LIMITED OBJECTION UNDER FEDERAL RULE OF BANKRUPTCY PROCEDURE 9033 OF DEFENDANTS MICHEL B. MORENO AND MOR MGH HOLDINGS, LLC TO THE PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW SET FORTH IN THE BANKRUPTCY COURT'S OPINION (D.I. 535) AND ORDER (D.I. 540)

Defendants Michel B. Moreno ("Moreno") and MOR MGH Holdings, LLC ("MOR MGH") (collectively the "Movants" or "Defendants"),[1] file this limited objection (the "Objection") pursuant to Federal Rule of Bankruptcy Procedure 9033 to the *Opinion and Findings of Fact and Conclusions of Law* (D.I. 535) (the "Opinion")[2] and corresponding Order (D.I. 540) (the "Order"). The Opinion found that some of the Counts alleged by the Trustee were statutorily "core" (Counts 1, 2, 19, 23, 24, and 29), and others "non-core" (Counts 3, 6, 7, 11, 12, and 14). To be clear, Movants object to the Court's proposed findings of fact and conclusions of law only as to Counts 11, 12, and 14.[3] On these three Counts the Court entered proposed findings of fact and conclusions of law and made recommendations to the District Court to enter judgment.

***54** While the Opinion sets forth proposed findings of fact and conclusions of law ("PPFCL"), the Opinion did not separate the findings or conclusions in numbered paragraphs. The absence of separately numbered paragraphs makes it difficult to identify and object to each of the Bankruptcy Court's proposed findings of fact and conclusions of law. The Defendants nevertheless attempt to do so in this Objection and Suggestion. Defendants reiterate that their objections are limited to the PPFCL as they relate to Counts 11, 12, and 14 as asserted in the Second Amended Complaint, and as the PPFCL and Opinion relate to the proposed imposition of a constructive trust against Moreno's exempt Texas homestead.

The Defendants also file a Suggestion in Support of this Objection, which is expressly incorporated herein by reference.[4]

I. OBJECTIONS

A. Specific Objections to the Proposed Findings of Fact[5]

1. Due to the weight of evidence and specific proposed findings to the contrary, Defendants object to the specific findings or conclusions, including the excerpt below, that Green Field was transitioning its business from traditional well services and hydraulic fracturing to power generation:[6]

> (i) On February 13, 2013, **while Green Field's was transitioning into the power generation market and negotiating with GE**, the payment for the fourth quarter of 2012 became due. PX 132 [APP 0645]; Trial Tr. 381:3-382:20 [APP 1117]. [APP 0026] (Opinion, 25) (emphasis added).

2. Also, due to the weight of evidence and specific proposed findings to the contrary, Defendants object to findings, including the following excerpt, which characterize Moreno's actions or portray Moreno's dealings with GE and other third-parties as an effort to harm Green Field or benefit himself:[7]

> (i) As explained below, on May 13, 2013, Moreno **orchestrated** Green Field's **waiver of the PowerGen Business in favor of himself personally** and Moreno caused TGS to enter into the $25M loan with GE. [APP 0026] (Opinion, 25) (emphasis added).

3. Defendants object to the Bankruptcy Court's findings that Moreno caused breaches of contract, including the following excerpt, which lack support in the evidentiary record:[8]

> (i) On May 15, 2013, two days after the Waiver, Moreno **caused** MOR MGH and MMR to breach their obligations under the 2012 SPA for the first quarter of 2013. Stip. Facts ¶¶ 71, 72. Moreno **caused** MOR

MGH's breach despite the fact that Moreno was the CEO of Green Field, had a fiduciary obligation to Green Field, and MOR MGH's only asset was its stock ownership in Green Field. [APP 1322] Trial Tr. 847:9-21. [APP 0026-27] (Opinion, 25-26) (emphasis added).

(ii) Accordingly, Moreno had additional funds on hand that would have allowed him to permit MOR MGH to satisfy its obligations under the 2012 SPA or the 2013 SPA (discussed and defined below). Moreno conceded at trial that "[i]t would have been beneficial for Green Field to have every dollar it could find." [APP 1135] Trial Tr. 469:17-19. He also acknowledged that the absence of cash "is absolutely the kiss of death" to a company. [APP 1137] Trial Tr. 478:12-17. Despite these acknowledgments, **he chose to cause** MOR MGH to fail to provide necessary cash to Green Field, even though he had funds on hand. [APP 0028] (Opinion 27).

***55** 4. Due to the weight of evidence weight and specific proposed findings to the contrary, Defendants further object to the findings or conclusions, including the following excerpts, relating to the Bankruptcy Court's rejection of Green Field's benefit from Moreno's efforts to raise capital through GE negotiations, bondholder discussions and third-party loans:[9]

(i) Putting aside Moreno's characterization of those transactions as purported contributions to Green Field,[9] of the $85M borrowed, $37M was either used by Moreno for his personal interest (i.e., $10M to purchase his Dallas house) or was otherwise unaccounted for. [APP 1321-22] Trial Tr. 844:20-846:10; [APP 0436] JX 3; [APP 0627] DX 221. [APP 0027-28] (Opinion, 26-27).

(ii) The turbine sales were in connection with the $25M advance from GE to TGS and were fair market value transactions that converted hard assets into cash. [APP 1437] Trial Tr. 1085:20-1086:23, [APP 1437-39] 1091:7-1092:3, [APP 1981] 1820:11-19, [APP 1982] 1824:20-1825:1.... The Court rejects Moreno's assertion that these transactions were intended to benefit Green Field. [APP 1099] Trial Tr. Conf. 3/20 at 5:16-6:8; [APP 0436] JX 3. [APP 0027] (Opinion, 26 fn.9).

(iii) Moreno falsely testified that "Green Field received every dollar that TGS ended up getting." [APP 1128] Trial Tr. 424:9-10. However, no monies went into Green Field other than in fair market value transactions (i.e., turbine sales) ([APP 1437-38] Trial Tr. 1085:20-1086:23, [APP 1439] 1091:7-1092:3, [APP 1981] 1820:11-19, [APP 1982] 1824:20-1825:1) or as deposits required to be held in trust. [APP 1134] Trial Tr. 466:2-6, [APP 1320] 837:12-840:24; [APP 1101] Trial Tr. Conf. 3/20 at 16:4-8. [APP 0119] (Opinion, 118).

5. Defendants object to the findings or conclusions, including the following statements, which purport to calculate damages to Green Field based on MOR MGH's breaches of the SPAs:[10]

(i) Green Field failed to make its $2 million monthly payments to Shell under the Shell Contract, as amended, for each of June, July, and August 2013, a default totaling $6 million. Stip. Facts ¶ 79. Moreno testified that had the SPAs been fulfilled, Green Field would have been able to make the required interest payments under the Shell Contract. [APP 1135] Trial Tr. 469:20-470:3. Green Field's failure to satisfy the requirements of the 2012 SPA forced Moreno to notify the Indenture Trustee of the defaults and publicly acknowledge the same in the Q2 2013 Quarterly Report. [APP 0205] Stip. Facts ¶ 83. [APP 0031] (Opinion, 30).

(ii) Moreno also acknowledged that had the SPAs been fulfilled, Green Field would have been able to make the required interest payments under the Shell Contract. [APP 1135] Trial Tr. 469:20-470:3. Green Field then would have avoided its cross-defaults under the Shell Contract and the Bond Indenture. See [APP 0205] Stip. Facts ¶ 83. Accordingly, the Court holds that Green Field would have been in a better economic position had MOR MGH and MMR complied with the SPAs than it was as a result of the breach. APP 0112 (Opinion, 111).

***56** (iii) Accordingly, the Trustee has proven that Green Field suffered damages in the amount of $15,961,923 due to MOR MGH's failure to honor its obligations under the 2012 and 2013 SPAs. The Trustee prevails on damages, plus applicable prejudgment interest. [APP 0114] (Opinion, 113).

6. Defendants Object to the Opinion, including the statements below, which purport to interpret the Goldman Sachs loans to Moreno and the DOH GRATs by concluding that: (a) Moreno was obligated to use such personal loans to satisfy contractual obligations of MOR MGH; (b) some or all of the Goldman Sachs loans were earmarked to purchase stock from Green Field; (c) Green Field obtained a property interest in the Goldman Sachs loan proceeds; or (d) Moreno did not use any of the funds he borrowed from Goldman Sachs to help Green Field:[11]

(i) The specified purpose of the personal loan was to make an "equity investment in Green Field which shall be used as working capital to fulfill equipment orders and to make and [sic] equity investment in Turbine Generation Services, L.L.C." [APP 0691] PX 156 at GS0002950. The second tranche for $15 million was dated July 5, 2013. Trial Tr. 417:5-20; PX 166. Moreno put none of this money into Green Field. [APP 0029] (Opinion, 28).

(ii) The 2013 SPA was a condition of Goldman Sachs loaning the second tranche of $15 million to Moreno personally and it required Moreno to purchase additional preferred stock in Green Field and then pledge that stock to Goldman Sachs as security for the personal loan. [APP 1121] Trial Tr. 397:20-398:3; [APP 0775-77] PX 160. Goldman Sachs required that Moreno provide a written certification once the stock had been purchased. [APP 1122] Trial Tr. 400:12-402:19; [APP 0788-94] PX 165. [APP 0029] (Opinion, 28).

(iii) The Court finds that Moreno knowingly and intentionally lied to Goldman Sachs and intentionally diverted $10M earmarked for Green Field to his own personal use. [APP 0030] (Opinion, 29).

(iv) Moreno acknowledged his responsibility for the SPA obligations and promised to cure the defaults that quarter. [APP 1133] Trial Tr. 445:10-446:7; [APP 0882] PX 177 at p.5 ("I do plan on (inaudible) that default this quarter ... certainly I'll be in a position to cure this default in this quarter."). [APP 0032] (Opinion, 31).

(v) Additionally, [Moreno] promised to cure the defaults, demonstrating that he still believed he had an obligation that he needed to fulfill. [APP 1133] Trial Tr. 445:10-446:7; [APP 0882] PX 177 at p. 5. [APP 0114] (Opinion at 113).

(vi) The Court observes that Moreno testified at trial that he referred interchangeably to the SPA obligations as his own and that of MOR MGH. [APP 1118] Trial Tr. 385:22-386:10; see also [APP 0898] PX 217 at p. 9; [APP 0663] PX 143 at p. 6; [APP 0882] PX 177 at p. 5. [APP 0116] (Opinion, 115 fn. 20).

B. ***Specific Objections to the Proposed Conclusions of Law***

***57** 7. Defendants object to the Bankruptcy Court's conclusions on Pages 111-113 of the Opinion that Green Field suffered damages in excess of $16 million due to MOR MGH's failures to purchase common stock under the 2012 and 2013 SPAs.[12]

8. Defendants object to the Bankruptcy Court's conclusions on Pages 113-115 and 120 of the Opinion to the extent the Court concluded, without adequate factual or legal support, that Moreno was personally liable for MOR MGH and MMR's obligations under the 2012 and 2013 SPAs.[13]

9. Defendants further object to the Bankruptcy Court's conclusions on Pages 111-112 of the Opinion that MOR MGH had access to cash "through Moreno" to satisfy its obligations under the SPAs, or that Moreno "improperly siphoned off" or misused personal loan proceeds to the detriment of Green Field.[14]

10. Defendants further object to the Bankruptcy Court's conclusions on Pages 115-120 of the Opinion, including the following excerpts, regarding Moreno's intent to cause MMR and MOR MGH to breach their obligations under the 2012 and 2013 SPAs:[15]

(i) Even though Moreno directed Blackwell to represent to Moody and Rucks that Moreno was intending to make the payments, **Moreno had no intention to perform**, did not perform and, as a result, caused Moody and Rucks to breach the 2012 SPA. [APP 2045-46] Blackwell Dep. 42:11-44:16; 55:7-12; [APP 0678-80] PX 148. [APP 0116] (Opinion, 115) (emphasis added).

(ii) The Court finds that Moreno acted with malicious intent in causing the breaches of the SPAs. MOR MGH's only asset was its ownership of the common shares of Green Field. [APP 1322] Trial Tr. 847:9-21. By causing MOR MGH to breach its obligations under the 2012 and 2013 SPAs, **Moreno deprived Green Field of $17 million of capital which Green Field needed in order to satisfy obligations to Shell and to continue its business.** [APP 1135] Trial Tr. 469:20-470:3. [APP 0117] (Opinion, 116) (emphasis added).

(iii) The first breach of the 2012 SPA occurred on May 15, 2013, **just two days after Green Field waived the PowerGen opportunity in favor of Moreno personally**. See [APP 0204] Stip. Facts ¶ 71; [APP 0596-99] JX 61. In other words, Moreno made the decision to stop complying with the obligations of the 2012 SPA as soon as he knew that he would no longer be pursuing the PowerGen business opportunity

in Green Field. **He was thus willing to let Green Field suffer and, as he put it, give it the "kiss of death" by denying it needed funds and instead putting the money towards a business that he now personally owned outside of Green Field.** [APP 1137] Trial Tr. 478:12-17. Indeed, Moreno admitted to Green Field bondholders on a quarterly conference call that the very reason for his default was because he was devoting his personal capital to PowerGen, which he had intentionally seuqestered [sic] outside of Green Field. [APP 1132] Trial Tr. 440:1-441:14; [APP 0882] PX 177 at p. 5. [APP 0118] (Opinion, 117) (emphasis added).

***58** 11. Defendants object to the Bankruptcy Court's findings or conclusions, including the following excerpts on Pages 118-119 of the Opinion, which the Bankruptcy Court relied upon for purposes of finding evidence of Moreno's malicious intent:[16]

(i) Moreover, even under Moreno's accounting, there was at least $35 million on hand that he borrowed either personally or through TGS, which either went to Moreno personally or was unaccounted for. [APP 1321-22] Trial Tr. 844:20-846:10; [APP 0436] JX 3; [APP 0627] DX 221. [APP 0119] (Opinion, 118).

(ii) Instead, Moreno took that same $10 million and used it to purchase his Dallas home. Trial Tr. [APP 1124-27] 411:18-420:12; [APP 0874-76] PX 168. Moreno testified that he was allowed under the loan agreement to use the funds for personal real estate purposes. [APP 1126] Trial Tr. 416:4-417:2. But his testimony is flatly contradicted by the terms of the loan agreement itself. [APP 0819] PX 166 at GS0003763; [APP 1126] Trial Tr. 417:5-418:21. Moreno's lies at trial only underscore his malicious intent and desire to avoid liability. There can be no question that spending available funds on one's personal residence in direct violation of the terms of the loan agreement, rather than fulfilling obligations to the company, constitutes placing one's personal interests ahead of the company's. [APP 0119-20] (Opinion, 118-119).

(iii) Moreno testified that the payment was not accounted for properly and that he sent the money to MOR DOH which sent it to TGS which sent it to Green Field. Trial Tr. [APP 1122-23] 403:11-405:23. The Court rejected this argument at summary judgment. [APP 2095-96] D.I. 463 at pp. 38-39. In any event, the capital contribution chart shows the payments from TGS to Green Field, and none of those monies are the $10 million owed under the 2013 SPA; rather, those monies were deposits held for TPT or turbine engine purchases. JX 3. [APP 0120] (Opinion, 119).

12. Defendants object to the Bankruptcy Court's conclusion on Pages 120-121 of the Opinion that a constructive trust is an available remedy where the Trustee fails to plead or prove any "recognized cause of action" such as fraud, breach of fiduciary duty or unjust enrichment.[17]

***59** 13. Defendants object to the Bankruptcy Court's conclusion on Page 121 of the Opinion that tortious interference is a "recognized cause of action" that can give rise to the imposition of a constructive trust remedy. Defendants would show that an adequate legal remedy, including a money judgment, exists for such a cause of action.[18]

14. Defendants object to the Bankruptcy Court's conclusion that the Texas homestead exemption does not preclude the imposition of a constructive trust. [APP 0123] (Opinion, 122 fn.23).

15. Defendants object to the Bankruptcy Court's conclusion that the Trustee need only prove wrongdoing by a preponderance of the evidence. [APP 0123-24] (Opinion, 122-123).[19]

16. Defendants object to the Bankruptcy Court's conclusions, including the following excerpts from Pages 122-123 of the Opinion, holding that the Trustee carried its burden of proof on the elements necessary to impose a constructive trust on Moreno's homestead:

(i) As explained above, $10 million of the funds Moreno borrowed from Goldman Sachs, which were to be used to purchase stock in Green Field, was instead used to purchase his Dallas home, in violation of the express terms of the loan agreement. [APP 1124-27] Trial Tr. 411:18-420:12; [APP 0874-76] PX 168. [APP 0123-24] (Opinion, 122-123).[20]

(ii) Moreno then lied to Goldman Sachs about the stock purchase. [APP 1122-23] Trial Tr. 403:11-404:20; [APP 0788-94] PX 165. Moreno signed the Goldman Sachs certification on behalf of both MOR MGH and Green Field, thus concealing the fraud from Green Field. [APP 0788-94] PX 165. This is the type of fraudulent, unfair

and unconscionable conduct that justifies imposition of a constructive trust. [APP 0124] (Opinion, 123).[21]

(iii) Moreno was enriched by using $10 million to buy a home,[22] and Green Field was impoverished because it was deprived of $10 million of funding.[23] [APP 0124] (Opinion, 123).

(iv) The impoverishment is directly related to the enrichment, and there is no justification for Moreno's actions.[24] [APP 0124] (Opinion, 123).

(v) Further, there is no adequate remedy at law to be able to recover the $10 million spent on the home.[25]

***60** 17. Finally, for the reasons set forth herein and described more fully in the Suggestion, Defendants object to the summary portion on Page 125 of the Opinion in its entirety.

II. PRAYER

WHEREFORE, pursuant to Bankruptcy Rule 9033, Defendants ask the District Court to: (i) reject the portions of the PPFCL and the recommendations in the Bankruptcy Court's Order as they relate to Counts 11, 12 and 14; (ii) reject the Bankruptcy Court's proposed imposition of a constructive trust; (iii) render judgment in favor of the Defendants on all counts; and (iv) award Defendants such other and further relief, at law or equity, to which they are justly entitled.

SUGGESTION IN SUPPORT FOR THE LIMITED OBJECTION UNDER FEDERAL RULE OF BANKRUPTCY PROCEDURE 9033 OF DEFENDANTS MICHEL B. MORENO AND MOR MGH HOLDINGS, LLC TO THE PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW SET FORTH IN THE BANKRUPTCY COURT'S OPINION (D.I. 535) AND ORDER (D.I. 540)

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Defendants Michel B. Moreno ("Moreno") and MOR MGH Holdings, LLC ("MGH Holdings") (collectively the "Movants" or "Defendants"),[1] file this suggestion (the "Suggestion"), in support for their Limited Objection (the "Objection") pursuant to Federal Rule of Bankruptcy Procedure 9033 to the *Opinion and Findings of Fact and Conclusions of Law* (D.I. 535) [APP 0001-127] (the "Opinion")[2] and corresponding Order (D.I. 540) [APP 0128-131] (the "Order"). In support of the Limited Objection, the Defendants respectfully show as follows:

I. INTRODUCTION

***62** 1. This adversary was filed in April 2015, by the liquidating plan trustee appointed in Green Field's chapter 11 bankruptcy case, which was initially filed in October of 2013. At one point during the three years of litigation, the Trustee asserted as many as 35 counts, including claims for unjust enrichment, breach of fiduciary duty, and fraudulent transfers, seeking damages in excess of $230 million. By the time the case went to trial, the Trustee had dismissed the unjust enrichment and other claims, and the Trustee's own expert calculated damages at a fraction of those initially plead. As described in the Opinion, the issues presented at trial included three categories of claims, summarized as follows:

(i) Counts 1, 2, 3, 6 and 7 – fraudulent transfer, breach of fiduciary duty and corporate waste claims against Moreno and Turbine Generation Services, LLC ("TGS") related to the alleged transfer or waiver of the power generation business (the "PowerGen");

(ii) Counts 11, 12 and 14 – breach of contract and tortious interference claims against MOR MGH Holdings, LLC ("MGH Holdings") and Moreno related to the alleged breaches of the two stock purchase agreements ("SPAs") between Green Field and MGH Holdings; and

(iii) Counts 19, 23 and 24 – Moreno's personal liability for any avoidable transfers under the "transfer beneficiary" theory of 11 U.S.C. § 550(a)(1).

2. The Bankruptcy Court held a six day trial, which included six live witnesses (two of them experts) and nearly a dozen additional witnesses by deposition. In addition to this testimony, the evidentiary record included dozens of stipulations, hundreds of exhibits, and thousands of pages of documentary evidence. After considering this extensive record, the Bankruptcy Court made specific findings about, among other things, Moreno's background [APP 0007-23] (Opinion, 6-22), his tumultuous negotiations with GE that ultimately provided liquidity for Green Field [APP 0033-51] (Opinion, 32-50), and Moreno's transparency with third-party bondholders and board members regarding his negotiations with GE [APP 0051- 66] (Opinion, 50-65).

3. The Bankruptcy Court ruled in the Defendants' favor on the Trustee's constructive and actual fraudulent transfer claims (Counts 1 and 2) and in Moreno's favor on the preferential transfer claims (Counts 19, 23, and 24), concluding that neither Moreno nor TGS could be held liable for the so-called PowerGen transfer because: (a) the Trustee did not prove that Green Field held an interest in the PowerGen opportunity; (b) the Trustee failed to prove that any such transfers were constructively or actually fraudulent; and (c) Moreno was not a beneficiary of any such transfers. [APP 0089-99] (Opinion, 88-98). The Bankruptcy Court entered judgment on those statutorily "core" claims. No party moved for reconsideration of the Bankruptcy Court's Judgment on those claims.

4. The Bankruptcy Court proposed a ruling in the Defendants' favor on the Trustee's breach of fiduciary duty and corporate waste claims (Counts 3, 6, and 7) [APP 0085-109] (Opinion, 84-108), concluding that, *inter alia*, the Trustee failed to prove that Moreno had access to or received direct benefit from certain transfers, [APP 0085-89] (Opinion, 84-88). These recommendations are consistent with the opinion and judgment of the Bankruptcy Court and Defendants do not object to the recommendations on Counts 3, 6, and 7.

5. The PPFCL's discussion of the fiduciary duty claims is detailed. The Bankruptcy Court addresses Moreno's interactions with potential investors, his board of directors and Green Field's existing creditors. [APP 0099-109] (Opinion, 98-108). The Bankruptcy Court concluded that Moreno's actions were consistent with his fiduciary duties, under even the highest level of scrutiny under Delaware law. [APP 0099-109] (Opinion, 98-108). Notably, the Bankruptcy Court explained:

> ***63** After months of searching, the best Moreno could do [to raise capital for Green Field] was sign personal guarantees to borrow from GE (through TGS), Goldman Sachs (through the DOH GRATs) and Powermeister (through DOH Holdings). None of those lenders were willing to lend to or invest in Green Field directly. Only by taking those actions was Moreno able to insert approximately $50 million for the benefit of Green Field.

[APP 0105] (Opinion at 104). This and a number of other findings and conclusions throughout the Opinion are critical because they are supported by the record and consistent with the Bankruptcy Court's conclusions and recommendations regarding all claims **except** the claims related to the stock purchase agreements ("SPAs").

6. Defendants' Limited Objection focuses only on the Bankruptcy Court's findings, conclusions, and recommendations regarding the SPA claims (Counts 11, 12 and 14) and the proposed imposition of a constructive trust on Moreno's Texas homestead. Central to the Bankruptcy Court's recommended ruling are the following proposed findings:

(i) Moreno's actions to cause MGH Holdings to breach its SPA obligations led Green Field to default on $6 million in interest payments owed to Shell, Green Field's most significant customer;

(ii) Moreno had cash available from third-party loans, but chose not to fund Green Field's operations out of self-interest;

(iii) The third-party loan proceeds were earmarked to be invested in Green Field; and

(iv) Moreno deceived Green Field and his third-party lenders by using the loan proceeds for his personal benefit rather funding MGH Holdings' stock purchase agreements with Green Field.

7. As discussed in greater detail below, these proposed findings and resulting conclusions must be rejected as they are not supported by the great weight of evidence and are irreconcilable with the Bankruptcy Court's detailed findings elsewhere in the Opinion.

8. For the reasons that follow, the Defendants ask this Court to reject only the proposed findings and conclusions described in the Limited Objection, which relate to Counts 11, 12 and 14, as well as the proposed imposition of a constructive trust.[3]

II. ARGUMENTS AND AUTHORITIES

A. Legal Standard

9. The Defendants file the Limited Objection pursuant to Bankruptcy Rule 9033(d). The Limited Objection is timely, because an extension was sought under Bankruptcy Rule 9033(c) within 14 days of the Bankruptcy Court's entry of its Opinion and Order. *See* Fed. R. Bankr. P. 9033(b)&(c). "Once a bankruptcy court determines that a pending matter is not a core proceeding under 28 U.S.C. § 157(b)(2), but is nonetheless related to a case under title 11, it shall submit proposed findings of fact and conclusions of law to the district court. Thereafter, 'any final order or judgment shall be entered by the district court judge after considering the

bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected.' " *Gavin v. Tousignant (In re Ultimate Escapes Holdings, LLC),* 551 B.R. 749, 760 (D. Del. 2016) (quoting 28 U.S.C. § 157(b)(2) & (c)(1)). "In conducting a de novo review, the Court must consider **all** of the Bankruptcy Court's findings and conclusions and afford them **no presumption of validity**." *In re Ultimate Escapes Holdings, LLC,* 551 B.R. at 760 (quoting *In re Montgomery Ward & Co.*, 2004 U.S. Dist. LEXIS 2330, 2004 WL 323095, at *1 (D. Del. Feb. 13, 2004), *rev'd on other grounds*, 428 F.3d 154 (3d Cir. 2005)) (emphasis added).

***64** 10. Under the Rule, this Court "shall make a de novo review upon the record or, after additional evidence, of any portion of the bankruptcy judge's findings of fact or conclusions of law to which specific written objection has been made in accordance with this rule." Fed. R. Bankr. P. 9033(d). Upon its de novo review of the record and the Objection, this Court may "accept, reject or modify the proposed findings of fact or conclusions of law, receive further evidence, or recommit the matter to the bankruptcy judge with instructions." *Id.*

11. The foregoing standard is applicable to the Bankruptcy Court's PPFCL with regard to the second category of claims described above—*i.e.,* the SPA-related claims for breach of contract, tortious interference and the imposition of a constructive trust (Counts 11, 12 and 14). By contrast, the Bankruptcy Court's Opinion with respect to the first and third categories of claims is not subject to the same de novo review under Bankruptcy Rule 9033. That is because, pursuant to the parties' stipulation, and the Bankruptcy Court's *Order Regarding Core/Non-Core Status* [APP 2048-56] (D.I. 288), entered on January 6, 2017, the parties have agreed, and the Bankruptcy Court has ruled, that the PowerGen fraudulent transfer claims (Counts 1 and 2) and the preference claims (Counts 19, 23 and 24) were core bankruptcy claims. Thus, the Bankruptcy Court's findings and conclusions with respect to those claims are now final and not subject to review under Bankruptcy Rule 9033.[4]

12. Similarly, the Bankruptcy Court's findings and conclusions in connection with the PowerGen fraudulent transfer claims were essential to resolve the claims for breach of fiduciary duty and corporate waste (Counts 3, 6 and 7). As such, even though the claims for breach of fiduciary duty and corporate waste are non-core, the underlying findings and conclusions are not subject to de novo review under Bankruptcy Rule 9033. *See Frazin v. Haynes & Boone, L.L.P. (In re Frazin),* 732 F.3d 313, 323 (5th Cir. 2013).

13. In *Frazin*, the Fifth Circuit held that a fee claim dispute was a "core" proceeding for which the bankruptcy court could enter final findings and conclusions, and that those findings and conclusions would not be subject to de novo review under Rule 9033 if they were necessary to resolve non-core claims, such as a claim under the Texas Deceptive Trade Practices Act:

> By contrast, it *was* necessary for the bankruptcy court to decide whether the factual allegations were true and if so, the impact on the fee applications, regardless of whether the factual allegations could form an element of one or more state-law causes of action outside of the court's jurisdiction. The bankruptcy court carefully scrutinized each of Frazin's factual allegations and the evidence, made factual determinations, and resolved the impact on the fee applications. The analysis of the claims that Frazin alleged were DTPA violations consumes twenty-six pages of the bankruptcy court's Memorandum Opinion. The testimony and other evidence are examined in minute detail. **In sum, the *factual* resolutions were part and parcel of the adjudication of the fee applications, so they must survive reversal.**

In re Frazin, 732 F.3d at 323 (emphasis added). While the Third Circuit has not expressly adopted the *Frazin* ruling, its rationale has been applied by bankruptcy courts in this and many other circuits. *See, e.g., Holber v. Suffolk Constr. Co. (In re Red Rock Servs. Co., LLC),* 522 B.R. 551, 562 (Bankr. E.D. Pa. 2014) (citing *Frazin*).

***65** 14. Another reason why the Bankruptcy Court's findings and conclusions regarding Counts 1, 2, 3, 6, 7, 19, 23, and 24 are now final is because the Trustee has consented to the Bankruptcy Court's final adjudication of the Trustee's claims. *See Wellness International Network, Ltd. v. Sharif,* No. 13-935, —— U.S. ——, 135 S.Ct. 1932, 191 L.Ed.2d 911 (2015). Through the course of over three years of litigation before the Bankruptcy Court, the Trustee never once reserved the right to challenge the Bankruptcy Court's constitutional authority to enter final orders. There is no reservation in the Complaint, as amended multiple times. There is no reservation in the stipulation approved by the Bankruptcy Court on January 6, 2017 [APP 2051-56], and the Trustee never once sought to withdraw the reference. By contrast, the Defendants have reserved this right throughout the litigation. Under the circumstances, it is clear that the Trustee consented to the Bankruptcy Court's authority to enter final orders,

while the Defendants did not. Because the Defendants are not challenging the Bankruptcy Court's rulings on the first and third categories of claims described in Paragraph 1 above (Counts 1, 2, 3, 6, 7, 19, 23, and 24), those rulings are now final and not subject to review under Bankruptcy Rule 9033.

B. Specific Objections Based on the Record

(i) Moreno's Actions Were Intended to Help Green Field.

15. As detailed in the Limited Objection, the Bankruptcy Court's proposed findings include a statement that Moreno "orchestrated" a "waiver" from Green Field, causing it to transfer the PowerGen Business "in favor of himself personally." [APP 0026] (Opinion, 25). This proposed finding directly contradicts the Bankruptcy Court's findings and conclusions and is not supported by the evidentiary record.

16. In the more detailed reasoning portions of the Opinion, the Bankruptcy Court ruled that Green Field never obtained a property interest in the PowerGen business or opportunity. [APP 0090-94] (Opinion, 89-93). The Bankruptcy Court also found that the creation of TGS and development of a PowerGen business outside of Green Field was a mandate from GE. [APP 0022-23] (Opinion, 21-22) (citing [APP 0437-40] JX 27, [APP 0441-43] JX 30, [APP-0646-56] PX 136, [APP-0681-84] PX 152, [APP-0758-74] PX 157; [APP-1001-02] Trial Tr. 291-295, [APP-1006] 312:6-14, [APP-1164] 588:4-7, [APP-1006,1161] 697:24-368:7, [APP-1306] 782:3-19, [APP-1307] 785-87). Moreover, the Bankruptcy Court made specific findings, based on Moreno's "credible" testimony and substantial corroborating evidence presented at trial that "Moreno established TGS for legitimate business reasons aimed to support Green Field, not harm Green Field or create an unfair opportunity for Moreno." [APP-0023] (Opinion, 22). The Bankruptcy Court described the tumultuous negotiations with GE that led to a $25 million cash infusion into Green Field—consideration that "would not have been possible but for Moreno's continuous negotiations with GE and extensive efforts to find capital to save Green Field." [APP-0039-51] (Opinion, 38-50). Finally, the Bankruptcy Court's conclusions of law on the Trustee's breach of fiduciary duty claims detailed the reasons why Moreno's actions were consistent with his fiduciary duties, even under Delaware's highest standard of scrutiny. [APP-0099-109] (Opinion, 98-108). Considering these detailed findings and proposed conclusions, the District Court must reject the Bankruptcy Court's proposed findings that Moreno orchestrated a waiver for his own personal benefit. Such a statement contradicts the more reasoned rulings in the Opinion.

(ii) The Causation Findings are Not Supported by the Evidence.

17. The Bankruptcy Court's proposed finding regarding Moreno's "choice to cause" MGH Holdings' breaches of the SPAs warrants further review:

> Accordingly, Moreno had additional funds on hand that would have allowed him to permit MOR MGH to satisfy its obligations under the 2012 SPA or the 2013 SPA (discussed and defined below). Moreno conceded at trial that "[i]t would have been beneficial for Green Field to have every dollar it could find." Trial Tr. 469:17-19. He also acknowledged that the absence of cash "is absolutely the kiss of death" to a company. Trial Tr. 478:12-17. **Despite these acknowledgments, he chose to cause MOR MGH to fail to provide necessary cash to Green Field, even though he had funds on hand**.

***66** [APP-0028] (Opinion 27) (emphasis added); *see also* [APP-0026-27] (Opinion, 25-26) (finding that Moreno caused the breach "despite the fact that Moreno was the CEO of Green Field, had a fiduciary obligation to Green Field, and [MGH Holdings'] only asset was its stock ownership in Green Field.") (citing [APP-1322] Trial Tr. 847:9-21).

18. There are two major problems with the proposed finding quoted above. First, the "funds on hand" were funds that Moreno borrowed, personally, or that TGS and the DOH GRATs borrowed for TGS (with Moreno's personal guarantees). [APP-0435-36] JX 3; [APP-0626-27] DX 221; [APP-1318-19] Trial Tr. 831:7 – 833:2. Green Field was not a borrower on any of the loans from GE, Goldman Sachs, or Powermeister. [APP-0685-757] (PX 156), [APP-0795-873] (PX 166); [APP-0444-523] (JX 41); [APP-0548-95] (JX 49). Moreover, of the four loans mentioned—one from GE, two from Goldman Sachs, and the convertible equity investment from Powermeister—all of them were specifically intended to fund TGS. [APP-0548-95] (JX 49); [APP-0685-757] (PX 156); [APP-0795-873] (PX 166); [APP-0444-523] (JX 41); [APP-0908-10] (Notice of Borrowing, May 15, 2013); [APP-0911-15] (Notice of Borrowing, July 5, 2013).

19. Only one of those four loans—the May 2013 Goldman Sachs loan—contemplated an advance to be used for an investment in Green Field. [APP-0685-757] (PX 156). However, according to the Notice of Borrowing under that loan agreement, only one advance of $10 million was made, and specified purpose for the advance, according to the Notice of Borrowing, was "[t]o invest $10,000,000 of proceeds **in Turbine Generation Services, L.L.C.** in accordance with Section 2.9 of the Loan Agreement." [APP-0908-10] (Notice of Borrowing, May 15, 2013 (emphasis added)). In other words, none of the funds advanced to Moreno, TGS, DOH Holdings, or the DOH GRATs directed, or even authorized, Moreno to use the proceeds to purchase stock in Green Field, despite his desires and intentions to maintain Green Field's liquidity. Rather, those loans were specifically intended to fund TGS to help develop the PowerGen business. Thus, it is not simply the case that Moreno "had funds on hand" to do with them what he desired; Moreno leveraged his own personal assets to obtain new capital for the development of PowerGen, which the Bankruptcy Court found was only being explored as a way to provide Green Field with the liquidity it needed to continue its initial business plan. [APP-0037-38] (Opinion, 36-37) (citing [APP-1148] Trial Tr. 523, [APP-1157-58] 559-62, [APP-1159] 567-68).

20. Second, the finding that Moreno "chose to cause MOR MGH to fail to provide necessary cash" is fundamentally flawed and contradicted by the evidentiary record. The Bankruptcy Court recognized that Moreno went to great lengths to raise capital for Green Field to ensure that it had the cash needed to operate its business. [APP-0036-51] (Opinion, 35-50) ("The Court finds that this payment provided additional consideration to Green Field, which would not have been possible but for Moreno's continuous negotiations with GE and extensive efforts to find capital to save Green Field."); *see also* [APP-0105] (Opinion, 104) ("... Moreno and Green Field's management had been trying for months to raise the capital needed .... Only by [Moreno's extensive efforts and personal guarantees] was Moreno able to insert approximately $50 million for the benefit of Green Field."); [APP-0108] (Opinion, 107) ("With the [Board Consent], GE advanced funds to TGS, knowing that TGS would use the funds to 'purchase' inventory from Green Field at a substantial mark-up—so substantial that it allowed Green Field to make its $17 million semi-annual interest payment to bondholders.").

***67** 21. Moreno testified (and the Bankruptcy Court agreed) that Moreno and Green Field were only considering the PowerGen business and negotiating with GE as a means to provide new sources of liquidity for Green Field, or to provide "a catalyst to help [Moreno] raise money for Green Field." [APP-0037-38] (Opinion, 36-37) (citing [APP-1148] Trial Tr. 523, [APP-1157-58] 559-62, [APP-1159] 567-68). Moreno leveraged his own personal wealth and other assets in order to borrow funds from GE, Goldman Sachs, and Powermeister—all for the specific purpose of developing the PowerGen business. The Bankruptcy Court's Opinion accepted Moreno's testimony and the evidence that at least $50 million of these funds went directly to Green Field to provide the necessary liquidity to make interest payments and maintain trade debt levels. [APP-0105] (Opinion, 104). Thus, based on the Bankruptcy Court's own specific findings, and the evidence presented at trial, the proposed finding that Moreno prevented Green Field from obtaining "necessary cash" is simply unsupported by the record and directly contradicted by the Bankruptcy Court's other findings. This Court should reject that finding.

22. Throughout trial and through its post-trial briefing, the Trustee argued vehemently that Green Field needed more cash in the Spring and Summer of 2013, over and above the cash obtained from TGS. [APP-0368-69] (D.I. 531 at pg. 51-52, 87). However, the only evidence presented on this point were: (1) Moreno's anecdotal acknowledgement that Green Field could have used "every dollar it could find," [APP-0112] (Opinion, 111); (citing [APP-1135] Trial Tr. 469:17-19); and (2) the stipulated fact that Green Field did not make three separate interest payments of $2 million each to Shell, Green Field's largest customer. [APP-0031, 112, 114] (Opinion, 30, 111, 113) (citing [APP-0205] Stip. Fact ¶ 79). The Bankruptcy Court relied on this evidence as an indication of a "downward spiral" into bankruptcy. [APP-0118] (Opinion, 117).

23. However, the record indicates that it was not the absence of liquidity that caused Green Field to miss these payments to Shell. Rather, Moreno testified (and the Trustee made no effort to controvert) that Shell notified Moreno and Green Field's management in June of 2013 that Shell would not fulfill its future revenue commitment. [APP-1128-29] (Trial Tr. 424:21 – 431:20). Moreno testified that this was a "bombshell" that Shell dropped on his lap in June of 2013. [APP-1129] (Trial Tr. 429:14 – 431:20). Shell was, by far, Green Field's most significant customer, representing up to 79% of Green Field's revenue. [APP-0014] (Opinion, 13; [APP-0203] Stip. Fact ¶ 61). The Bankruptcy Court recognized that Shell had committed $600 million toward

Green Field's future revenues, and that future revenues from Shell represented a critical part of Green Field's business plan. [APP-0014] (Opinion, 13; [APP-1143] Trial Tr. 542-43). The uncontroverted testimony was that Green Field would not have made payments to Shell, whether it had the cash or not. [APP-1128] (Trial Tr. 424:21 – 426:9).

24. Thus, based on the Bankruptcy Court's own findings about the significance of Shell's business, it is clear that MGH Holdings' failure to purchase stock under the SPAs was not the reason why Green Field elected not to pay Shell the $2 million interest due in June, July and August of 2013. The real reason was the sudden change to Green Field's business plan, caused by Shell's "bombshell" in June of 2013. For these reasons, the Bankruptcy Court's proposed finding above must be rejected.

(iii) The Evidentiary Record Does Not Support the Bankruptcy Court's Calculation of Damages on the SPA Claims.

25. The Bankruptcy Court's findings relating to contractual damages must also be rejected. The Bankruptcy Court found and concluded that Green Field suffered $15,961,923 in damages due to the MGH Holdings' failure to purchase stock under the 2012 and 2013 SPAs. [APP-0114] (Opinion, 113). But the only evidence supporting this conclusion is Green Field's failure to pay $6 million to Shell—Green Field's most significant customer—in June, July and August, which the Opinion found to be the reason for "cross defaults under the Shell Contract and the Bond Indenture." [APP-0112] (Opinion, 111).

***68** 26. This conclusion cannot be reconciled with the Bankruptcy Court's other findings that Green Field benefited from $50 million in cash infusions from TGS, through "extraordinary consideration" paid for stale inventory and deposits held to pay TPT for future work (which, until June of 2013, Green Field would have had to pay out of its own cash flow). [APP-0105-09] (Opinion, 104-108) ("With the [Board Consent], GE advanced funds to TGS, knowing that TGS would use the funds to 'purchase' inventory from Green Field at a substantial mark-up—**so substantial that it allowed Green Field to make its $17 million semi-annual interest payment to bondholders**. In addition to the inventory sales, Green Field was reimbursed over $1 million for its executives' time trying to develop the business within Green Field, and TPT began producing PowerGen units to sell to TGS at a 25% profit margin, half of which would supplement Green Field's cash flow.") (emphasis added); *see also* [APP-0080] (Opinion, 79); [APP-0524-47] (JX 42); [APP-0602-25] (DX 51); [APP-0628-43] (DX 311); [APP-1959] (Trial Tr. 1732:7-1733:20) ("Before the execution of the Tri-Party Agreement, Green Field was responsible for paying all of TPT's overhead and expenses. In other words, TPT was a cost center to Green Field. **Following the execution of the Tri-Party Agreement, TGS would be paying all of TPT's expenses, plus a 25% profit margin on all units produced.** This converted TPT from a cost center into a profit center for Green Field.") (emphasis added).

27. The Bankruptcy Court also recognized that "consistent with the other entities set up by Moreno to support Green Field's operations, Moreno established TGS for legitimate business reasons aimed to support Green Field, not to harm Green Field or create an unfair opportunity for Moreno." [APP-0023] (Opinion, 22).

28. Additionally, the Bankruptcy Court went into extensive detail concerning Moreno's negotiations with GE surrounding the PowerGen business. Notably, the Bankruptcy Court recognized that "Moreno was looking to generate capital for Green Field and had discussions with several capital sources, ultimately beginning with GE. [APP-0958-81] Trial Tr. 121:20-213:12." [APP-0033] (Opinion, 32). After months of negotiations, GE ultimately advanced $25 million to TGS under a senior secured note, which obligation Moreno personally guaranteed. [APP-0036, 39-51] (Opinion, 35, 38-50). The Bankruptcy Court made specific findings about how these funds were used, and how the 300% purchase price mark-up was "extraordinary consideration" for Green Field, providing immediate liquidity necessary for Green Field to satisfy its immediate obligations in May of 2013. [APP-0050-51, 83-84] (Opinion, 49-50, 82-83). The Bankruptcy Court also found that over $1 million of the GE loan proceeds were used to reimburse Green Field once it became clear that the PowerGen business line would not be held within Green Field. [APP-0051] (Opinion, 50).

29. In addition to the use of the $25 million GE loan proceeds, the Bankruptcy Court found that Moreno personally, DOH Holdings, and the DOH GRATs, borrowed funds from Powermeister and Goldman Sachs,[5] without causing Green Field to become obligated for any of this debt.

> ... Moreno and Green Field's management had been trying for months to raise the capital needed to start up the

> business with Green Field to no avail. Moreno's efforts included meetings with dozens of potential investors, existing bondholders and strategic investors like GE. After months of searching, the best Moreno could do was sign personal guarantees to borrow from GE (through TGS), Goldman Sachs (through the DOH GRATs) and Powermeister (through DOH Holdings). None of those lenders were willing to lend to or invest in Green Field directly. **Only by taking those actions was Moreno able to insert approximately $50 million for the benefit of Green Field.**

[APP-0105] (Opinion, 104) (emphasis added). As quoted above, in supporting the conclusion that Green Field was harmed by the breaches of the SPAs, the Bankruptcy Court found that none of the Goldman Sachs loan proceeds were transferred to Green Field. However, the Bankruptcy Court found that nearly $50 million in loan proceeds from *other* lenders and investors *did* make it to Green Field. Not only does the above-quoted finding conflict with basic principles of math, it is not consistent with the extensive evidentiary record cited by the Court elsewhere in the Opinion.

***69** 30. On the one hand, the Bankruptcy Court found that Moreno's efforts to arrange for Green Field to receive $50 million in new sources of liquidity (without any corresponding debt obligations) was sufficient to exculpate Moreno from liability under fraudulent transfer, corporate waste and breach of fiduciary duty theories. [APP-0083-84] (Opinion, 82-83) ("The [inventory] sales provided much-needed liquidity for Green Field that allowed Green Field to make payments on its senior secured notes and maintain a level of liquidity through the end of the month. **Accordingly, the profit of $14,363,262.46 to Green Field on the sale of the turbines to TGS must be taken into account as mitigation of damages.**") (emphasis added). While that may not have excused MGH Holdings' obligation to perform under the SPA, this Court must reject the Bankruptcy Court's damage calculation to remain consistent with the Bankruptcy Court's findings in other portions of the Opinion. Because the Bankruptcy Court's PPFCL accepted this evidence as mitigation of damages under breach of fiduciary duty, corporate waste, and fraudulent transfer claims, this Court must also accept the same evidence as mitigation of potential damages for the SPA-related claims. Accordingly, this Court must reject the Bankruptcy Court's PPFCL as it relates to damages under Counts 11, 12 and 14.

31. Moreover, even if this Court concludes that this evidence was considered, the Bankruptcy Court's findings of a $6 million payment default to Shell does not support a finding of nearly $15.9 million in contractual damages. As discussed in the preceding Section, Moreno testified that Green Field elected not to pay Shell because Shell had notified Green Field of its intentions to terminate its customer relationship, not because the company lacked the cash necessary to make the $2 million payments. Other than Moreno's anecdotal statement that Green Field could have used "every dollar" it could find, the Trustee presented no evidence of Green Field's cash balance in June. And the Trustee made no attempt to controvert Moreno's explanation that Shell's "bombshell" was the reason why Green Field elected not to make the $2 million interest payments in June, July and August of 2013:

> Q. And in June of 2013 Green Field did not make that payment, right?
>
> A. That's correct.
>
> Q. And if you had paid the May cash call under the 2012 SPA, which was $4-1/2 million, Green Field would have had the money to pay Shell, correct?
>
> A. Even if we had the money to pay Shell, we wouldn't have made it. At the time I was having conversations with Shell, the repayment was subject to them giving us a certain amount of revenue and work, and that would -- but I was declining and I was having conversations with Shell about altering that payment schedule. I wouldn't have made that payment regardless if the cash was there or not.
>
> Q. Okay. But your Shell agreement didn't say that the payment was subject to them giving you a certain amount of work. It just said that you had the obligation to repay?
>
> A. Well, I'm just telling you from a practical standpoint, Shell at that point was starting to cancel our contract. And I made it clear to Shell that if they canceled our contract and didn't continue giving us the revenue that they promised, there was no way we could continue to make those payments.
>
> Q. Okay. And so you didn't make the payment in June. And you will agree with me that the company did not make the payment in July or August either, right?
>
> A. No. And that's the time that Shell ended up canceling our contract, not because of that, obviously. It had nothing to do with the payments. They ended up shutting their operations down.
>
> ...

> Q. Shell did cancel the contract in June?
>
> A. Shell brought us in -- Russ Ford president of Shell, brought me in in June and Mr. Rick Fontova, and says, Guys, I have bad news for you. In a week you are going to see a press release from Shell writing down $6 billion in North America and abandoning our Eagle Ford development that we have invested $3 billion. The bad news for you guys is we might be able to continue our 2013 budget through the rest of the year, but in no way can we honor our agreement for the $600 million in services over the five-year period. You guys have to find something else to do.
>
> ***70** That was disclosed to us in conversations in June. And we were trying to figure out a way to get around that bombshell that was laid on us in June of 2013.

[APP-1128-29] (Trial Tr. 424:21 – 426:9, 430:11 – 431:20).

32. Accordingly, the Bankruptcy Court's reliance on a $6 million payment default to find $15.9 million in damages must be rejected. The record does not support a finding that Green Field's lack of liquidity caused the $6 million payment default to Shell, or any of the subsequent events triggered by that payment default. The Bankruptcy Court found and concluded that Moreno caused $50 million to flow into Green Field from TGS, including a $14 million profit from the sale of stale inventory. Thus, although MGH Holdings did not purchase stock as contemplated by the SPAs, the record evidence shows that Green Field likely had liquidity but nonetheless, declined to make the interest payments to Shell because Shell would not fulfill its revenue commitment to Green Field.

(iv) Green Field Never Transitioned Its Business to PowerGen.

33. A final glaring, but less material, issue in the Opinion is a proposed finding that implies that Green Field was ceasing its core well servicing business and pivoting toward the power generation market. [APP-0026] (Opinion, 25). This was an argument presented by the Trustee, but never actually proven. The two citations to the record in support of this finding (PX 132 [APP-0644-45] and Trial Tr. 381:3-382:20 [APP-1117]) are incorrect citations. They correctly support the second half of the sentence, regarding when payments under the 2012 SPA were due, but they do not support the first part of the sentence, which states: "Green Field's [sic] was transitioning into the power generation market and negotiating with GE" on February 13, 2013.

34. The uncontroverted evidence presented at trial demonstrated that Green Field never pivoted its business away from "legacy" oil and gas services, pressure pumping, and hydraulic fracturing. Green Field's former President, Rick Fontova, testified that he was in charge of operations during the period in question and never diverted Green Field's resources away from Green Field's core well services. [APP-1296, 1760-62] (Trial Tr. 742-43, 1304-08, 1312-13). Indeed, handwritten notes from one of Green Field's bondholders in April of 2013 reveal that, in addition to providing updates on GE negotiations, Moreno was also communicating with bondholders about Green Field's core well services business. [APP-0600-01] (DX 45). Moreover, the Bankruptcy Court concluded that the Trustee failed to prove that Green Field ever obtained a cognizable property interest in the PowerGen business opportunity. [APP-0090-94] (Opinion, 89-93). "Based on the extensive record described above, the Court is unable to conclude that [Green Field] had an interest or expectancy in the potential PowerGen business opportunity." [APP-0092] (Opinion, 91). Thus, the proposed finding about Green Field's business transition is not only unsupported by the trial record, it is directly contradicted by credible and uncontroverted trial evidence and the Bankruptcy Court's conclusions of law. For these reasons, it must be rejected.

(v) Conclusions that Moreno Defrauded or Intended to Harm Goldman Sachs or Green Field Are Based on Erroneous Findings and Conclusions of Earmarking and Are Contradicted by the Record.

***71** 35. The Bankruptcy Court's ruling on the tortious interference claim (Count 14) is premised entirely on two flawed findings: (i) the loans obtained by Moreno or non-Green Field entities were intended or "earmarked" for Green Field's benefit; and (ii) Moreno obtained third-party loans for himself, DOH Holdings, and the DOH GRATs, but failed to invest all the proceeds into Green Field or account for the funds not transferred to Green Field.

36. While Bankruptcy Court's PPFCL indicate that Moreno misled or defrauded Goldman, it is notable that Goldman Sachs was not a party to this lawsuit and, as Moreno testified at trial, all disputes with Goldman Sachs were resolved before trial. [APP-1098] (Trial Tr. CONFIDENTIAL Mar. 20, 2018

at 3:12–4:10). Furthermore, the Trustee failed to produce any evidence establishing that Moreno had an obligation to use all funds borrowed from third-party sources to provide direct support for Green Field or to fund MGH Holdings' SPA obligations.[6] The Trustee, who bears the burden of proof on all claims, attempted to shift his burden to Moreno to provide evidence of the use of all Goldman Sachs loan proceeds.[7] The Trustee's reliance on evidence related to the Goldman Sachs loans and receipt was not only irrelevant and highly prejudicial,[8] but further review of the Bankruptcy Court's PPFCL as they relate to the Goldman Sachs loan transactions reveal the flaws in this portion of the Opinion, warranting rejection by this Court.

37. The first critical issue is the Bankruptcy Court's proposed finding below:

> Moreno personally borrowed funds from Goldman Sachs in May and July of 2013, totaling $40 million. [APP 1121] Trial Tr. 396:19-397:9. The first tranche for $25 million was dated May 15, 2013, i.e. two days after the Waiver Date. [APP 0685-757] PX 156. The specified purpose of the personal loan was to make an "equity investment in Green Field which shall be used as working capital to fulfill equipment orders and to make and [sp] equity investment in Turbine Generation Services, L.L.C." [APP-0685-757] PX 156 at GS0002950 [APP-0691]. The second tranche for $15 million was dated July 5, 2013. Trial Tr. 417:5-20 [APP-1126]; PX 166 [APP-0795-873]. Moreno put none of this money into Green Field.

***72** [APP-0029] (Opinion, 28). A few points are relevant in the above-quoted finding. First, the use of terms like "Waiver Date" indicate that this portion of the Opinion closely tracks the Trustee's proposed findings of fact. For the reasons discussed above in Section II.B(iv) above, findings and conclusions with terms like "waiver" must be rejected given the Bankruptcy Court's conclusion that Green Field did not hold a property interest in the PowerGen business or opportunity. [APP-0090-94] (Opinion, pgs. 89-93) ("Based on the extensive record described above, the Bankruptcy Court is unable to conclude that [Green Field] had an interest or expectancy in the potential PowerGen business opportunity.").

38. Second, while it is true that the specified purpose of the first loan (dated May 15, 2013) allowed Moreno to make an equity investment into either Green Field or TGS, [APP-0691] (PX 156, at GS0002950), the actual Notice of Borrowing was more limited. The Notice of Borrowing executed on or about May 15, 2013, reveal that Goldman Sachs only advanced $10 million to Moreno, and the advance was made for the limited purpose of investing in TGS. [APP-0908-10] (Notice of Borrowing, May 15, 2013).

39. It is necessary to clarify that the "second tranche for $15 million" referenced above is actually an entirely different loan agreement with a different borrower. Whereas, Moreno and his wife were the borrowers under the May loan, the DOH GRATs were the borrowers under the July loan agreement.[9] The July loan agreement was also a self-contained set of loan documents with a different stated purpose than the May loan: "The Borrowers shall use the proceeds of the Loan to make an **equity investment in Turbine Generation Services, L.L.C.**" (*compare* [APP-0819] PX 166, GS0003763 (emphasis added); *with* [APP-0691] PX 156, at GS0002950). This evidentiary distinction (which the Trustee glosses over in submitting his proposed findings and conclusions) is critical, because it undermines the contested finding that follows:

> On June 28, 2013, Green Field and MOR MGH executed a new share purchase agreement (the "2013 SPA," together with the 2012 SPA, the "SPAs"). Stip. Facts ¶ 75; PX 162. **The 2013 SPA was a condition of Goldman Sachs loaning the second tranche of $15 million to Moreno personally and it required Moreno to purchase additional preferred stock in Green Field and then pledge that stock to Goldman Sachs as security for the personal loan. Trial Tr. 397:20-398:3; PX 160.** Goldman Sachs required that Moreno provide a written certification once the stock had been purchased. [APP-1122] Trial Tr. 400:12-402:19; [APP-0788-94] PX 165.

[APP-0029] (Opinion, pg. 28) (emphasis added). On the next page, the Bankruptcy Court found or concluded that "Moreno knowingly and intentionally lied to Goldman Sachs and intentionally diverted $10M **earmarked** for Green Field to his own personal use." [APP-0030] (Opinion, pg. 29) (emphasis added).[10]

***73** 40. The proposed finding that Moreno "knowingly lied to Goldman Sachs" and "diverted $10M earmarked for Green Field" is flawed from an evidentiary standpoint for two key reasons. First, there is no evidence that Goldman Sachs was actually misled by this certificate. There is no direct evidence that the SPA or the written certification was actually made a closing condition for this July loan. There is also no direct or indirect evidence in the record that Goldman Sachs actually relied upon the 2013 SPA or written certification in advancing

the funds on July 5, 2013. The Notice of Borrowing from that date—through which Goldman Sachs advanced $15 million to the DOH GRATS—makes no reference to the 2013 SPA or written certification. [APP-0911-15] (Notice of Borrowing, July 5, 2013). Further Moreno testified that the funds were intended to flow from the DOH GRATS to the MGH GRATs, but that transaction never occurred. [APP-1121, 1318] (Trial Tr. 399:4-13; 830:3-832:8). While the Court questioned Moreno's credibility on this point, the Trustee offered no evidence to controvert Moreno's explanation of the events. Thus, the finding that Moreno "knowingly and intentionally" lied to Goldman Sachs is without evidentiary support and must be rejected.

41. Second, the evidence cited in support of the highlighted finding above does **not** actually support a finding of "earmarking." Nothing in the record supports a finding that the loan proceeds from Goldman Sachs were earmarked or specifically intended for Green Field, nor is there any credible evidence that Goldman Sachs actually conditioned the July loan on Moreno's promises to use the proceeds for stock purchases under the SPAs.

42. The "earmarking doctrine" is a court-made doctrine typically used in the avoidance action context to determine whether a payment from a third-party creditor was "property of the debtor" such that the trustee can prove an element of 11 U.S.C. § 547(b). *See Shubert v. Lucent Techs. Inc (In re Winstar Communs., Inc.),* 554 F.3d 382, 400 (3d Cir. 2009) (quoting *McCuskey v. Nat'l Bank of Waterloo (In re Bohlen Enters., LTD.),* 859 F.2d 561, 565 (8th Cir. 1988)). The Trustee's incantation of the term in this context is intended to prove that Green Field *did* obtain an interest in loans made to Moreno or the DOH GRATs. The Bankruptcy Court's use of the term throughout portions of the Opinion implies that the Bankruptcy Court accepted the Trustee's argument that Green Field obtained an interest in the Goldman Sachs loan proceeds. The question, however, is whether the Trustee actually carried its burden of proof on this issue.

43. In *Winstar*, a secured creditor (Lucent) sought to apply the "earmarking" doctrine as a defense to show that the funds in question were *not* property of the debtor, because they had been earmarked to be paid directly to Lucent. The Third Circuit held that Lucent did not carry its burden of proof, and that the trustee succeeded in proving that the funds had been property of the debtor before they were paid to Lucent. *See id.* at 402.

44. The Third Circuit explained that "earmarking" requires proof of: (1) the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt, (2) performance of that agreement according to its terms, and (3) the transaction viewed as a whole does not result in any diminution of the debtor's estate. *Id.* at 400 (citations omitted).[11]

45. In *Winstar*, there was an agreement between the debtor (Winstar) and Siemens (the new lender). However, the bankruptcy court held, and the Third Circuit agreed, that the agreement was not specific enough to conclude that the funds were earmarked for Lucent:

> In sum, Siemens was (at most) aware that the Second Credit Agreement between Lucent and Winstar required Winstar to pay the proceeds of the Siemens loan to Lucent and that Winstar intended to do so. Although Lucent is correct that a failure to do so would have ultimately led to an event of default under the Bank Facility, that merely implies that the Bank Facility lenders (including Siemens) could have brought breach of contract claims against Winstar-not that Siemens conditioned its loan on Winstar's payment to Lucent. Thus, **the Bankruptcy Court properly held that earmarking was inapplicable**.

***74** *Id.* at 402 (emphasis added).

46. The record in this case is analogous to the facts in *Winstar*. Nowhere in the written documents, including the loan agreements between Goldman Sachs and the DOH GRATs (PX 166) [APP-0795-873], or the Notice of Borrowing, dated July 5, 2013 [APP-0911-15], does Goldman Sachs specifically require the loan proceeds to be used for stock purchases under the SPA, nor is there any evidence from Goldman Sachs that it conditioned its July 5, 2013 advances upon use of the proceeds to fund MGH Holdings' obligations under the 2013 SPA. As in *Winstar*, MGH Holdings' failure to purchase stock as contemplated in the 2013 SPA gives rise to a claim for breach of contract between Green Field and MGH Holdings, but it does not support the finding or conclusion that the Goldman Sachs loan proceeds had been earmarked for Green Field.

47. The evidence presented in support of the "earmarking" argument is quite limited, and nothing in the record reaches the level of demonstrating Goldman Sachs's intent beyond the specific terms of the loan documents. The Trustee and the Bankruptcy Court relied on an e-mail submitted as PX 160 [APP-0775-77], but that is merely an e-mail

exchange between Moreno's personal lawyer and Green Field's corporate lawyer discussing what was contemplated to do with the second tranche of funding from Goldman Sachs. In *Winstar*, the Third Circuit held that the debtor's intentions were insufficient to show a specific agreement between the debtor and the new lender. Nowhere in that exchange does Mr. Slavich indicate that the $10 million stock purchase was actually a closing condition imposed by Goldman Sachs. Indeed, Mr. Slavich says in the e-mail that "[w]e don't have any documents from Goldman yet but the closing date is Friday." [APP-0775-77] (PX 160). Further, as discussed above, the Notice of Borrowing dated July 5, 2013, reflects an advance of $15 million to the DOH GRATs for the specific purpose of making an equity investment in TGS. [APP-0911-15] (Notice of Borrowing, July 5, 2013). Nothing in that Notice of Borrowing required a stock purchase from Green Field, referenced the SPAs or earmarked the funds for Green Field, MGH Holdings, or the MGH GRATs.

48. The Trustee and Bankruptcy Court also rely on the following testimony in support of the "earmarking" finding or conclusion:

> Q. Okay. And the reason that that agreement [the 2013 SPA] was entered into and that purchase was committed to was because that was a requirement by Goldman for you to purchase additional preferred stock in Green Field, and then pledge that stock to Goldman as security for its loan to you. Correct?
>
> A. Yes.

[APP-1121] (Trial Tr. 397:20-398:3). In the context of this line of questioning, the Trustee's counsel was asking Mr. Moreno about both loans from Goldman Sachs, generally. Counsel's question did not ask if the SPA was a "closing condition," nor was this question limited to the $15 million July loan to the DOH GRATs. Thus, this testimony does not carry the Trustee's burden under the *Winstar* analysis.

***75** 49. The best evidence on this issue is the loan documents themselves—the terms of the July 2013 loan do not support a finding of "earmarking." The first loan agreement, dated May 15, 2013, was entered into for the stated purpose that Moreno use the proceeds *either* to make an equity investment in Green Field or TGS *or* otherwise use the proceeds as working capital on orders for TGS. [APP-0691] (PX 156, at GS0002950). The Notice of Borrowing on May 15, 2013, demonstrates that Goldman Sachs only advanced $10 million of those funds, and only for the purpose of making an equity investment in TGS. [APP-0908-10] (Notice of Borrowing, May 15, 2013). The Trustee presented no evidence that Moreno failed to use those proceeds appropriately.[12]

50. The documents for the second loan agreement, in July 2013, contain no specific reference to an "earmark" or a specific obligation to invest in Green Field, MGH Holdings or the MGH GRATs. Rather, the stated purpose for the July loans was to make an equity investment in TGS (i.e., not Green Field). [APP-0795-873] (PX 166). The Notice of Borrowing dated July 5, 2013, confirms that Goldman Sachs advanced $15 million to the DOH GRATs for this specific purpose. [APP-0911-15] (Notice of Borrowing, July 5, 2013). The proposed finding that the 2013 SPA was a closing condition for Goldman Sach's July loan was an argument advanced by the Trustee at trial, but was not supported by credible evidence and, in fact, is contradicted by the weight of the evidence presented.

51. The Goldman Sachs loan documents allowed, but did not require, Moreno to use the first $25 million loaned in May 2013 to purchase equity in Green Field. [APP-0685-757] (PX 156). Ultimately, Goldman Sachs only advanced $10 million to Moreno on May 15, 2013, for the limited purpose of making an equity investment in TGS. [APP-0908-10] (Notice of Borrowing, May 15, 2013). On or about that same date, GE advanced $25 million to TGS under a senior secured promissory note (which Moreno personally guaranteed). [APP-0548-95] (JX 49). Months later, on July 5, 2013, Goldman Sachs advanced another $15 million to the DOH GRATs for the stated purpose of investing in TGS. [APP-0795-0873] (PX 166); [APP-0911-15] (Notice of Borrowing, July 5, 2013). The Bankruptcy Court found that Moreno caused nearly $50 million of cash to flow into Green Field, through TGS, between May and September of 2013. [APP-0105] (Opinion, pg. 104). This finding directly contradicts the above-quoted finding that none of the Goldman Sachs loan proceeds went to Green Field.[13] The Trustee made no effort to trace the Goldman Sachs loan proceeds. Rather, the Trustee took a different approach by arguing that it was Moreno's burden to show that all of the loan proceeds were transferred to Green Field. This Court must reject the PPFCL to the extent it incorrectly shifted the burden on Moreno to account for the use of third-party loan proceeds that were never specifically earmarked for Green Field.

***76** 52. There is virtually no difference between this evidence and the record described by the Third Circuit in *Winstar*. *See In re Winstar Communs.,* 554 F.3d at 400-02.

The only agreement between Goldman Sachs and the DOH GRATs is the loan agreement. Because the July loans to the DOH GRATs contained no specific terms requiring the proceeds to be invested in Green Field or used toward MGH Holdings' obligations under the 2013 SPA, this Court must conclude that the Trustee has not carried its burden of demonstrating that Green Field obtained an interest in the July 2013 Goldman Sachs loan proceeds. There is simply no basis to find or conclude that those proceeds were earmarked for Green Field, notwithstanding the vigor and sheer number of times the Trustee repeats the phrase through its briefing. *See In re Winstar Communs.,* 554 F.3d at 401.

53. Because the inaccurate findings above are relied upon later in the Opinion to support the Bankruptcy Court's conclusions on the tortious interference claim, this Court must reject the Bankruptcy Court's recommended ruling in the Trustee's favor, to the extent it is premised on rejected findings.

54. By way of example, at the end of the Opinion, after finding **no** liability for breach of fiduciary duty, corporate waste, fraudulent transfer, and preferential transfer, the Bankruptcy Court concludes the following:

> Moreno falsely testified that "Green Field received every dollar that TGS ended up getting." [APP-1128] Trial Tr. 424:9-10. However, no monies went into Green Field other than in fair market value transactions (i.e., turbine sales) ([APP-1437-38] Trial Tr. 1085:20-1086:23, [APP-1439] 1091:7-1092:3, [APP-1981] 1820:11- 19, [APP-1982] 1824:20-1825:1) or as deposits required to be held in trust. [APP-1134] Trial Tr. 466:2-6, [APP-1320] 837:12-840:24; [APP-1101] Trial Tr. Conf. 3/20 at 16:4-8. Moreno acknowledged that these payments were distinct and unrelated to the SPAs. [APP-1134-35] Trial Tr. 468:9-469:12, [APP-1322] 846:11-22. Moreover, even under Moreno's accounting, there was at least $35 million on hand that he borrowed either personally or through TGS, which either went to Moreno personally or was unaccounted for. [APP-1321-22] Trial Tr. 844:20-846:10; [APP-0435-36] JX 3; [APP-0626-27] DX 221.

[APP-0119] (Opinion, 118).

55. First, Moreno's testimony was not false. The conclusion that "no moneys went into Green Field other than in fair market value transactions ... or as deposits required to be held in trust," is directly contradicted by the Bankruptcy Court's findings and conclusions concerning "extraordinary consideration" for the turbines and the value of converting TPT from a cost center into a profit center. [APP-0048-51, 80-81] (Opinion, 47-50, 79-80). Second, as noted above, requiring Moreno to account for his personal loans unfairly shifts the burden on Moreno where the Trustee has failed to carry its initial burden of demonstrating that these loan proceeds were intended for Green Field. The Bankruptcy Court found and concluded that: (a) Green Field did not hold a property interest in the PowerGen opportunity, [APP-0090-94] (Opinion, 89-93); (b) Moreno set up TGS and continued negotiations with GE in an effort to provide liquidity for Green Field, [APP-0022-23, 99-110] (Opinion, 21-22, 98-109); and (c) through these efforts, Moreno caused $50 million of liquidity to flow into Green Field [APP-0105] (Opinion, 104). Given the extensive record and findings relating to Moreno's efforts to find new sources of capital and liquidity for Green Field, and given the Bankruptcy Court's conclusion that the $50 million in liquidity during this time period mitigated harm to Green Field, additional scrutiny of the above-quoted findings and conclusions is necessary to clarify the relevance of the "unaccounted for" personal loan proceeds. The above findings are contrary to the weight of the uncontroverted evidence at trial.

***77** 56. Moreover, the Bankruptcy Court continues as follows:

> The most egregious evidence of Moreno's malicious intent was his diversion of $10 million from the second tranche of the Goldman Sachs loan. Moreno secured the loan by promising Goldman Sachs that he would cause MOR MGH to use $10 million of the funds to purchase additional preferred stock in Green Field which he would then pledge to Goldman Sachs. [APP-1121] Trial Tr. 397:20-398:3; [APP-0775-77] PX 160. Goldman Sachs required Moreno to certify in writing that the purchase did in fact occur. [APP-1122] Trial Tr. 400:12-402:19; [APPCase 0788-94] PX 165. Moreno, in turn, provided Goldman Sachs with the written certification, which he signed on behalf of both MOR MGH and Green Field. [APP-1122-23] Trial Tr. 403:11-404:20; [APP-0788-94] PX 165. The certificate, as previously stated, was untrue. Instead, Moreno took that same $10 million and used it to purchase his Dallas home. [APP-1124-27] Trial Tr. 411:18-420:12; [APP-0874-76] PX 168. Moreno testified that he was allowed under the loan agreement to use the funds for personal real estate purposes. [APP-1126] Trial Tr. 416:4-417:2. But his testimony is flatly contradicted by the terms of the loan agreement itself. [APP-0819] PX 166 at GS0003763; [APP-1126] Trial Tr. 417:5-418:21. Moreno's lies at trial only underscore his malicious intent and desire to avoid

> liability. There can be no question that spending available funds on one's personal residence in direct violation of the terms of the loan agreement, rather than fulfilling obligations to the company, constitutes placing one's personal interests ahead of the company's.

[APP-0119-20] (Opinion, pgs. 118-19).

57. Not only is the above conclusion unsupported by the evidentiary record, but in reaching this conclusion, the Bankruptcy Court conflates Goldman Sachs with Green Field and, by extension, the alleged harm caused to Goldman Sachs with the absence of actual harm to Green Field. On the one hand, Goldman Sachs actually advanced money to Moreno in reliance upon Moreno's assurances that it would use the funds as contemplated in the loan documents. Had Moreno actually misused any of these loan proceeds, it would be Goldman Sach's claim to pursue, not Green Field's or the Trustee's.

58. On the other hand, unlike Goldman Sachs, Green Field gave up nothing in order to allow Moreno to borrow funds from Goldman Sachs. It is questionable whether Green Field could even argue third-party beneficiary status of the Goldman Sachs loans given that the May loans allowed equity investments in either Green Field *or* TGS, and the July loans only contemplated equity investments in TGS. Thus, the Bankruptcy Court's reliance on any misrepresentations to Goldman Sachs as evidence of Moreno's malicious intent to harm Green Field is not only unsupported by the record, but also an unsustainable exercise in logic.

59. Finally, such conclusions regarding Moreno's malicious intent toward Goldman Sachs and Green Field simply cannot be reconciled with the Bankruptcy Court's extensive findings and conclusions as they relate to how Moreno conducted his business normally. The Bankruptcy Court made extensive findings regarding Moreno's negotiations with GE, concluding that Moreno at all times had Green Field's best interests in mind. The Bankruptcy Court further found and concluded that Moreno kept his bondholders apprised of business and GE-related developments, in virtual real time, and that such updates were truthful and transparent. Moreover, the Bankruptcy Court found that Moreno kept his board members apprised of these same developments in a forthcoming and transparent manner. Yet, in stark contrast to these extensive findings of Mr. Moreno's honesty and transparency, the Bankruptcy Court accepted the Trustee's position that Moreno "lied" in his dealings with Goldman Sachs and, therefore, had some malicious intentions of depriving Green Field of financing through MOR MGH and MMR. This Court must reject those findings or conclusions—there is no logical explanation for Moreno to spend years of his life creating and saving a business, providing transparency with bondholders and board members, personally guaranteeing or pledging $50 million in new capital to save the company, but then withholding only $6 million at the last minute for personal reasons. Nothing in the record or the Bankruptcy Court's Opinion explains why Moreno would go out of his way to be so transparent with bondholders and board members, but not Goldman Sachs or Powermeister (which was related to an existing bondholder). As such, this Court should scrutinize these findings and ensure that they are consistent with the evidentiary record, as a whole.

C. Objections to Proposed Conclusions of Law Regarding the Constructive Trust.

***78** 60. As noted above, the Motion to Reconsider asks the Bankruptcy Court to reconsider its findings and conclusions to correct manifest errors of fact or law. Much of the Motion is devoted to the Bankruptcy Court's decision to propose the imposition of a constructive trust. Defendants incorporate by reference the arguments presented in that Motion, particularly as they relate to the Bankruptcy Court's proposed findings and conclusions in support of the imposition of a constructive trust. As detailed in that Motion to Reconsider, the Bankruptcy Court misapplied the choice of law rules and applied the wrong standard of evidence,[14] summarily concluded that all elements had been met without citing the specific facts or concluding that the Trustee had proven its case by "clear and convincing evidence,"[15] failed to acknowledge that the Trustee already had an adequate remedy at law[16] and did not require the Trustee to trace the proceeds to any specific res.[17] The Bankruptcy Court also assumed (without evidence) that Goldman Sachs had been deceived by Moreno's conduct and, relying upon that unfounded assumption, found that Moreno also deceived Green Field.[18] Finally, without the benefit of briefing on the issue, the Bankruptcy Court did not consider Texas homestead exemption laws, which Texas courts construe liberally in favor of debtors such as Moreno.[19] For these reasons, and as explained further below, this Court should decline to impose a constructive trust on Moreno's residence in Dallas, Texas.

(i) The Proper Standard for Constructive Trusts is "Clear and Convincing."

61. Earlier in this proceeding, in ruling upon a motion to dismiss, the Bankruptcy Court applied Delaware law to claims for unjust enrichment and breach of fiduciary duty. (*See* [APP-2127, 2130-32] Memorandum Opinion, D.I. 63, pgs. 22 & 25-27) (citing *Nemec v. Shrader,* 991 A.2d 1120, 1130 (Del. 2010); *Grunstein v. Silva,* No. 3932-VCN, 2009 WL 4698541, at *6 (Del. Ch. Dec. 8, 2009); *Gale v. Bershard,* No. 15714, 1998 WL 118022, at *5 (Del. Ch. Mar. 4, 1998); *Schuss v. Penfield Partners, L.P.,* No. 3132-VCP, 2008 WL 2433842, at *10 (Del. Ch. June 13, 2008)). This decision is relevant here, because the Third Circuit has held that, in cases such as these where the application of New York state law would "warp the definition Congress intended to provide to the exclusion from the bankruptcy estate for equitable interests," courts should apply the federal common law of constructive trusts. *See In re Columbia Gas Sys.,* 997 F.2d 1039, 1056 (3d Cir. 1993). In the present case, the Bankruptcy Court applied New York's constructive trust doctrine so broadly that the Trustee was allowed to attach assets (i.e., Moreno's personal residence) which could not have been recovered under any theory or provision of the Bankruptcy Code. Under *Columbia Gas* and its progeny, the Bankruptcy Court's application of New York's constructive trust doctrine is erroneous, warranting rejection of this portion of the Opinion to ensure proper application of the law.[20]

***79** 62. A key distinction under Delaware law is the burden imposed on the plaintiff seeking the imposition of a constructive trust. Courts in Delaware have applied a "clear and convincing" standard to such a drastic equitable remedy. *Shuttleworth v. Abramo,* Del. Ch., 1992 WL 25756, 1992 Del. Ch. LEXIS 40, C.A. No. 11650, Allen, C. (Feb. 6, 1992) ("To make out a case for a constructive trust, or like form of specific performance, a mere preponderance of the evidence will not suffice. **The court will not exercise its equitable powers in this regard unless the plaintiff has made out her case by clear and convincing evidence**.") (emphasis added); *see also In re Interlake Mat. Handling, Inc.,* 441 B.R. at 441 ("Furthermore, the grounds for imposing a constructive trust **must be so clear, convincing, strong and unequivocal as to lead to but one conclusion**.") (quoting *Suttles v. Vogel*, 126 Ill.2d 186, 127 Ill.Dec. 819, 533 N.E.2d 901, 905 (Ill. 1988), emphasis added). As discussed below, the Opinion did not apply the "clear and convincing" burden on the Trustee.[21]

(ii) The Trustee Failed to Plead or Prove a "Recognized Cause of Action."

63. A constructive trust could not be imposed on Moreno's personal residence because the Trustee failed to plead a constructive trust remedy, or any "recognized cause of action" at trial. A court cannot award a remedy not sought or argued during trial.

64. Under Delaware law and federal common law applied by Delaware bankruptcy courts, a constructive trust remedy is only available for "recognized causes of action" such as fraud, breach of fiduciary duty or unjust enrichment. *Teachers Ret. Sys. v. Aidinoff,* 900 A.2d 654, 670-71 (Del. Ch. 2006) ("[T]his court cannot impose the remedy of a constructive trust against a party unless that party is properly subject to an order of relief **under a recognized cause of action**.") (emphasis added, citing *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 991 (Del. Ch. 2000)); *see also Tiare Int'l, Inc. v. United Fixtures Co. (In re Interlake Mat. Handling, Inc.),* 441 B.R. 437, 441 (Bankr. D. Del. 2011) ("Mere nonpayment of a money debt is not 'wrongdoing' sufficient to justify imposition of a constructive trust.") (citations omitted, applying Illinois law). A review of Delaware case law on constructive trust remedies reveals no published opinions imposing a trust on a contract or tortious interference claim such as the one pursued by the Trustee in the present case. The Trustee had an opportunity to plead and prove "recognized causes of action" but chose not to do so. This Court should decline to impose a constructive trust on this ground alone. Because the Trustee elected to limit its relief to a money judgment for breach of contract and tortious interference, the Trustee should not be allowed to seek equitable remedies after trial.

(iii) The Trustee Had an Adequate Remedy at Law.

65. Even if the Court determines that New York applies to the constructive trust remedy, the Bankruptcy Court's application of the law was erroneous because the Trustee already had an adequate remedy at law, barring the imposition of a constructive trust. "With respect to constructive trusts specifically, New York courts have clarified that '[a]s an equitable remedy, a constructive trust should not be imposed unless it is demonstrated that a legal remedy is inadequate.' " *Superintendent of Ins. v. Ochs (In re First Cent. Fin. Corp.*), 377 F.3d 209, 215 (2d Cir. 2004) (quoting *Bertoni v. Catucci*,

117 A.D.2d 892, 498 N.Y.S.2d 902, 905 (App. Div., 3d Dep't 1986)); *see also Evans v. Winston & Strawn*, 303 A.D.2d 331, 757 N.Y.S.2d 532, 534 (App. Div., 1st Dep't 2003); *Boyle v. Kelley*, 365 N.E.2d 866, 42 N.Y.2d 88, 91 (N.Y. 1977). Where there is a valid agreement that controls the rights and obligations of the parties, "an adequate remedy at law typically exists." *In re First Cent. Fin. Corp.,* 377 F.3d at 215. In *First Cent. Fin. Corp.,* the Second Circuit rejected the constructive trust theory, recognizing that the plaintiff could obtain a money judgment for the harm and, thus, the equitable remedy was unavailable. *Id.* at 215-16. "We concede that [the plaintiff], like many other creditors, will not, in all probability, be made whole in the proceedings; but that does not mean its remedy is legally inadequate, simply that it is imperfect." *Id.* at 216.

***80** 66. In the present case, a contract controlled the rights between Green Field and its stockholders. Specifically, the 2012 and 2013 SPAs governed Green Field's rights and the obligations of MMR and MOR MGH. This contract also gave the Trustee a legal right to pursue claims for tortious interference and breach of fiduciary duty. The Trustee sought money damages for both.[22] Even though there was no direct contract between Moreno and Green Field, the Trustee asserted a legal theory to hold Moreno personally liable for the contractual obligations of MMR and MOR MGH (Count 14 – Tortious Interference). Through its Opinion, the Bankruptcy Court proposes to award the Trustee a money judgment against Moreno on the tortious interference count in the amount of $16,607,081. [APP-0121] (Opinion, 120).[23] Nowhere in the evidentiary record has the Trustee argued or presented any evidence concerning the inadequacy of a money judgment against Moreno, nor has the Trustee established that Green Field held a property interest in any of the loan proceeds from Goldman Sachs.[24] Moreover, the Bankruptcy Court made no specific findings or conclusions regarding the adequacy of a money judgment against Moreno. Thus, a crucial element of the Trustee's burden is lacking.

67. Indeed, under the Second Circuit's application of New York law, such a money judgment constitutes an adequate, albeit "imperfect," remedy at law. *See First Cent. Fin. Corp.,* 377 F.3d at 216; *see also 1659 Ralph Ave. Laundromat Corp. v. Ben David Enters., LLC*, 307 307 A.D.2d 288, 762 N.Y.S.2d 288, 288-89 (App. Div. 2003) (finding an adequate remedy at law where "[t]he plaintiff sought money damages for breach of a lease and tortious interference with its business opportunities"). Here, a money judgment was available to the Trustee for its tortious interference claim. No further remedies are necessary.

(iv) The Trustee Failed to Meet its Burden of Proof for a Constructive Trust.

68. Under New York law, the party seeking imposition of a constructive trust has the burden to establish "(1) a confidential or fiduciary relation, (2) a promise, (3) a transfer in reliance thereon and (4) unjust enrichment." *Sharp v. Kosmalski*, 40 N.Y.2d 119, 121, 386 N.Y.S.2d 72, 351 N.E.2d 721 (N.Y. 1976) (internal citations omitted). As detailed above, Delaware law has no specific elements, but requires the plaintiff to plead and prove *by clear and convincing evidence* a claim for a "recognized cause of action" such as fraud, breach of fiduciary duty or unjust enrichment. See *Teachers Ret. Sys.,* 900 A.2d at 670 n.22 ("Unless a plaintiff can prove out a claim under a recognized cause of action -- such as one for fraud, breach of fiduciary duty, or unjust enrichment -- the plaintiff should have no eligibility for any remedy, including the remedy of constructive trust.").[25]

69. Nonetheless, in interpreting New York law, the Bankruptcy Court for the District of Delaware has stated that the "absence of any one of the [ ] elements is fatal to a party's request for imposition of a constructive trust." *See Asurion Ins. Servs. v. Amp'd Mobile, Inc. (In re Amp'd Mobile, Inc.)*, 377 B.R. 478, 483 (Bankr. D. Del. 2007). Further, even courts permitting a flexible approach find that the "key factor under New York law is unjust enrichment." *Id. In re First Cent. Fin. Corp.*, 269 B.R. at 500; *Simonds*, 45 N.Y.2d at 242, 408 N.Y.S.2d 359, 380 N.E.2d 189 ("It is agreed that the purpose of the constructive trust is prevention of unjust enrichment.") (citing *Sharp*, 40 N.Y.2d at 12; Restatement, Restitution, § 160; 5 Scott, Trusts [3d ed], § 462.2).

70. Here, the Trustee not only failed to plead any of these elements, as discussed above, but it is also impossible for him to establish at least three of the four constructive trust elements, including the critical "unjust enrichment" element.

81** 71. ***First, the Trustee cannot show that Moreno made a promise to Green Field. As discussed in greater detail below, the offensive conduct found by the Bankruptcy Court concerns a promise Moreno allegedly made to non-party Goldman Sachs, as part of the loan agreement. That loan agreement did not actually obligate Moreno to make an equity investment into Green Field,[26] and it is undisputed that Green

Field was not a party to this loan. Indeed, the Bankruptcy Court found that Moreno spent months searching for capital to infuse into Green Field, but could not locate a lender or investor willing to make a loan or investment in Green Field directly. [APP-0105] (Opinion, 104). Therefore, the Trustee cannot establish that Moreno made a promise to Green Field, as was its burden to prove. Because New York courts reject the imposition of a constructive trust without evidence of a promise being made to the plaintiff, *See Scivoletti v. Marsala*, 61 N.Y.2d 806, 808, 473 N.Y.S.2d 949, 462 N.E.2d 126 (N.Y. 1984) ("The record does not contain evidence to support a finding of any promise, express or implied, to convey the premises to plaintiff and, consequently, a constructive trust may not be imposed.") (internal citation omitted), this Court must reject the imposition of a constructive trust.

72. ***Second***, the Trustee cannot establish that Green Field made a transfer in reliance upon any promise. As demonstrated above, Moreno and the DOH GRATs made promises to Goldman Sachs, not to Green Field. The only contractual obligor to Green Field was MGH Holdings. While the Bankruptcy Court was concerned with Moreno's use of the loan proceeds advanced by Goldman Sachs, Green Field gave up nothing in reliance for the promises made under this loan agreement. Even if the Bankruptcy Court were to focus on the 2012 and 2013 SPAs, Green Field still gave up nothing in reliance upon the promises made in those documents. The Trustee failed to argue or present any evidence at trial demonstrating what promises Moreno made to Green Field in connection with the Goldman Sachs loan. Because the Trustee presented no evidence of specific promises made to Green Field or transfers made by Green Field in reliance upon such promises, there is a critical element missing from the Trustee's constructive trust theory. The Trustee cannot establish that Green Field made a transfer in reliance on a promise to Green Field. As such, this Court should reject the Bankruptcy Court's proposed imposition of a constructive trust. *Igneri v. Igneri*, 125 A.D.3d 813, 814 (N.Y. App. Div. 2015) (holding that plaintiff failed to sufficiently plead and could not sufficiently plead constructive trust where the evidence demonstrated no promise and no transfer in reliance on any promise was made to party).

73. ***Third***, and most importantly, the Trustee has not pled and cannot show that Moreno was unjustly enriched. Under New York law, "[a] person may be deemed to be 'unjustly enriched' if he has received a benefit, the retention of which would be unjust." *Counihan v. Allstate Ins. Co.*, 194 F.3d 357, 360 (2d Cir. 1999) (quoting 106 N.Y. Jur.2d Trusts § 162 (1993)). Moreno never received "a benefit, the retention of which would be unjust." Moreno borrowed funds from Goldman Sachs, but borrowing money does not unjustly enrich the borrower where he assumes a corresponding debt obligation. Upon receiving the funds from Goldman Sachs, Moreno simultaneously assumed the liability to repay the funds with a personal guaranty and pledged personal assets to Goldman Sachs to secure the loans. While the Trustee presented Moreno's alleged misuse of the loan proceeds as evidence of fraud, as described more fully in Section II.B(v), *supra*, the loan documents did not obligate Moreno to make an equity investment in Green Field—the May 2013 loans contemplated equity investments in, or working capital for, *either* Green Field *or* TGS, and the July 2013 loans contemplated an equity investment in only TGS. (Compare [APP-0685-757] PX 156 with [APP-0795-873] PX 166). Thus, contrary to the Trustee's arguments and the Bankruptcy Court's proposed findings, there is no documentary evidence to support the Trustee's argument that the Goldman Sachs loan proceeds were "earmarked" for Green Field. *Cf.* [APP-0030] (Opinion, pg. 29).

***82** 74. Even if the Court accepts the Trustee's position that Moreno benefited from Goldman Sachs's loans, this does not mean that such benefit was unjust. As the Bankruptcy Court explained in its Opinion, unjust enrichment requires proof of: (i) an enrichment; (ii) an impoverishment; (iii) a relation between the enrichment and impoverishment; (iv) the absence of justification; and (v) the absence of a remedy provided by law. [APP-0122] (Opinion, 121) (citing *In re Direct Response Media, Inc.,* 466 B.R. 626, 661 (Bankr. D. Del. 2012).

75. The Trustee originally pled unjust enrichment as a cause of action, but withdrew it in the weeks leading up to trial. This is likely the case because the Trustee understood that it could not prove one or more of the critical elements to unjust enrichment. Here, there is no proof that Green Field was actually impoverished by Moreno's use of the loan proceeds. Green Field took on none of the debt to Goldman Sachs. Yet, Moreno *did* cause nearly $50 million to flow into Green Field between May and September 2013, providing much needed liquidity, without adding any new liabilities to Green Field's balance sheet. [APP-0105] (Opinion, 104). Thus, there is simply no evidence of a relationship between Moreno's use of the Goldman Sachs loan proceeds and any impoverishment to Green Field. Moreover, for the same reasons discussed above, the Trustee did not argue and cannot demonstrate that a money judgment against Moreno for tortious interference is an inadequate remedy at law. *See In re First Cent. Fin. Corp.*,

377 F.3d at 215-16. For these reasons, this Court should not impose a constructive trust.

(v) The Trustee Failed to Satisfy his Burden to Trace.

76. In support of the Bankruptcy Court's conclusion to impose a constructive trust on Moreno's residence in Dallas, Texas, the Bankruptcy Court relied upon very limited evidence, none of which actually traced the proceeds of the Goldman Sachs loans to the purchase of the home.

77. As noted above and detailed in Section II.B(v) above, the evidentiary record is insufficient to support conclusions that Green Field obtained a property interest in the July Goldman Sachs loan proceeds, whether through earmarking or otherwise. Moreover, there is no direct evidence that Moreno used these loan proceeds to purchase his Dallas home. The specific exchange cited above is quoted below:

> Q. Okay. And so, and that second tranche was supposed to be the source of the funding for the 2013 SPA purchase, right?
>
> A. The loan had the ability for me to invest in Green Field, Shale Support Services and anything related to those companies. It also had the ability for me to pay back any advances in loans that I had made to Green Field or any of the entities.
>
> And so what simply happened here, Jim, is the second tranche, I elected to repay myself loans that I had made, and used then for the purchase of a home in Dallas.

[APP-1126] (Trial Tr. 416:4-19).

78. Both speakers above were incorrect about the stated purpose of the July loan, although Moreno's understanding is much closer than the Trustee's understanding. The stated purpose of the July loan was "to make an equity investment in Turbine Generation Services, L.L.C." [APP-0819] (PX 166, GS0003763). Nowhere in the loan documents does Goldman Sachs contemplate or demand an equity infusion into or stock purchase from Green Field. There had been a stock pledge in previous loan advanced in May of 2013—*i.e.,* when the stated purpose for the loan included making an equity investment in Green Field, [APP-0691] (PX 156, GS0002950). However, the Notice of Borrowing in May, 2013 indicates that only $10 million was advanced to Moreno to be invested in TGS. [APP-0908-10] (Notice of Borrowing, May 15, 2013). Moreover, the July loan contained no reference to Green Field or MGH Holdings, and the July 5, 2013, Notice of Borrowing required the $15 million advance to be used toward TGS, not Green Field. [APP-0795-873] (PX 166); [APP-0911-15] (Notice of Borrowing, July 5, 2013). Thus, it is unclear how the Bankruptcy Court reached a conclusion that Green Field obtained a property interest in the July loan proceeds, or that such proceeds were in any way "earmarked" for Green Field. Even if Moreno did misuse the July loan proceeds,[27] there is no basis to conclude that such misuse harmed or defrauded Green Field, because Green Field had no right to those proceeds.

***83** 79. In terms of tracing, the only evidence presented by the Trustee was: (i) Moreno's explanation (quoted above) on cross examination of what happened to the July loan proceeds; and (ii) an e-mail exchange between Moreno's attorney and his accountant regarding the potential options available for the use of $15 million advanced by Goldman Sachs to the DOH GRATs in July, 2013. [APP-0874-76] (PX 168). Neither piece of evidence actually demonstrates how Green Field obtained an equitable interest in the Goldman Sachs loan proceeds, or how the loan proceeds were used to purchase Moreno's personal residence in Dallas, Texas. As discussed above, the evidence presented by the Trustee on "earmarking" does not satisfy the standards set forth by the Third Circuit in *Winstar*.

80. Give the extremity of the remedy, this Court should ensure that the Trustee has proven the what, when, where and how regarding Moreno's use of proceeds to purchase a house. The record is devoid of this evidence. Nowhere in the record does the Trustee demonstrate what specific property was purchased (i.e., the address or legal description), when it was purchased (i.e., the closing date), how it was financed or paid for (i.e., did Moreno actually use Goldman Sachs loan proceeds to fund the closing). The very limited evidence on this issue is far from the "clear and convincing" standard required for such an extreme remedy. As such, the District Court should reject these proposed findings and conclusions, and deny the imposition of a constructive trust on the current record.

III. CONCLUSION

81. For the foregoing reasons, the Defendants ask this Court to reject the Bankruptcy Court's PPFCL as they relate to Counts 11, 12 and 14, rule in the Defendants' favor on such Counts, and decline to impose a constructive trust.

CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that on the 23rd day of October, 2018, I served a true and correct copy of the foregoing **Suggestion in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)** upon the parties listed below in the manner indicated:

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RESPONSE OF PLAINTIFF ALAN HALPERFN, TRUSTEE OF THE GFES LIQUIDATION TRUST, TO LIMITED OBJECTION UNDER FEDERAL RULE OF BANKRUPTCY PROCEDURE 9033 OF DEFENDANTS MICHEL B. MORENO AND MOR MGH HOLDINGS, LLC TO THE PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW SET FORTH IN THE BANKRUPTCY COURT'S OPINION (D.I. 535) AND ORDER (D.I. 540)

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NATURE AND STAGE OF THE PROCEEDING

Plaintiff Alan Halperin, in his capacity as Trustee ("Trustee") of the GFES Liquidation Trust ("Trust"), by and through his undersigned counsel, hereby submits this response ("Response") to the *Limited Objection under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [D.I. 550] (the "Objection"). In support of this Response, the Trustee respectfully states as follows:

SUMMARY OF THE ARGUMENT

The Bankruptcy Court trial involved two conceptually separate claims against Michel B. Moreno ("Moreno") and entities he controlled arising from two discrete, yet parallel factual patterns.

The first factual pattern involved the transfer by debtor, Green Field Energy Services, Inc. ("GFES"), to Moreno of the power generation ("PowerGen") business. GFES was primarily a fracking company, but upon a downturn in the market, Moreno began to explore other potential business ventures, like PowerGen. Ultimately, Moreno decided not

to pursue the PowerGen business within GFES, but rather formed a separate entity, Turbine Generation Services ("TGS") in which he would pursue the opportunity. To effectuate the transfer of the business to TGS, Moreno and the other directors of GFES executed a May 13, 2013 Written Consent of the Stockholders and Directors of GFES. As a result of the Written Consent, GFES could not pursue the PowerGen business and was left to focus on its fracking business. But Moreno, the principal of both GFES and TGS, chose to focus his efforts on PowerGen.

Running parallel with these events are the facts involving two Share Purchase Agreements ("SPAs"). In these agreements, Moreno, through his investment vehicle MOR MGH Holdings, LLC ("MOR MGH"), whose only asset was GFES stock, promised to purchase certain amounts of preferred stock in GFES. The first agreement, executed in late 2012, required MOR MGH to purchase enough preferred stock in GFES, on a quarterly basis, to keep the company's cash balance at $10 million. While initially MOR MGH complied with its obligations, once Moreno decided to focus his efforts on power generation instead of GFES' fracking business, Moreno caused MOR MGH to cease compliance with its continuing obligations. The second agreement, executed in June 2013, required the purchase of additional preferred stock in GFES, which in turn would be pledged to Goldman Sachs to partially secure Goldman's loan to Moreno, which Moreno entered into ostensibly to develop PowerGen.

Prior to trial, the Bankruptcy Court had entered summary judgment as to liability only against MOR MGH, holding that it had breached each of the SPA agreements by failing to make payments in accordance with each contract's terms. D.I. 463. At the time those orders were entered, the Bankruptcy Court also ruled that the Trustee had the burden of proving some damages above and beyond the amount of the non-payments. Although the Trustee disagreed with the court's ruling as to the burden of proof on damages, given that ruling, the Trustee proceeded at trial to establish damage to GFES different and distinct from the non-payments. At the same time, the Trustee reserved its right to challenge the court's earlier summary judgment ruling on damages, and indeed asked the Bankruptcy Court to revisit that issue when the Trustee submitted his proposed findings of fact and conclusions of law to the court. The Bankruptcy Court did in fact revisit the issue in its proposed findings and conclusions and concluded that it had improperly required proof of damages to GFES beyond the non-payments required under each agreement. The Bankruptcy Court could have stopped there, but inasmuch as the evidence was before it, it also ruled that the evidence supported the conclusion that GFES had in fact been damaged by the non-payments.

***87** The Bankruptcy Court also found that Moreno had tortiously interfered with MOR MGH's contractual obligations because he wrongfully diverted monies intended to be paid to GFES to instead purchase his personal home in Dallas, and otherwise put his own personal interests before those of MOR MGH. The court also found that Moreno interfered with the obligations of Moody Moreno and Rucks LLC ("MMR"), the other GFES shareholder, under the 2012 SPA. The siphoning off of $10M to buy his personal residence was, the court found, the type of conduct that warranted the imposition of a constructive trust over that residence.

As to the separate and discrete PowerGen-related claims (i.e., actual and constructive fraudulent transfer, breach of fiduciary duty, and corporate waste), the Bankruptcy Court ruled in Defendants' favor. Although there were certain intersections of facts between the two sets of claims, the PowerGen-related tort claims and the SPA-related contract claims are legally distinct with different relevant factual predicates. The Defendants' Objection is to the SPA-related claims only, of course, as they prevailed on the PowerGen-related claims. But, as the District Court will see, their Objection is predicated entirely on attempting to engraft the PowerGen factual findings onto the SPA-related claims so as to persuade this Court that Moreno, individually, could not have acted with the requisite self-interest to support the interference with contract ruling. Additionally, they work mightily to persuade this Court to reject the constructive trust remedy proposed by the Bankruptcy Court on Moreno's home, which, absent the remedy, could stand beyond the Trustee's reach due to Texas homestead law.

The Defendants' attempted reliance on the PowerGen facts to negate the SPA rulings renders every argument raised by the Defendants flawed at birth, because the former facts are irrelevant to the latter holdings. Indeed, the actual facts underlying the court's proposed SPA findings and rulings are not specifically challenged by the Defendants; and thus should be adopted by this Court. The attempt to negate those facts by reliance on facts relevant only to different claims is a tacit admission that the conduct found by the Bankruptcy Court to support the SPA findings and rulings is unassailable. In short, what Defendants ask this Court to do is reject the Bankruptcy Court's recommendation on the basis that if Moreno is not personally liable on one claim, he cannot be

liable on any claim. That is a remarkable position and one supported neither by fact nor law.

The Bankruptcy Court's Opinion regarding the SPA-related claims is supported by the evidence adduced at trial and controlling legal precedent. This Court should adopt the recommendation and enter judgment accordingly.

PROCEDURAL HISTORY

The Trustee commenced this adversary proceeding on April 6, 2015. After over three years of litigation, the Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") held a trial on March 19-23, 2018 and May 1-2, 2018. The claims for the Bankruptcy Court to consider at trial were against Defendants Moreno, MOR MGH, Frac Rentals, LLC ("Frac Rentals"), Aerodynamic, LLC ("Aerodynamic"), Casafin II, LLC ("Casafin"), and TGS (collectively, the "Defendants") and consisted of:

- Count 1 - Constructive Fraudulent Transfer (against Moreno and TGS)
- Count 2 - Actual Fraudulent Transfer (against Moreno and TGS)
- Count 3 - Breach of Fiduciary Duty (against Moreno)
- Count 6 - Aiding and Abetting Breach of Fiduciary Duty (against TGS)
- Count 7 - Corporate Waste (against Moreno)
- Counts 11 and 12 - Breach of Contract (against MOR MGH)

***88** • Count 14 - Tortious Interference with Contract (against Moreno)

- Counts 19, 23, and 24 - Preferential Transfers (as to Moreno's liability only)
- Count 29 - Disallowance (against Aerodynamic, Casafin, and Frac Rentals)

Counts 1, 2, 3, 6, and 7 related to the alleged transfer of the PowerGen business from Moreno to himself, personally, through TGS. Counts 11, 12, and 14 related to MOR MGH's alleged breaches of the SPAs that required it to purchase preferred stock in GFES, and Moreno's interference with the obligations under those contracts. Counts 19, 23, 24, and 29 were bankruptcy-related claims against creditors.[1]

The parties agreed that Counts 1, 2, 19, 23, and 24 were statutorily "core" claims within the meaning of 28 U.S.C. § 157(b)(2) for which the Bankruptcy Court could enter final judgments. APP 0187.[2] The parties also agreed that Counts 3, 6, 7, and 14 were "non-core" claims for which the Bankruptcy Court could enter proposed findings of fact and conclusions of law to be submitted to this Court (the "District Court"). APP 0187. The parties disputed whether Counts 11 and 12 were "core" or "non-core" claims.

On May 26, 2017, the Trustee moved for summary judgment on his breach of contract and tortious interference claims. See generally D.I. 371 [APP 2404-2483]. On January 24, 2018, the Bankruptcy Court ruled on the motion and found that the SPAs had been breached, but deferred on the issue of damages until trial.[3] D.I. 463 at pp. 36-42 [APP 2093-2099]. Instead, the Bankruptcy Court required the Trustee to prove that GFES would have been in a better "economic position" had MOR MGH fully performed. D.I. 463 at pp. 40-41 [APP 2097-2098], On a Motion for Reconsideration, the Trustee argued that he had, in fact, satisfied that burden of proof by demonstrating the nonpayment of monies owed under a contract, citing extensive New York case law on the issue. D.I. 465 [APP 2484-2494]; D.I. 469 [2495-2499]. On February 23, 2018, the Bankruptcy Court again declined to enter judgment in the Trustee's favor due to the high standard of a reconsideration motion and out of an abundance of caution in the absence of a trial record. D.I. 473 [APP 2450-2453],

***89** On September 12, 2018, the Bankruptcy Court issued its *Findings of Fact and Conclusions of Law* [D.I. 535] (the "Opinion"). APP 0002-0127. The formal Order reflecting the Bankruptcy Court's Opinion [D.I. 540] (the "Order") was entered on September 18, 2018. APP 0129-0131. With respect to the PowerGen claims, the Court entered final judgment in favor of Defendants on Counts 1 and 2 and recommended to the District Court that it enter final judgment in favor of Defendants on Counts 3, 6, and 7. APP 0129-0130. No appeal has been taken from the proposed findings and rulings as to Counts 3, 6, and 7.

With respect to the SPA-related claims, the Bankruptcy Court determined that Counts 11 and 12 were "non-core" claims and it recommended to the District Court that it enter judgment in favor of the Trustee on Counts 11, 12, and 14. APP 0130. Specifically, the Bankruptcy Court recommended to

the District Court that it enter judgment on Counts 11 and 12 in favor of the Trustee and against MOR MGH Holdings in the amount of $15,961,923, plus applicable prejudgment interest,[4] and on Count 14 in favor of the Trustee against Moreno, personally, in the amount of $16,607,081, plus applicable prejudgment interest.[5] Id. The Bankruptcy Court also recommended to the District Court that it impose a constructive trust on Moreno's Dallas residence in favor of the Trustee in the amount of $10 million, plus prejudgment interest, as a result of the Trustee's recommended success on his tortious interference claim against Moreno.[6] Id.

***90** On October 2, 2018, Defendants filed a *Motion to Amend Opinion and Order* [D.I. 544] ("Motion to Amend") asking the Bankruptcy Court to reconsider its opinion with respect to the contract claims. D.I. 544. On October 16, 2018, the Trustee opposed the Motion to Amend. D.I. 546.[7] As of the date of this filing, the Bankruptcy Court has not yet ruled on the Motion to Amend.

On October 2, 2018, Defendants sought a 21-day extension to file objections to the Opinion pursuant to Federal Rule of Bankruptcy Procedure 9033. D.I. 545. On October 23, 2018, Defendants filed their Limited Objection to the Opinion [D.I. 550] and their "Suggestion" in support thereof [D.I. 552] (collectively, the "Objection"). On October 30, 2018, the Bankruptcy Court granted Defendants' request for an extension. D.I. 557.

PROPOSED FINDINGS

The Bankruptcy Court detailed the facts supporting its recommendation of liability against Defendants on the Trustee's breach of contract and tortious interference claims. Opinion at pp. 12-32, 109-123 [APP 0013-0033, 0110-0124]. For the sake of clarity and for the benefit of the District Court, the Trustee shall summarize those facts here.[8]

I. Relevant Entities

The Bankruptcy Court explained the various entities that were either owned by Moreno or were otherwise related to GFES. Opinion at pp. 16-22 [APP 0017-0023]. The relationship between the entities is relevant to the Bankruptcy Court's findings with respect to the breach of contract and tortious interference claims, and Defendants' objections to those findings.

- MOR MGH Holdings ("MOR MGH"): In 2011, Moreno and his wife formed two GRATs called the MBM 2011 MGH Grantor Retained Annuity Trust and the TCM 2011 MGH Grantor Retained Annuity Trust (collectively, the "MGH GRATs"). Opinion at p. 17 [APP 0018] (citing Stipulation No. 9 [APP 0200]). Moreno was responsible for managing the assets and investments of the MGH GRATs. Opinion at p. 114 [APP 0115] (citing Trial Tr. 67:17-20, 75:13-76:2 [APP 0946, 0948]). The sole asset of each MGH GRAT was an equal share of MOR MGH. Opinion at p. 17 [APP 0018] (citing Stipulation No. 9 [APP 0200]; PX 96 [APP 2224-2225]; PX 97 [APP 2252-2253]). MOR MGH was established as a special purpose limited liability company registered in the state of Delaware. Opinion at p. 17 [APP 0018] (citing Stipulation No. 6 [APP 0200]). Its sole asset was stock in Green Field. Opinion at p. 17 [APP 0018]; see also Trial Tr. 847:9-21 [APP 1322]. During the relevant time frame, MOR MGH owned 88.9% of GFES common stock. Opinion at p. 17 [APP 0018] (citing Stipulation No. 7 [APP 0200]). Moreno was the manager of MOR MGH. Opinion at p. 114 [APP 0115] (citing Stip. Facts ¶ 8 [APP 0200]; Trial Tr. 62:2-12 [APP 0945]; PX 92 at § 3.2 [APP 2187]). Moreno acknowledged that whatever money MOR MGH had in its possession was derived from money borrowed by Moreno. Opinion at p. 112 [APP 0113] (citing Trial Tr. 846:23-847:8 [APP 1322]).

***91** • Moody Moreno and Rucks, LLC ("MMR"): MMR was the other GFES shareholder, along with MOR MGH. Opinion at p. 19 [APP 0020]. At all relevant times, MMR owned 11.1% of GFES common stock. Id. (citing Stipulation No. 10 [APP 0200]). MMR was equally owned by TMC Investment, L.L.C., Elle Investments, L.L.C., and Rucks Family Limited Partnership. Id. (citing Stipulation No. 11 [APP 0200]). Elle Investments, L.L.C. was owned and controlled by Moreno. Trial Tr. 96:9-97:5 [APP 0952].

- MOR DOH Holdings ("MOR DOH"): Similar to the MGH GRATs, Moreno and his wife formed two additional GRATs called the MBM 2011 DOH Grantor Retained Annuity Trust and the TCM 2011 DOH Grantor Retained Annuity Trust (collectively, the "DOH GRATs"). Opinion at p. 18 [APP 0019] (citing PX 98 [APP 2277-2304]; PX 99 [APP 2305-2332]). The sole asset of each DOH GRAT was an equal share of MOR DOH. Id. (citing Trial Tr. 68 [APP 0946]). MOR DOH

eventually came to own three different entities, including Turbine Generation Services, LLC. Id.

- Turbine Generation Services, LLC ("TGS"): TGS was a subsidiary of MOR DOH formed by Moreno in March 2013. Opinion at p. 21 [APP 0022]. Moreno formed it as a "place-holder" for the joint venture with General Electric outside of GFES. Opinion at pp. 21-22 [APP 0022-0023]. It was at all times a corporate shell with no employees, no capital, and no infrastructure. Trial Tr. 293:15-20 [APP 1001]. Moreno conceded that it was established for the sole purpose of holding the power generation business and opportunity. Trial Tr. 843:7-18 [APP 1321].

II. Facts Relating to the SPAs

Hub City Industries, L.L.C. ("Hub City") was a traditional oil and gas well-related service company that was originally formed in 1969. Opinion at p. 7 [APP 0008]. In December 2010, Hub City began offering hydraulic fracturing services to its customer base. Id. A recapitalization and buyout of Hub City's members began in May 2011 and in September 2011, Hub City changed its name to Green Field Energy Services, LLC, and later to Green Field Energy Services, Inc. upon its incorporation. Opinion at p. 8 [APP 0009]. The recapitalization and buyout resulted in MOR MGH owning 88.9% of GFES common stock and MMR owning 11.1% of GFES common stock. Id. Moreno became the Chairman of the Board of Directors and CEO in October 2011 and remained Chairman and CEO until the company's liquidation. Id.

When Moreno took control of the company, natural gas prices were high and the company was able to borrow $53 million under a bridge loan from Jeffries & Company, a $30 million revolving senior credit facility for up to an aggregate amount of $100 million from Shell Western Exploration and Production, Inc. ("Shell"), and another $250 million through a bond issuance memorialized in an indenture agreement (the "Indenture"). Opinion at pp. 13-14 [APP 0014-0015]. The bond proceeds were used to repay outstanding amounts under the Jeffries bridge loan, reduce the Shell revolver, and for working capital. Opinion at p. 14 [APP 0015]. However, in mid-2012, after a deterioration in natural gas prices, GFES had spent virtually all of its cash on hand and required additional cash in order to continue its fracking operations pursuant to its Contract for High Pressure Fracturing Services with Shell (the "Shell Contract"), at all times GFES' most significant customer. Opinion at pp. 13-15 [APP 0014-0016].

GFES initially borrowed money from Shell in the form of a senior credit facility for up to an aggregate amount of $100 million, but due to a limitation in the Indenture, GFES was limited to additional debt of no more than $30 million. Opinion at p. 14 [APP 0015]. In May 2012, GFES fully drew the $30 million from Shell, but this was still insufficient. Opinion at p. 15 [APP 0016]. Shell agreed to amend the loan to provide the remaining $70 million in funding, which required, among other things, interest-only payments of $2 million per month until November 2013 (at which point they would increase to $4 million and then $7.5 million in May 2014). Id. In order to obtain the additional borrowing, Moreno also needed its bondholders to consent to a modification to the terms of the Indenture. Id. Part of the consideration for that modification was the agreement by MOR MGH and MMR, GFES' shareholders, to enter into a share purchase agreement dated October 24, 2012 (the "2012 SPA"), pursuant to which the shareholders agreed to purchase GFES preferred stock. Id.

***92** Specifically, according to the terms of the 2012 SPA, MOR MGH and MMR collectively were required to purchase $10 million of GFES preferred stock at execution, and up to an additional $15 million on a quarterly basis pursuant to a specified formula (in proportion to their respective shareholder interests). Opinion at pp. 15-16 [APP 0016-0017]. The formula required the purchase of preferred stock equal to the difference between actual cash on hand at quarter's end and $10 million (e.g., if cash on hand at quarter's end equaled $9 million, the required purchase by MOR MGH and MMR would be $1 million). Opinion at p. 16 [APP 0017]. MOR MGH and MMR purchased the initial $10 million of preferred stock at execution (October 24, 2012), as well as at the close of the fourth quarter of 2012 (December 31, 2012) in the total amount of $1,566,461. Opinion at p. 25 [APP 0026]; PX 132 [APP 2345]. The actual payment was due under the 2012 SPA on "the Business Day immediately following the date on which the Company is required under the Indenture to furnish to its holders of Notes the Company's quarterly or annual report, as applicable" (roughly forty-five days following a quarter's close). PX 119 [APP 2333]. As to the Q4 obligation, the performance date was February 13, 2013. Opinion at p. 25 [APP 0026].

Because of the deterioration in the fracking market, beginning in the fourth quarter of 2012 and continuing through 2013 until GFES filed for bankruptcy, Moreno switched his focus from GFES' fracking business to the development of a new business and product offering: power generation

("PowerGen"). Opinion at pp. 22-24 [APP 0023-0025]. Ultimately, Moreno decided that because the fracking market was stressed, the best option was to pursue the PowerGen business with an equity partner. Opinion at pp. 21-22, 32 [APP 0022-0023, 0033]. That equity partner turned out to be General Electric ("GE"). Id. After initially intending to pursue this new business inside GFES, Moreno ultimately decided to pursue it in a company he owned and controlled through his grantor retained annuity trusts and holding company, and in which GFES maintained no ownership interest; the name of the company was TGS. Opinion at pp. 21-22 [APP 0022-0023]. Moreno and GE engaged in negotiations for a $100M equity investment by GE into a joint venture to develop PowerGen. Opinion at p. 41 [APP 0042]. Those negotiations took place between October 2012 (PX 120 [APP 2342-2344]) and, of relevance here, culminated on May 13, 2013. As stated above, Moreno initially sought to form a joint venture with GE and GFES as the joint venturers. Ultimately, Moreno and GE decided that the joint venture would be between GE and Moreno within the TGS entity. Opinion at pp. 21-22 [APP 0022-0023].

The negotiations between GE and Moreno reached an initial culmination of sorts on May 13, 2013 in the form of a $25M convertible loan by GE to TGS to be used to begin the development of the PowerGen business. Opinion at p. 35 [APP 0036]. That loan included a non-binding term sheet between GE and TGS for the continued negotiation of an ultimate joint venture. Id. (citing JX 49 [APP 0549-0595]). Because of the months of negotiations and the use of GFES assets and personnel preceding the loan, GE required that GFES cause its shareholders and board of directors to execute a written waiver of the corporate opportunity to develop power generation. Opinion at pp. 54-55 [APP 0055-0056]; JX 1 [APP 2153]. A Written Consent dated May 13, 2013 was so executed and delivered to GE. Opinion at p. 35 [APP 0036] (citing Stipulation No. 91 [APP 0205]; JX 61 [APP 0597-0599]). From that point forward, GFES had no ownership interest in the PowerGen business opportunity or its associated assets.[9]

***93** Although Moreno was increasingly focusing his attention on the PowerGen opportunity with GE, GFES was still active in the fracking business. GFES's first quarter 2013 closed on March 31, 2013, and the cash-on-hand amounted to $5,535,374. PX 147 [APP 2346]. Accordingly, in accordance with the terms of the 2012 SPA, Earl Blackwell, the GFES CFO, sent the requisite notices to Moreno (MOR MGH) and MMR advising them of their obligation to purchase $4,464,626 in preferred stock on or before May 15, 2013. PX 147 [APP 2346]. Given the emphasis on negotiations underway with GE and the likelihood that the PowerGen business would not reside within GFES, Moreno's two partners in MMR, Billy Rucks and Kevin Moody, specifically asked Moreno on May 3, 2013, in writing, whether Moreno intended to make his allocable purchase of GFES preferred stock. PX 148 [APP 2347-2348]. Rucks and Moody expressly stated that they would only make their purchase if Moreno made his. Trial Tr. 388:2-392:14 [APP 1119-1120]; PX 149 [APP 2349]; Blackwell Dep. 55:13-17 [APP 2374]. Moreno in turn instructed Blackwell to inform Moody and Rucks that Moreno intended to make his purchase as required. PX 148 [APP 2347-2348]; Blackwell Dep. 42:11-44:16, 55:7-12 [APP 2371, 2374]. He never did and Rucks and Moody in turn never did.

That dialogue and the Q1 notice all occurred before May 13th. The performance date under the 2012 SPA was not until May 15th. PX 147 [APP 2346]. On May 13th, the Written Consent was executed and GE advanced to TGS the $25M loan. Opinion at p. 35 [APP 0036]. On May 15th, when the quarterly payment for the first quarter of 2013 became due, both MOR MGH and MMR breached by failing to make the purchase in their respective allocable amounts. Opinion at pp. 25-26 [APP 0026-0027] (citing Stip. Facts ¶¶ 71, 72 [APP 0204]; PX 147 [APP 2346]).

Thereafter, between May and September, GE and Moreno continued to negotiate in an effort to reach an agreement on the joint venture that would have resulted in GE advancing $75M of additional equity and converting the earlier $25M loan to equity. Opinion at pp. 31-32 [APP 0032-0033] (finding GE continued negotiations until September). While these negotiations were on-going, Moreno caused TGS to purchase from GFES specialized turbines (previously earmarked for use in GFES' fracking business) to begin building its PowerGen units. Opinion at p. 49 [APP 0050] (citing JX 3 [APP 0436]). Moreno also entered into loan agreements with Goldman Sachs pursuant to which Moreno, or the entity through which he owned and controlled TGS, MOR DOH, borrowed an additional $40M ostensibly to make capital contributions to GFES and TGS. Opinion at p. 28 [APP 0029] (citing PX 156 [APP 0686-0757]; PX 166 [APP 0796-0873]). In order to secure those loans, Goldman required Moreno to buy $10M of additional preferred stock in GFES, which he was then required to pledge to Goldman. Opinion at p. 28 [APP 0029] (citing Trial Tr. 397:20-398:3 [APP 1121]; PX 160 [APP 0776]). Moreno purported to

fulfill this obligation by causing GFES to enter into a second stock purchase agreement on June 28, 2013 (the "2013 SPA"). Opinion at p. 28 [APP 0029] (citing Stip. Facts ¶ 75 [APP 0204]; PX 162 [APP 0779-0784]). Although Defendants attempt to challenge the requirement now, Moreno admitted at trial that the purchase and pledging of $10M of preferred stock, memorialized in the 2013 SPA, "was a condition of Goldman Sachs loaning the second tranche of $15 million to Moreno personally and it required Moreno to purchase additional preferred stock in Green Field and then pledge that stock to Goldman Sachs as security for the personal loan." Opinion at p. 28 [APP 0029] (citing Trial Tr. 397:20-398:3 [APP 1121]; PX 160 [APP 0776]); see also PX 162 [APP 0779] ("in connection with a borrowing from Goldman Sachs."). That admission by Moreno was premised, in part, on his attorney's written acknowledgement of the requirement three days before the 2013 SPA was entered. PX 160 [APP 0776] ("$10,000,000 of the funds are being used to purchase additional preferred shares in GFES."); see also PX 166 at § 5.15 [APP 0823] ("The Borrowers shall cooperate in good faith to perform any action ... as may be reasonably requested by the Lender in connection with *pledging additional collateral to the Lender, including, without limitation, shares of stock in Green Field Energy, Inc.*") (emphasis added).

***94** Because the 2013 SPA was a condition of the July Goldman loan, Goldman required that Moreno provide a written certification once the stock had been purchased. Opinion at p. 28 [APP 0029] (citing Trial Tr. 400:12-402:19 [APP 1122]; PX 165 [APP 0789-0794]). Moreno provided this certification to Goldman signing on behalf of both GFES (as putative seller) and MOR MGH (as putative buyer). Opinion at p. 29 [APP 0030] (citing Trial Tr. 404:17-20 [APP 1123]). In fact this was a lie. The purchase was never made; instead Moreno took the money for himself and bought his home in Dallas. The Court found as follows:

> MOR MGH did not buy the $10 million of Green Field preferred stock as required by the 2013 SPA. Stip Facts ¶ 78 [APP 0205]. Despite not purchasing the required preferred stock under the 2013 SPA, Moreno provided a written certification to Goldman Sachs that the stock had in fact been purchased. Trial Tr. 403:11-404:20 [APP 1122-1123]; PX 165 [APP 0789-0794]. The certification detailed the specific accounts into which the money was allegedly deposited. PX 165 [APP 0793]. Moreno signed the certification on behalf of both Green Field and MOR MGH. Trial Tr. 404:17-20 [APP 1123]. The certification was false. Instead of funding his 2013 SPA obligation, Moreno admitted at trial that he used the $10 million to purchase his residential home in Dallas. Trial Tr. 411:24-420:12 [APP 1124-1127]; PX 168 [APP 0875]. The Court observes that Moreno initially denied that he used the proceeds to purchase a home. Trial Tr. 411:18-23 [APP 1124]. However, when confronted with a document from his estate planning professionals (PX 168), he then admitted it. Trial Tr. 411:24-420:12 [APP 1124-1127]; PX 168 [APP 0875].

Opinion at pp. 28-29 [APP 0029-0030]. Accordingly, the Court found that "Moreno knowingly and intentionally lied to Goldman Sachs and intentionally diverted $10M earmarked for Green Field to his own personal use." Opinion at p. 29 [APP 0030].

While all of this was happening, GFES was continuing to engage in the fracking business. The second quarter ended on June 30, 2013, and Mr. Blackwell again notified Messrs. Moreno, Moody and Rucks of the cash shortfall below $10M and their quarterly preferred stock purchase obligation under the 2012 SPA. PX 169 [APP 2350-2351]. Blackwell also reminded everyone that their May payment had not been made. PX 169 [APP 2350]. Rucks and Moody again inquired of Moreno, through Blackwell, of Moreno's intent to honor the 2012 SPA obligations, the failure of which would mean they too would not perform. PX 175 [APP 2352]. Moreno, again through Blackwell, assured his partners in MMR that he fully intended to honor the 2012 SPA obligations of MOR MGH as well as his 1/3 portion of MMR's obligation. PX 175 [APP 2352]. He did not do either and so neither did Rucks or Moody. The performance date for the Q2 payment, August 19, 2013, came and went without the requisite payments being made. Opinion at p. 26 [APP 0027].

Without the nearly $17M in preferred stock purchases required in May (Q-l 2012 SPA), June (2013 SPA) and August (Q-2 2012 SPA) 2013, GFES was left strapped for cash with which, amongst other things, it could have used to service its debt to its other major lender, Shell.[10] Opinion at p. 30 [APP 0031] (citing Stip. Facts ¶ 79 [APP 0205]). Moreno admitted at trial that had the SPAs been fulfilled, GFES would have been able to make the required interest payments. Opinion at p. 30 [APP 0031] (citing Trial Tr. 469:20-470:3 [APP 1135]). Following defaults of $2M of debt service payments to Shell for the months of June through August 2013, GFES ultimately was required to disclose those defaults in its Q-2 10K filed with the Securities and Exchange Commission. Opinion at p. 30 [APP 0031] (citing Stip. Facts ¶ 83 [APP 0205]). After the public disclosure, GFES' corporate ratings were

downgraded by Moody's. Opinion at p. 31 [APP 0032] (citing Stip. Facts ¶ 83 [APP 0205]). On September 6, 2013, before GE officially terminated negotiations, Moreno, in a quarterly bondholder conference call, confessed to GFES bondholders that he failed to make the equity commitments under the SPAs because he was directing all capital to his personal PowerGen business. Opinion at p. 31 [APP 0032] (citing Trial Tr. 440:1-441:14 [APP 1132]; PX 177 at p. 5 [APP 0883]). Moreno acknowledged the default, his obligation to cure that default, and promised he would cure the default that very quarter. PX 177 at p. 5 [APP 0883]. He never did. Instead, after learning of the defaults, GE terminated negotiations with Moreno for the PowerGen business, and Moreno simply walked away from GFES. Opinion at pp. 31-32 [APP 0032-0033] (citing JX 50 [APP 2173-2177]; PX 215 [APP 2359]). Bankruptcy followed on October 27, 2013. Opinion at p. 32 [APP 0033] (citing Stip. Facts ¶ 4 [APP 0200]).

***95** In total, MOR MGH and MMR respectively failed to purchase $5,961,923 and $745,158 in GFES preferred stock pursuant to the 2012 SPA. Opinion at p. 120 [APP 0121]. MOR MGH also failed to purchase the $10M in preferred stock required by the 2013 SPA. Opinion at p. 109 [APP 0110]. The total unpaid amounts equaled $16,707,081. All amounts became due between May and August 2013.

III. The Bankruptcy Court's Well-Reasoned Legal Conclusions

The Bankruptcy Court had determined at the summary judgment stage that the 2012 and 2013 SPAs were enforceable agreements that had been breached by MOR MGH, leaving only the issues of damages and Moreno's tortious interference with MOR MGH and MMR's obligations for trial. D.I. 463 at pp. 39, 41-42 [APP 2096, 2098-2099].

A. The Nonpayment of Monies Owed Under the SPAs Damaged GFES.

As stated above, during the summary judgment phase, the Bankruptcy Court refrained from entering judgment as to damages because it incorrectly concluded that New York law required proof of some damage above and beyond the non-payments required by the contracts at issue. D.I. 463 at pp. 39-41 [APP 2096-2098]. As framed by the court then, the Trustee was required to prove a separate and distinct harm to GFES; that is, a showing that GFES was worse off without the payments than it would have been had compliance occurred. Id. Although the Trustee maintained throughout that this "burden of proof" imposed by the court was in error, it nonetheless proceeded to trial with the required proof whilst concurrently preserving its position as to the correct legal standard for damages.

Following trial, the Bankruptcy Court, upon further reflection and review of controlling New York case law, reversed its earlier position and correctly held that "the Trustee has met his burden of proof of damages by establishing non-payment of the amounts owed under the 2012 and 2013 SPAs." Opinion at p. 111 [APP 0112]. The Bankruptcy Court relied on cases holding that "under New York law, where the breach of contract was a failure to pay money, the plaintiff is entitled to recover the unpaid amount due under the contract plus interest." Opinion at p. 110 [APP 0111] (citing House of Diamonds v. Borgioni, LLC, 737 F.Supp.2d 162, 172 (S.D.N.Y. 2010) (citing Scavenger, Inc. v. GT Interactive Software Corp., 289 A.D.2d 58, 58-59, 734 N.Y.S.2d 141 (N.Y. App. Div. 2001)). The Bankruptcy Court also relied on two cases that provided context to this general proposition. Opinion at p. 110-11 [APP 0111-0112] (citing Stokoe v. E-Lionheart, LLC. 129 A.D.3d 703, 704 (N.Y. App. Div. 2015); cf. Bi-Economy Market, Inc. v. Harleysville Ins. Co. of N.Y., 10 N.Y.3d 187, 193, 856 N.Y.S.2d 505, 886 N.E.2d 127 (2008)).[11] Defendants do not object to any of these legal holdings by the Bankruptcy Court. "Accordingly, the Trustee has proven that Green Field suffered damages in the amount of $15,961,923 due to MOR MGH's failure to honor its obligations under the 2012 and 2013 SPAs. The Trustee prevails on damages, plus applicable prejudgment interest."[12] Opinion at p. 113 [APP 0114].

B. Moreno Tortiously Interfered with MOR MGH and MMR's SPA Obligations.

***96** During the summary judgment phase, the Bankruptcy Court had concluded that material questions of fact remained as to whether Moreno's conduct satisfied the standard required under New York law for an officer of a company to interfere with that company's contract with another. D.I. 463 at pp. 41-42 [APP 2098-2099]. In the Opinion, the court enunciated the appropriate standard under New York law, which requires a showing that the officer was acting for his or her own personal interest in causing the breaches. Opinion at pp. 115-16 [APP 0116-117] (citing Rockland Exposition, Inc. v. Alliance of Auto. Serv. Providers of N.J., 894 F.Supp.2d 288, 336-37 (S.D.N.Y. 2012); Hoag v. Chancellor, Inc., 246 A.D.2d 224, 677 N.Y.S.2d 531, 533-34 (N.Y. App. Div. 1998); Petkanas v. Kooyman, 303 A.D.2d 303, 759 N.Y.S.2d

1, 2 (N.Y. App. Div. 2003); Albert v. Loksen, 239 F.3d 256, 272-76 (2d Cir. 2001); Zuckerwise v. Sorceron Inc., 289 A.D.2d 114, 735 N.Y.S.2d 100, 102 (N.Y. App. Div. 2001)). The Bankruptcy Court found that Moreno caused MOR MGH to breach its obligations under both the 2012 and 2013 SPAs, and MMR to breach its obligations under the 2012 SPA. Opinion at pp. 114-15 [APP 0115-0116]. Specifically, the court found that Moreno was the cause for MOR MGH's breaches of the SPAs due to his managerial control of the entity. Id. It also held that Moreno was responsible for MMR's failure to make the requisite payments because he knew that if he did not cause MOR MGH to make its purchases, then his partners in MMR would not make their purchases. Opinion atp. 115 [APP 0116].

The Bankruptcy Court also held that Moreno acted with malicious intent in causing the breaches of the SPAs because he caused the breaches in order to enhance his own personal interest.[13] Specifically, the evidence at trial demonstrated that GFES's principal business was fracking [APP 0008]; that the fracking industry at large experienced significant decline in 2012 [APP 0015]; that Moreno, in response, turned his focus away from fracking and towards power generation in Q4 2012 [APP 0023-0025]; that after initially attempting to develop power generation within GFES, Moreno caused GFES to waive its interests in power generation so that Moreno could develop that business outside the company in an entity that he alone owned and controlled [APP 0022-0023, 0036]; that at the time of the waiver, Moreno and GE were valuing the potential power generation business in the range of $200M [APP 0044-47]; that immediately following the transfer Moreno caused MOR MGH to cease performing under the 2012 SPA [APP 0026-0027]; that Moreno then used GFES to induce Goldman to loan $40M dollars more, ostensibly to be used to infuse working capital into both TGS (to develop power generation) and GFES (in exchange for preferred stock to be pledged to Goldman to secure the loan) [APP 0029]; and that Moreno secretly siphoned away $10M, expressly earmarked for GFES by Goldman, to purchase his personal residence in Dallas, Texas [APP 0029-0030]. The evidence also established that Moreno could not account for an additional $25M in available funds that could have been used to satisfy the SPA obligations [APP 0027-0028]. Moreno admitted at trial that GFES needed all of the money it could get due to the then-prevailing headwinds in the fracking industry, that it was the "kiss of death" for any company to lack cash, and that GFES would have been better off had MOR MGH and MMR honored their obligations under the SPAs [APP 0028]. Indeed, Moreno acknowledged that had the SPAs been honored, GFES would have had cash available to service the Shell debt, which, in turn, would have avoided default under both the Shell loan agreement and bond indenture that led to GE terminating negotiations for the power generation joint venture [APP 0031-0033]. Finally, the evidence at trial established that Moreno admitted, contemporaneously with events, that he had caused the SPA defaults because he was investing his capital in power generation, which he owned and controlled to the exclusion of GFES [APP 0032].[14] Because MOR MGH's only asset was its stock in GFES, any harm he caused to GFES would also harm MOR MGH, the entity that he managed [APP 0018; Trial Tr. 847:9-21 [APP 1322]]. Thus, Moreno placed his own personal interests ahead of those of the entity to which he owed a duty. He was also fully aware that his failure to satisfy his portion of the obligations under the 2012 SPA would cause his partners in MMR to fail to satisfy their portions [APP 0116]. Thus, Moreno intentionally caused MMR to breach its obligations to further his pursuit of his own personal interests at the expense of GFES.

C. Moreno's Diversion of Funds Earmarked to GFES to Instead Purchase a Home Warranted Imposition of a Constructive Trust.

***97** The Bankruptcy Court found the most egregious evidence of Moreno's malicious intent - the use of the $10 million borrowed from Goldman that was specifically earmarked to satisfy MOR MGH's obligations under the 2013 SPA, to instead secretly purchase himself his personal residence - to be precisely the type of behavior justifying the imposition of a constructive trust over that residence. Opinion at p. 123 [APP 0124]. The Bankruptcy Court found that "[u]nder Delaware law, 'a constructive trust is an equitable remedy of great flexibility and generality. A constructive trust is proper when a defendant's fraudulent, unfair or unconscionable conduct causes him to be unjustly enriched at the expense of another to whom he owed some duty." Opinion at pp. 120-21 [APP 0121-0122] (citing Ruggerio v. Estate of Poppiti, No. CIV.A. 18961-NC, 2005 WL 517967, at *3 (Del. Ch. Feb. 23, 2005); In re Onus E., 528 B.R. at 106)). It went on, "courts analyze the same elements for a constructive trust as they do for an unjust enrichment claim. 'To prevail on a claim for unjust enrichment or imposition of a constructive trust[,] the Trustee must allege sufficient facts to plausibly show that (i) there was an enrichment; (ii) an impoverishment; (iii) a relation between the enrichment and the impoverishment; (iv) the absence of justification; and (v) the absence of a remedy provided by law.' " Opinion at p. 121

[APP 0122] (citing In re Direct Response Media, Inc., 466 B.R. 626, 661 (Bankr. D. Del. 2012)).

The Bankruptcy Court found that Moreno's conduct was sufficient to satisfy this standard. Specifically, it held: "Moreno was enriched by using $10 million to buy a home, and Green Field was impoverished because it was deprived of $10 million of funding. The impoverishment is directly related to the enrichment, and there is no justification for Moreno's actions. Further, there is no adequate remedy at law to be able to recover the $10 million spent on the home." Opinion at p. 123 [APP 0124].

RESPONSES TO DEFENDANTS' OBJECTIONS

I. Standard of Review

"Pursuant to FRBP 9033, the district court only makes a de novo review of any portion of the bankruptcy judge's findings of fact or conclusions of law to which specific written objection has been made in accordance with this rule." In re Preston, 516 B.R. 606, 608 (C.D. Cal. 2014) (internal citations and quotations omitted) (emphasis added); see also Davis v. Orion Fed. Credit Union, No. 16-MC-00035-SHL-DKV, 2016 WL 6157894, at *1 (W.D. Tenn. Oct. 19, 2016) ("A district court reviews de novo only those proposed findings of fact or conclusions of law to which a party objects."). "An 'objection' that does nothing more than state a disagreement with a magistrate's suggested resolution, or simply summarizes what has been presented before, is not an 'objection' as that term is used in this context."[15] Silagy v. Morris, No. 5:13-CV-2645, 2015 WL 853499, at *2 n.3 (N.D. Ohio Feb. 26, 2015). "Bare statements that are devoid of any reference to specific findings or recommendations to which a party objects and why, and unsupported by legal authority, are not sufficient to constitute actionable objections." Messer v. Peykar Int'l Co., 510 B.R. 31, 39 (S.D.N.Y. 2014). "Absent specific objections, the court reviews proposed factual findings for clear error and legal conclusions de novo." 1250 Oceanside Partners v. Buckles (In re 1250 Oceanside Partners), 260 F.Supp.3d 1300, 1304 (D. Haw. 2017).

"[I]f following a review of the record the district court is satisfied with the magistrate judge's findings and recommendations it may in its discretion treat those findings and recommendations as its own." Goffman v. Gross. 59 F.3d 668, 671 (7th Cir. 1995); see also Charleston v. Gilmore, 305 F.Supp.3d 612, 617 (E.D. Pa. 2018) ("District Courts, however, are not required to make any separate findings or conclusions when reviewing a Magistrate Judge's recommendation de novo ...." (citing Hill v. Bernacle, 655 F. App'x 142, 147 (3d Cir. 2016))). "De novo review does not mean a de novo hearing; rather, it means that [the] district judge may accept, reject, or modify the proposed findings of fact or conclusions of law, receive further evidence, or recommit the matter to the bankruptcy judge with instructions." Zazzali v. 1031 Exchange Grp. (In re DBSI, Inc.), 467 B.R. 767, 775 (Bankr. D. Del. 2012) (internal quotations omitted).

II. The District Court Should Accept the Bankruptcy Court's Factual Findings Because They are Supported by the Record

***98** The objections raised by Defendants are merely a recitation of the facts they presented to the Bankruptcy Court at trial. Defendants simply disagree with the Bankruptcy Court's rulings and present nothing new that warrants a different outcome. This is not a valid objection pursuant to Rule 9033. Silagy, 2015 WL 853499, at *2 n.3 ("An 'objection' that does nothing more than state a disagreement with a magistrate's suggested resolution, or simply summarizes what has been presented before, is not an 'objection' as that term is used in this context."). However, for the sake of completion, the Trustee will address Defendants' putative objections.

A. The Undisputed Record Demonstrates that Moreno Caused MOR MGH's Breaches of the SPAs.

Defendants object to the Court's finding that Moreno caused MOR MGH to breach the SPAs.[16] Objection at ¶ 17.[17] Yet Defendants have not objected to any of the specific proposed factual findings supporting the Bankruptcy Court's finding of causation. The Court found:

> Moreno was the manager of MOR MGH. Stip. Facts ¶ 8 [APP 0200]; Trial Tr. 62:2-12 [APP 0945]; PX 92 at § 3.2 [APP 2187]. MOR MGH, in turn, was owned by two grantor retained annuity trusts, collectively referred to as the MGH GRATs. Stip. Facts ¶ 9 [APP 0200]. Moreno was responsible for managing the assets and investments of the MGH GRATs. Trial Tr. 67:17-20, 75:13-76:2 [APP 0946, 0948]. Accordingly, Moreno exercised full control over MOR MGH and controlled whether or not it made payments in compliance with its obligations under the SPAs.

Opinion at pp. 114-15 [APP 0115-0116]. Additionally, Moreno acknowledged that whatever money MOR MGH had in its possession was derived from money borrowed by Moreno. Opinion at p. 112 [APP 0113] (citing Trial Tr. 846:23-847:8 [APP 1322]). MOR MGH was an investment vehicle as its only asset was its GFES stock. Opinion at p. 17 [APP 0018]; see also Trial Tr. 847:9-21 [APP 1322]. For example, as demonstrated in the documents relating to Moreno's May 2013 loan from Goldman Sachs, Moreno made several loans to MOR MGH and pledged those notes as security for the funds from Goldman. Trial Tr. 847:22-850:12 [APP 1322-1323]; Trial Tr. Conf. 3/22 1:10-4:16 [APP 1254]; PX 156 at GS0002986 [APP 0727]. Defendants did not object to any of these specific facts and therefore, they should be accepted by the District Court. The Bankruptcy Court also noted that Moreno testified at trial that he referred interchangeably to MOR MGH's obligations under the SPAs as his own and that of MOR MGH.[18] Opinion at p. 115 n.20 [APP 0116]. These are the findings that support the Court's conclusion that Moreno was responsible for MOR MGH's breaches of the SPAs. Moreno was the lone decision-maker for the entity and MOR MGH could not have breached its contractual obligations if not by his direction. In any event, the Court found, Moreno himself acknowledged, and Defendants do not object, that Moreno alone was responsible for providing funding to MOR MGH. Opinion at p. 112 [APP 0113] ("Moreno acknowledged that whatever money ... MOR MGH had in its possession was derived from money borrowed by Moreno." (citing Trial Tr. 846:23-847:8 [APP 1322])). Thus, MOR MGH required Moreno to provide it funding in order for it to satisfy its obligations.

***99** Defendants phrase their argument in terms of causation, but it appears they are really arguing with respect to Moreno's "intent" or "malice"; that is, Moreno could not have caused the breaches because other evidence showed that he tried to benefit GFES in other ways unrelated to the SPAs. These arguments have absolutely no bearing on whether or not Moreno acted with the requisite self-interest in causing MOR MGH's breaches of the SPAs. The Bankruptcy Court already decided, and Defendants have not objected, that the Trustee satisfied his burden of proof with respect to whether or not MOR MGH caused *damages* to GFES through breaches of the SPAs by demonstrating the nonpayment of money owed under the contracts. Opinion at p. 111 [APP 0112]. The additional "causation" that need be shown with respect to the tortious interference claim relates only to whether Moreno personally caused MOR MGH's *breaches* of the contracts with the requisite degree of malice (i.e., putting his personal interests ahead of those of MOR MGH or GFES), not that Moreno himself caused the damages thereunder with malicious intent. See, e.g., Ullmannglass v. Oneida, Ltd., 121 A.D.3d 1371, 1372, 995 N.Y.S.2d 776 (N.Y. App. Div. 2014) ("Causation is an essential element of a claim for tortious interference with contractual relations. Such a cause of action requires proof that, 'but for' the defendants' conduct, the plaintiff would not have breached its contract with a third party.").

To the extent Defendants assert these arguments in an attempt to challenge the Court's finding that Moreno was acting with self-interest in causing the breaches of the SPAs, those arguments are unavailing. Again, under applicable New York law, an officer of a company can be held liable for tortious interference with the company's contract if he or she is acting for his or her own personal gain. Rockland Exposition, Inc. v. Alliance of Auto. Serv. Providers of N.J., 894 F.Supp.2d 288, 336-37 (S.D.N.Y. 2012); Hoag v. Chancellor, Inc., 246 A.D.2d 224, 677 N.Y.S.2d 531, 533-34 (N.Y. App. Div. 1998); Petkanas v. Kooyman, 303 A.D.2d 303, 759 N.Y.S.2d 1, 2 (N.Y. App. Div. 2003); Albert v. Loksen, 239 F.3d 256, 272-76 (2d Cir. 2001); Zuckerwise v. Sorceron Inc., 289 A.D.2d 114, 735 N.Y.S.2d 100, 102 (N.Y. App. Div. 2001). The Bankruptcy Court found that Moreno did in fact act in his own self-interest to the detriment of GFES in causing both MOR MGH and MMR to breach the SPAs. Opinion at pp. 114-123 [APP 0115-0124]. As he did at trial, Moreno asks the Court to ignore his actions in connection with the SPA agreements and instead focus on his efforts to launch PowerGen outside of GFES. Moreno focuses the Court there because he maintains that these actions resulted in ancillary benefit to GFES. That ancillary benefit, Moreno asserts, "proves" he was not putting his personal interests first when he caused MOR MGH to breach. However, as the Bankruptcy Court found, the evidence presented at trial made clear that Moreno's actions with respect to the SPAs demonstrate that he was acting in his own personal interest, notwithstanding any ancillary benefits GFES received from the PowerGen business. Opinion at pp. 114-20 [APP 0115-0121]. In fact, Moreno's singular focus on trying to develop PowerGen after he caused GFES to waive its ability to pursue that opportunity was, by his own admission, the very reason he stopped performing under the SPAs. PX 177 at p. 5 [APP0883] ("Finally, one of the defaults that obviously occurred in the quarter, there was a $6 million Equity commitment that I was personally going to have to fulfill in the quarter. That didn't happen, obviously it didn't happen for a couple of reasons that I'll share with you guys. One, obviously is I've been funding a

large part of the start-up expenses personally on PowerGen ... so a lot of my personal capital has gone to that.").

Defendants argue that Moreno was not *required* by the Goldman, GE, and Powermeister loan documents to use the funds he borrowed to satisfy MOR MGH's obligations under the SPAs. Objection at ¶ 19. First, as explained herein, $10M of the Goldman loan was specifically earmarked for use by MOR MGH to satisfy the 2013 SPA. Moreover, whether or not the loan documents themselves *required* Moreno to fund MOR MGH is inconsequential with respect to Moreno's malicious intent. Again, Moreno set up MOR MGH as a shell company with no liquid assets, its only asset being GFES stock. Opinion at p. 17 [APP 0018]; see also Trial Tr. 847:9-21 [APP 1322]. Moreno knew the only way MOR MGH could ever satisfy the SPAs was if he funded it, which he did repeatedly; the exhibit attached to the May Goldman loan illustrates that fact. Trial Tr. 847:22-850:12 [APP 1322-1323]; Trial Tr. Conf. 3/22 1:10-4:16 [APP 1254]; PX 156 at GS0002986 [APP 0727]. Thus, by declining to provide MOR MGH the funds it needed to purchase GFES preferred stock as required by the SPAs and instead using the money for his own personal benefit, Moreno intentionally interfered with MOR MGH's obligations. The fact that some borrowed funds were intended to fund TGS is also irrelevant. Moreno did, in fact, use $48 million of his borrowings to fund TGS. TGS is not GFES; GFES owned no part of TGS. Moreno owned TGS through his limited liability company, MOR DOH. Opinion at pp. 18-19 [APP 0019-0020]. Thus, putting resources into a company he owned to the exclusion of GFES in no way absolved MOR MGH of its obligations under the SPAs. The Bankruptcy Court properly found that in addition to that $48 million, Moreno also spent $10 million on buying a home and had another $27 million that was unaccounted for. Opinion at p. 111-12 [APP 0112-0113]. He could, and should, have used that money to satisfy the SPAs.

***100** Defendants next assert that the Court's finding that Moreno decided not to honor the SPA obligations is in conflict with its finding that Moreno searched for investors relating to the PowerGen business. Objection at ¶ 20. Once again Defendants attempt to conflate the completely distinct PowerGen claims and SPA claims. Moreno's search for capital was his attempt to get the PowerGen business off the ground and part of that had ancillary benefits to GFES, not because he was specifically trying to benefit GFES, but rather because he knew that he needed GFES in order to support the PowerGen business. As Moreno acknowledged, TGS had no assets of its own and relied on GFES resources and personnel. Trial Tr. 293:15-20 [APP 1001]; JX 1 [APP 2153]. Again, while GFES may have stood to receive ancillary benefits through investments made into TGS to support the PowerGen business, it did not receive what would have been the direct benefits of the cash payments vis-a-vis the SPAs, even though both could have been accomplished. Defendants allege that Moreno could not find investors to invest directly in GFES, but there was one such entity that could have, and was in fact required to, invest directly in GFES - MOR MGH. But, because this was an entity that Moreno himself was responsible for funding, and because Moreno was focusing his efforts on PowerGen instead of GFES' fracking business, he chose not to satisfy MOR MGH's obligations to GFES.

Defendants contend that Moreno "leveraged his own personal wealth and other assets" in order to borrow funds, Objection at ¶ 21, but he did this to develop PowerGen, not GFES, and not to honor the SPA obligations.[19] To the extent it is relevant - and it is not - the only time Moreno used his assets to secure a loan to benefit GFES was in connection with the Shell loan at the outset of the entry into the fracking market and before Moreno had shifted his focus to power generation. See APP 2062-2063. Moreover, Defendants' assertion that the approximately $50 million invested in TGS provided all of the "necessary liquidity" to GFES is unsupported by the record and simply irrelevant. See Objection at ¶ 21. First, this "liquidity" argument is not a cognizable defense to the Trustee's contract claims. Moreover, the so-called "liquidity" resulted from i) the sale of inventory, which was intended to benefit the PowerGen business, not GFES; and ii) from deposits which the Bankruptcy Court found were not actually GFES' property, but rather were held in trust for the benefit of the PowerGen business (D.I. 463 at pp. 22-29 [APP 2079-2086]), and for which TGS filed a claim in the bankruptcy proceedings to reclaim. JX 46 [APP 2154-2172]. GFES did not receive the direct liquidity promised by MOR MGH under the SPAs.

Defendants finally and remarkably attempt to argue that GFES did not "need" additional cash from the SPAs and it was Shell's decision to reduce its business with GFES that caused MOR MGH to breach its contractual obligations to GFES. Objection at ¶¶ 22-23. First, as explained below, the Court's holding with respect to damages obviates a showing of what GFES would have done with the money once it received it; the nonpayment itself was sufficient to show damages. Second, an inquiry into what GFES would have done with the funds after receiving it is inappropriate under New York law. See, e.g., Merrill Lynch & Co. v. Allegheny Energy, Inc., 500 F.3d

171, 185 (2d Cir. 2007) ("[E]vents subsequent to the breach, viewed in hindsight, may neither offset nor enhance [a party's] general damages."). In any event, Moreno's self-serving and hypothetical statement that GFES would not have made the interest payments to Shell even if it had the cash on hand is not persuasive. Indeed, the Bankruptcy Court was not persuaded when it heard this testimony at trial. The fact remains that GFES could have chosen to make those payments, or use it for some other purpose in furtherance of its business, if it had additional liquidity through the SPAs, but Moreno ensured that GFES did not have any such choice to make. Notably, the 2013 SPA was executed after the June interest payment to Shell became due. Moreno also made statements to bondholders as late as September claiming that he would cure the defaults under the SPAs. Opinion at p. 113 [APP 0114] (citing Trial Tr. 445:10-446:7 [APP 1133]; PX 177 at p. 5 [APP 0883]). It would defy logic if Moreno would make these statements and enter into an additional contract requiring the injection of funds directly into GFES if he did not believe that GFES could still use the funding for some purpose.

B. The Court's Damages Calculation is Well-Supported by the Record

***101** Defendants argue that the Bankruptcy Court somehow erred in calculating that GFES was damaged in the amount of the unmade payments under the contracts. This argument is not only absurd on its face but defies the Court's well-reasoned findings.

The procedural history of this case is important with respect to the Bankruptcy Court's damages finding. The Trustee moved for partial summary judgment on his breach of contract and tortious interference claims. See generally D.I. 371 [APP 2404-2483]. The Bankruptcy Court found that the SPAs had been breached, but deferred on the issue of damages until trial. D.I. 463 at pp. 36-41 [APP 2093-2098]. The Bankruptcy Court imposed on the Trustee the burden to prove that GFES would have been in a better "economic position" had MOR MGH fully performed. D.I. 463 at pp. 40-41 [APP 2097-2098]. On a Motion for Reconsideration, the Trustee argued that he had, in fact, satisfied that burden of proof by demonstrating the nonpayment of monies owed under a contract, citing extensive New York case law on the issue. D.I. 465 [APP 2484-2494]; D.I. 469 [APP 2495-2499]. Again, the Bankruptcy Court declined to enter judgment in the Trustee's favor due to the high standard of a reconsideration motion and out of an abundance of caution in the absence of a trial record. D.I. 473 [APP 2450-2453].

In the Opinion following trial, the Bankruptcy Court corrected itself and agreed with the Trustee's well-reasoned position. It held: "The Court now holds that the Trustee has met his burden of proof of damages by establishing non-payment of the amounts owed under the 2012 and 2013 SPAs." Opinion at p. 110-11 [APP 0111-0112] (citing House of Diamonds, 737 F.Supp.2d at 172; Stokoe, 129 A.D.3d at 704; Bi-Economy Market, 10 N.Y.3d at 193, 856 N.Y.S.2d 505, 886 N.E.2d 127). Thus, the damages to GFES are simply calculated by the amounts owed under the SPAs that remained unpaid. The undisputed evidence demonstrates that MOR MGH failed to purchase $15,961,923 and MMR failed to purchase $745,158 of GFES preferred stock pursuant to the SPAs. Opinion at pp. 113, 120 [APP 0114, 0121].

Defendants ignore this critical holding, which they have not objected to and thus should be accepted by the District Court. No further evidence was necessary. Ignoring the effect of the Court's application of the correct burden of proof on damages, Defendants argue that "the only evidence" supporting the Court's damage finding is "Green Field's failure to pay $6 million to Shell." Objection at ¶ 25. This is a red herring. The evidence of damages is the nonpayments under the SPAs - an amount equaling $16,707,081,[20] before assessment of prejudgment interest. The other evidence was submitted by the Trustee because of the incorrect damages burden imposed on the Trustee at summary judgment. After the Bankruptcy Court corrected its burden of proof, that evidence no longer became relevant to damages. Satisfaction of its Shell interest payment obligations is but one of any number of uses to which GFES could have put the cash it would have received had MOR MGH complied with its contractual obligations, but, based on the Bankruptcy Court's correct application of applicable New York law, what GFES would or would not have done with the funds is irrelevant. See Opinion at p. 111 [APP 0112].

***102** Second, Defendants argue that the damages caused by the breaches of the SPAs cannot be reconciled with the fact that "Green Field benefited from $50 million in cash infusions from TGS" and "Moreno established TGS for legitimate business reasons." Objection at ¶¶ 26-27. Once again, Moreno's efforts with PowerGen have nothing to do with his deprivation of funds to GFES and its fracking business by causing the breaches of the SPAs. Moreover, Defendants' argument is irrelevant in light of the Court's correct application of the Trustee's burden of proof. In any event, the argument nonetheless fails on the trial record. The

Court clearly considered and dismissed the argument in its Opinion. The Bankruptcy Court made the following findings:

> MOR MGH, through Moreno, had access to additional funds to make the payments, **without impacting the ability of TGS to satisfy its obligations to TPT in connection with the manufacture of the PowerGen units.** The evidence at trial established that Moreno or his entity MOR DOH, which owned TGS, borrowed at least $85 million from GE, Goldman Sachs and Powermeister between May and August 2013. Trial Tr. 843:7-844:19 [APP 1321]. Putting aside Moreno's characterization of certain transactions as "capital contributions," the evidence establishes that approximately $48 million of transactions between TGS and Green Field occurred during this time period in the form of turbine sales ($23M) and deposits ($25M). JX 3 [APP 0436]; DX 221 [APP 0627]; Trial Tr. 844:11-846:10 [APP 1321-1322]. From the remaining $37 million of available funds, Moreno admitted - only after being confronted with a document from his estate planning professionals - that $10 million was improperly siphoned off to purchase his Dallas home. Trial Tr. 411:18-420:12, 844:11-19 [APP 1124-1127, 1321]. The additional $27 million was completely unaccounted for. Trial Tr. 844:20-846:10 [APP 1321-1322]; JX 3 [APP 0436]; DX 221 [APP 0627]. That $37 million was thus available to satisfy the $17 million in SPA obligations, **without impacting in any way TGS' obligations to TPT.** Further, Moreno could have borrowed additional money on behalf of MOR MGH in order to fulfill its obligations under the SPAs. Moreno acknowledged that whatever money either TGS or MOR MGH had in its possession was derived from money borrowed by Moreno. Trial Tr. 846:23-847:8 [APP 1322]. Indeed, all of the money that Defendants allege TGS paid to Green Field to satisfy the SPA obligations was either from Moreno's personal funds or money that he borrowed. Trial Tr. 817:14-24, 846:23-847:8 [APP 1315, 1322].

Opinion at pp. 111-12 [APP 0112-0113] (emphasis added). Notably, Defendants do not object to the bolded findings. Thus, the Court already expressly considered that some of the money Moreno borrowed ended up being used for the direct benefit of TGS and the PowerGen business, which, in turn, resulted in ancillary benefits to GFES, but found that this did not excuse MOR MGH's performance under the SPAs and that Moreno had additional funds on hand that he could, and should, have used to satisfy the SPA obligations. The fact that some of Moreno's borrowings were ultimately channeled through GFES in furtherance of the PowerGen business does not negate the fact that GFES was otherwise damaged by MOR MGH's breaches of the SPAs, which the Court found Moreno could have satisfied *in addition to* the $48 million that went to GFES' benefit. All of the Bankruptcy Court's findings are entirely consistent.

Moreno's negotiations with GE are also completely irrelevant to the SPA claims. See Objection at ¶¶ 28-29. Again, the money that was borrowed was used to directly support the PowerGen business. That the way it was used (i.e. to purchase turbine inventory from GFES) provided ancillary benefit to GFES in the form of a profit from the sale did not obviate the requirement that Moreno satisfy MOR MGH's SPA obligations, nor does it mitigate the finding that Moreno acted in his own personal interest in causing the breaches of the SPAs.

***103** Defendants argue that "[b]ecause the Bankruptcy Court's PPFCL accepted this evidence as mitigation of damages under breach of fiduciary duty, corporate waste, and fraudulent transfer claims, this Court must also accept the same evidence as mitigation of potential damages for the SPA-related claims." Objection at ¶ 30. There is no legal support for this proposition, which alone suggests the District Court should dismiss the argument. See Messer, 510 B.R. at 39 ("Bare statements that are ... unsupported by legal authority, are not sufficient to constitute actionable objections."). The Trustee's breach of fiduciary duty, corporate waste, and fraudulent transfer claims all related to the transfer of the PowerGen business. The transactions through which Moreno invested approximately $50 million into TGS, including the sale of turbines, were also in connection with his attempt to develop the PowerGen business. Those transactions had nothing to do with MOR MGH's contractual requirement to purchase GFES stock under the two SPA agreements. Defendants cannot with a straight face argue that completely unrelated transactions somehow mitigate a failure to comply with contractual obligations under a completely different contract between different parties. In fact, the Bankruptcy Court long ago disposed of this argument at summary judgment. D.I. 463 at pp. 38-39 [APP 2095-2096].

Finally, Defendants again assert that GFES would not have made its interest payments to Shell even if the SPA payments had been made. Objection at ¶ 31. Again, a completely irrelevant argument. The Bankruptcy Court properly found that the damages to GFES were in the amounts that remained unpaid under the contracts, as supported by New York law and what GFES would or would not have done with the funds

is entirely irrelevant. See, e.g., Merrill Lynch, 500 F.3d at 185 ("[E]vents subsequent to the breach, viewed in hindsight, may neither offset nor enhance [a party's] general damages."); see also Suffolk Cty. v. Long Island Lighting Co., 728 F.2d 52, 63 (2d Cir. 1984) ("[U]nlike negligence and strict liability causes of action, which seek to make the injured party 'whole,' warranty and contract remedies exist to afford injured parties the benefit of their bargain.").

C. Moreno Used Funds Earmarked for GFES to Purchase a Home Rather than Satisfy MOR MGH's Obligations under the SPAs

Defendants object to the Bankruptcy Court's findings with respect to the tortious interference claim on two grounds. First, they argue that no funds were "earmarked" for GFES' benefit. Objection at ¶ 35. Second, they argue that the Trustee attempted to shift the burden to Moreno to show his use of his borrowings. Objection at ¶ 36.[21] Defendants' objection completely misses the mark and ignores the evidence adduced at trial.

First, there is substantial evidence in the record that supports the Bankruptcy Court's finding that $10 million of the loan from Goldman was intended to be used to satisfy MOR MGH's obligation under the 2013 SPA. In a June 25, 2013 e-mail, Moreno's attorney, Frank Slavich, expressly acknowledged that "$10,000,000 of the funds are being used to purchase additional preferred shares in GFES." PX 160 [APP 0776]. The 2013 SPA itself specifically provided that it was "in connection with a borrowing from Goldman Sachs." PX 162 [APP 0779]. It also defies logic to interpret the requirement (imposed by Goldman) that Moreno provide a written certification to Goldman that the stock had been purchased under the 2013 SPA if it was not a requirement to closing on the Goldman loan. PX 165 [APP 0789-0794]. And of course, Moreno never testified to that fact. Indeed, he testified to just the opposite, admitting that the 2013 SPA was required by Goldman. Trial Tr. 397:20-398:3 [APP 1121].[22] Moreover, the fact that the 2013 SPA was a closing condition of the loan is manifest in section 5.15 of the July loan document itself. Section 5.15 provides: "The Borrowers shall cooperate in good faith to perform any action ... as may be reasonably requested by the Lender in connection with pledging additional collateral to the Lender, including, without limitation, shares of stock in Green Field Energy, Inc." PX 166 at § 5.15 [APP 0823]. Additionally, there is evidence in the record that GFES expected to receive the $10 million due under the 2013 SPA, but it was never received. In October 2013, when Moreno's (and GFES') attorney Slavich inquired as to whether Moreno had caused GFES to receive the $10 million due under the 2013 SPA, Moreno told Slavich that MOR DOH, not GFES, received the money. PX 183 [APP 2356].[23] GFES' CFO Blackwell also stated that GFES never received the $10 million due under the 2013 SPA. Trial Tr. 408:4-410:18 [APP 1124]; Blackwell Dep. 68:3-15, 74:5-75:15 [APP 2377, 2379]; PX 187 [APP 2358].

***104** Although Defendants did not elicit testimony at trial, they now point to a "Notice of Borrowing" that was attached to the July Goldman loan to "prove" that $10M of the Goldman loan proceeds were not earmarked for GFES. Objection at ¶ 39. The Notice of Borrowing says no such thing and the failure to elicit Moreno's testimony on the topic at trial punctuates that his argument is mere afterthought. Moreover, even if the purpose of the July loan specified in the Notice of Borrowing was to make an equity investment in TGS, the loan agreement also explicitly manifested the intent to require the purchase of GFES stock to be used as collateral to Goldman. PX 166 at § 5.15 [APP 0823]. Combined with the other evidence described above, it is clear that the intention, and requirement by Goldman, was for $10 million to be used by MOR MGH to purchase $10M in preferred stock which in turn would be pledged as collateral to secure its loan to Moreno.[24]

Defendants next argue that the finding that Moreno lied to Goldman Sachs requires evidence that Goldman relied on Moreno's representation. Objection at ¶ 40. No such evidence is required to support the Trustee's tortious interference claim against Moreno relating to the 2013 SPA. The Trustee was required to show Moreno's self-interested conduct in connection with the 2013 SPA that put his own interests ahead and to the detriment of GFES and MOR MGH. In connection with that agreement, Moreno provided a written certification to Goldman which he signed not only on behalf of MOR MGH, but also on behalf of GFES, that falsely stated that MOR MGH had made the required stock purchase under the 2013 SPA. Opinion at pp. 28-29 [APP 0029-0030] (citing Trial Tr. 404:17-20 [APP 1123]). There can be no colorable dispute that the stock was never purchased and GFES never received the $10M it needed. Moreno lied to Goldman and concealed the lie from GFES. In any event, if it was relevant, the Court could infer that Goldman relied on Moreno's false certification because they required it in connection with the loan and they did, in fact, ultimately loan the money. Thus, the Bankruptcy Court's finding that Moreno lied in connection with the 2013 SPA, a requirement of the July Goldman loan,

in order to obtain $10 million that he would use to buy a home instead of purchasing GFES stock, is well founded.

Defendants also attempt to argue that Moreno intended for the stock to be purchased but his professionals did not account for it properly. First, Moreno testified at trial not that he *intended* that the payment be made, but rather that *it had in fact been made* but was simply not accounted for properly. Trial Tr. 403:11-405:23 [APP 1122-1123] ("The money was sent to TGS which sent the money to Green Field."). That argument has now been rejected by the Bankruptcy Court on multiple occasions based on substantial evidence contradicting that assertion. See D.I. 463 at p. 39 [APP 2096]. Now, Defendants are backtracking and attempt to argue that Moreno *intended* for the payment to have come from TGS. To the extent the Court even entertains this previously refuted argument, Moreno's self-serving testimony cannot be relied on, particularly given that he was demonstrated to have lied at trial. Opinion at p. 29 [APP 0030].

Defendants spend a considerable portion of their Objection arguing that the Trustee was required to prove that GFES held a "property interest" in the Goldman funds, and advocate that the District Court hold the Trustee to the requirements of earmarking in the context of the Bankruptcy Code. Objection at ¶¶ 41-53. Defendants completely misunderstand the Bankruptcy Court's findings. The Court found in favor of the Trustee on his contractual claims - breach of contract and tortious interference. The elements to those claims under New York law are well-settled (and not objected to by Defendants). The Bankruptcy Court's colloquial use of the term "earmark" to suggest that the purchase of $10 million of GFES stock under the 2013 SPA was a requirement of the July Goldman loan does not impose any additional legal requirements on the Trustee. Defendants' extended discussion of the *Winstar* case is completely inapposite. *Winstar* analyzed the "earmarking doctrine" with respect to a preferential transfer claim under Section 547 of the Bankruptcy Code, which requires that a debtor have an "interest in property" that is fraudulently transferred. Shubert v. Lucent Techs. Inc. (In re Winstar Communs., Inc.), 554 F.3d 382, 400-01 (3d Cir. 2009) ("The earmarking doctrine is entirely a court-made interpretation of the statutory requirement that a voidable preference must involve a 'transfer of an interest of the debtor in property.' " (quoting McCuskey v. Nat'l Bank of Waterloo (In re Bohlen Enters., Ltd., 859 F.2d 561, 565 (8th Cir. 1988))). There is no such requirement of a property interest in the context of a breach of contract or tortious interference claim. The "earmarking" of the money was simply evidence that Moreno, in his capacity as CEO of GFES, used the purchase of preferred stock to induce Goldman to advance additional funds to him. To memorialize the promise to Goldman, Moreno produced a contract between GFES and MOR MGH (i.e., the 2013 SPA). Once Goldman agreed to advance the funds, Moreno lied about the use of those funds to Goldman and, instead, caused MOR MGH to breach the 2013 SPA by failing to purchase the preferred stock, secretly siphoned the money off, and used it to purchase his personal residence.

***105** Defendants object to the extent that the Bankruptcy Court "incorrectly shifted the burden on Moreno to account for the use of third-party loan proceeds that were never specifically earmarked for Green Field." Objection at ¶ 51. This is both wrong and irrelevant. Again, as explained above, $10 million of the July Goldman loan was earmarked for GFES. In any event, nowhere did the Bankruptcy Court shift the burden to Moreno. The Trustee demonstrated at trial that Moreno borrowed $85 million. Opinion at p. 111 [APP 0112]. The court then relied on affirmative evidence, both in the form of trial testimony and exhibits proffered by Defendants, that purportedly recorded *all* of the money Moreno channeled through GFES, which totaled approximately $48 million. See Opinion at p. 112 [APP 0113] (citing JX 3 [APP 0436]; DX 221 [APP 0627]; Trial Tr. 844:11-846:10 [APP 1321-1322]). Based on the above, the court was able to reasonably conclude that $37 million was borrowed by Moreno yet not used to satisfy MOR MGH's obligations under the SPAs, nor to otherwise benefit either TGS or GFES. If Defendants had evidence to refute the affirmative evidence presented by the Trustee, they have had ample opportunity to do so.

Defendants argue that the Bankruptcy Court's finding that "no monies went into Green Field other than in fair market value transactions ... or as deposits required to be held in trust" is inconsistent with its findings related to the PowerGen claims. Objection at ¶ 55. Again, the facts related to the PowerGen claims are totally unrelated to Moreno's interference with the SPAs. As explained above, the Court expressly acknowledged in its findings on tortious interference that approximately $48 million of the $85 million that Moreno borrowed resulted in some ancillary benefit to GFES. Regardless of the nature of those transactions, they did not absolve Moreno from his bad faith, self-interested conduct with respect to the SPAs, which, as Moreno conceded, were obligations entirely independent of any benefits provided to GFES through TGS. Opinion at p. 118 [APP 0119] (citing Trial Tr. 468:9-469:12, 846:11-22 [APP 1134-1135, 1322]).

Defendants argue that Goldman Sachs, and not GFES, was harmed by Moreno's conduct, Objection at ¶ 57-58, but Defendants once again misconstrue the Bankruptcy Court's holding. The court did not hold that Moreno tortiously interfered with his personal loan from Goldman. Rather, his fraudulent certification to Goldman was evidence of his bad faith in causing MOR MGH to breach its obligations to GFES under the 2013 SPA for his own personal gain. As explained above, the 2013 SPA was a condition of the Goldman loan. Moreno used GFES to obtain funds from Goldman and then diverted that money from GFES for his personal benefit. GFES was damaged by Moreno's conduct because it did not receive the $10 million due under the 2013 SPA, which, as explained above, was contemplated by and related to the Goldman loan. Thus, the tortious interference claim does, in fact, belong to the Trustee.

Finally, Defendants argue that Moreno's general business conduct with respect to the PowerGen business is indicative of his good intent with respect to the SPAs. Objection at ¶ 59. This is both illogical and untrue. As the Court found, Moreno made the decision by the winter/spring 2013 that there was no hope for GFES in its fracking business; that the only potential was in power generation, and that all his efforts would be focused there. Opinion at pp. 22-24 [APP 0023-0025]. He thus created TGS and placed the PowerGen business there. Opinion at pp. 21-22 [APP 0022-0023]; JX 61 [APP 0597-0599]. Thereafter he focused his efforts on negotiating with GE and borrowing money from GE, Goldman and PowerMaster, all of which was meant to benefit TGS and aid the development of PowerGen. Opinion at p. 111 [APP 0112] (citing Trial Tr. 843:7-844:19 [APP 1321]). The fact that in the process of so doing, Moreno orchestrated a transaction for the direct benefit of TGS (i.e., purchase of turbine inventory from GFES) that resulted in ancillary benefit to GFES (i.e., profit derived from those sales) does not compel a conclusion that Moreno did not simultaneously interfere with the SPA contracts. The facts adduced at trial, as found by the Court, showed that Moreno ceased fulfilling the SPA obligations immediately after the transfer of PowerGen to TGS because the SPA monies were solely for the benefit of GFES and its fracking business, rather than TGS and its PowerGen business. Opinion at pp. 25-26 [APP 0026-0027]. Moreover, just because Moreno's actions with respect to the PowerGen business were found to have been non-actionable, that does not absolve a defendant from bad faith conduct in a totally different context. The Bankruptcy Court found sufficient evidence to conclude that Moreno tortiously interfered with the SPAs for his own personal gain, notwithstanding any other actions he took that may have incidentally benefitted GFES. Again, the Bankruptcy Court already expressly rejected the notion that certain transactions that provided liquidity to GFES negated Moreno's tortious interference with the SPAs.

D. Moreno's Actions with Respect to the SPAs were Not Intended to Help GFES.

***106** Defendants object to the Court's finding that "Moreno orchestrated Green Field's waiver of the PowerGen Business in favor of himself personally." Objection at ¶¶ 15-16. Again, this fact is only relevant to the SPA claims for the purpose of demonstrating that, as Defendants admit in the Objection, following execution of the Written Consent on May 13, 2013, the PowerGen business was pursued "outside of Green Field." Objection at ¶ 16; JX 61 [APP 0597-0599]. By the Written Consent's very terms, GFES "waived" the opportunity to have an interest in PowerGen. JX 61 [APP 0597]. While Moreno engaged in transactions in support of the PowerGen business outside of GFES and in which GFES had no ownership interest, he neglected the obligations of MOR MGH under the SPAs that would directly benefit GFES. The fact that GFES may have received some *ancillary* benefits from the pursuit of the PowerGen business in TGS is irrelevant to the SPA claims, which would have provided *direct* benefits to GFES.

E. Moreno Shifted His Focus to PowerGen

Defendants take issue with the Bankruptcy Court's finding that "Green Field was transitioning into the power generation market and negotiating with GE," even though they characterize this fact as immaterial. Objection at ¶ 33. What is undisputed is that in late 2012 and early 2013, Moreno began to explore the possibility of pivoting from fracking services to PowerGen. Opinion at pp. 22-24 [APP 0023-0025]. The relevance of this fact is that, at the time that PowerGen could conceivably still have been pursued with GFES, Moreno continued to honor the requirements of the 2012 SPA. Opinion at p. 25 [APP 0026]. However, once Moreno decided that his only option to pursue the PowerGen business was with GE, and he would have to do so outside of GFES, Opinion at pp. 21-22 [APP 0022-0023], he repudiated MOR MGH's obligations to GFES under the SPAs. Opinion at pp. 25-26 [APP 0026-0027]. Again, as the Bankruptcy Court observed, the first breach of the 2012 SPA took place just two days after execution of the Written Consent that waived the PowerGen opportunity and allowed Moreno to pursue it outside of GFES. Opinion at pp. 25-26, 35 [APP 0026-0027, 0036]. The Bankruptcy Court properly found that this was suggestive

of Moreno's malicious intent in causing the breaches of the SPAs. Opinion at pp. 116-17 [APP 0117-0118].

Accordingly, none of Defendants' objections to the Bankruptcy Court's findings of fact are persuasive and the District Court should accept all of the Bankruptcy Court's findings.

III. The District Court Should Accept the Bankruptcy Court's Conclusions of Law Relating to the Constructive Trust

Defendants also raise a host of legal arguments in an attempt to derail the Court's imposition of a constructive trust.[25] However, the Court's legal application was sound and entirely consistent with applicable law, and therefore should be accepted by the District Court.[26] As a preliminary matter, Defendants' objection makes no sense because, on the one hand, they complain that the Bankruptcy Court should have applied Delaware law instead of New York law and on the other, they argue that the Trustee failed to satisfy New York law. See generally Objection at Section II.C. The Court did, in fact, apply Delaware law and found that the Trustee had satisfied his burden of proof.[27] Nowhere in the Opinion does the Court rely on New York constructive trust law.[28] See Opinion at pp. 120-121 [APP 0121-0122].

***107** Tellingly, Defendants have not objected to any case law applied by the Bankruptcy Court in its Opinion. The Court found that "[u]nder Delaware law, 'a constructive trust is an equitable remedy of great flexibility and generality. A constructive trust is proper when a defendant's fraudulent, unfair or unconscionable conduct causes him to be unjustly enriched at the expense of another to whom he owed some duty.' " Opinion at pp. 120-21 [APP 0121-0122] (citing Ruggerio v. Estate of Poppiti, No. CIV.A. 18961-NC, 2005 WL 517967, at *3 (Del. Ch. Feb. 23, 2005)). "To prevail on a claim for unjust enrichment or imposition of a constructive trust, the Trustee must allege sufficient facts to plausibly show that (i) there was an enrichment; (ii) an impoverishment; (iii) a relation between the enrichment and the impoverishment; (iv) the absence of justification; and (v) the absence of a remedy provided by law." Opinion at p. 121 [APP 0122] (citing In re Direct Response Media, Inc., 466 B.R. 626, 661 (Bankr. D. Del. 2012)). The Court properly applied this standard to its findings of fact and concluded:

> Moreno was enriched by using $10 million to buy a home, and Green Field was impoverished because it was deprived of $10 million of funding. The impoverishment is directly related to the enrichment, and there is no justification for Moreno's actions. Further, there is no adequate remedy at law to be able to recover the $10 million spent on the home.

Opinion at p. 123 [APP 0124].

Defendants first argue that the Court failed to apply a "clear and convincing" standard as required under Delaware law. Objection at ¶¶ 61-62. Again, the Court did apply Delaware law and found the Trustee to have satisfied his burden of proof. "The clear and convincing standard requires evidence that produces in the mind of the trier of fact an abiding conviction that the truth of the factual contentions is highly probable." Hudak v. Procek, 806 A.2d 140, 147 (Del. 2002); Padcom, Inc. v. NetMotion Wireless, Inc., 418 F.Supp.2d 589, 594 (D. Del. 2006) (same). There was clear and convincing evidence that Moreno was enriched because he stole $10 million to purchase his home; GFES was impoverished because it was deprived of $10 million of funding stolen by Moreno; the stolen funding from the SPAs was directly related to the Goldman loan; Moreno was not justified in stealing the money to buy his home instead of causing MOR MGH to make the $10M payment required by the 2013 SPA; and Moreno did not keep the money in recoverable form, but rather used it to purchase his home and then recorded a homestead declaration, rendering a money damage award for that amount inadequate.[29] As explained above, Moreno's own testimony in conjunction with the documentary evidence was sufficient for the Court to conclude that these facts are highly probable. In particular, Moreno's initial denial that he used the funds earmarked to satisfy MOR MGH's obligation under the 2013 SPA to instead purchase his home, and then his reversal of that statement in the face of documentary evidence, permits the District Court to make such a strong inference. Opinion at pp. 29, 119 [APP 0030, 0120]. Not surprisingly, the United States Supreme Court has expressly and repeatedly held that a party's dishonesty permits an inference of guilt. See Reeves v. Sanderson Plumbing Prod., Inc., 530 U.S. 133, 147, 120 S.Ct. 2097, 147 L.Ed.2d 105 (2000) ("In appropriate circumstances, the trier of fact can reasonably infer from the falsity of the explanation that the employer is dissembling to cover up a discriminatory purpose. Such an inference is consistent with the general principle of evidence law that the factfinder is entitled to consider a party's dishonesty about a material fact as 'affirmative evidence of guilt.' "). Accordingly, the Court did not ignore the applicable standard, but rather found that the Trustee had satisfied it.

***108** Next, Defendants appear to contend that a tortious interference with contract claim is not a "recognized cause of action" in Delaware, and therefore a constructive trust cannot be imposed as a remedy for that cause of action. Objection at ¶¶ 63-64. However, despite Defendants' contention that no such case law exists, Objection at ¶ 64, Delaware courts have awarded constructive trusts in the context of contract-based claims. See, e.g., ID Biomedical Corp. v. TM Techs., Inc., No. 13269, 1995 WL 130743, at *17 (Del. Ch. Mar. 16, 1995) ("TM possesses property rights in the patent applications through a licensing agreement with SUNY. These powers include the power to use the 'invention' and grant sublicenses. TM acquired these rights through deception and a breach of the Letter Agreement. Therefore, IDB is entitled to a constructive trust over these property rights."); see also Grunstein v. Silva, No. CIV.A. 3932-VCN, 2009 WL 4698541, at *7 (Del. Ch. Dec. 8, 2009) (dismissing breach of fiduciary duty claim in part because "the remedies available for the breach of the Partnership Agreement claim would seem to encompass the remedies sought for the breach of fiduciary duty claim, an accounting and the imposition of a constructive trust"). Defendants suggest that the "recognized causes of action" listed in Teachers Ret. Sys. v. Aidinoff, 900 A.2d 654, 670-71 (Del. Ch. 2006), is an exhaustive list of the only causes of action capable of giving rise to a constructive trust, namely unjust enrichment, fraud, and breach of fiduciary duty. That argument is simply wrong. In Teachers, the court was merely making the point that some type of liability had to be established against a defendant in order to impose a constructive trust; it was not purporting to limit the remedy to specific causes of action. Id. ("As Starr rightly points out, this court cannot impose the remedy of a constructive trust against a party unless that party is properly subject to an order of relief under a recognized cause of action. *Because the complaint does not attempt, by its own terms, to formulate the basis for a cause of action against Starr*, Starr argues that the complaint against it must be dismissed.") (emphasis added); see also Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 991 (Del. Ch. 2000) ("A constructive trust is simply one of many conceivable alternative remedies which might be available after trial should plaintiffs prevail on one or more of their theories of recovery."). In any event, those claims specifically identified by the court were all torts, much like the Trustee's *tortious* interference claim for which the Bankruptcy Court granted the constructive trust remedy.

Defendants next argue that "the Bankruptcy Court's application of the law was erroneous because the Trustee already had an adequate remedy at law." Objection at ¶ 65. This is clearly wrong. First, Defendants rely on New York cases for the proposition that a constructive trust cannot be imposed when a contract exists. Objection at ¶¶ 65, 67. Again, this is truly bizarre as Defendants began their argument by admonishing the Bankruptcy Court for applying New York law when it didn't, and now turn around and rely on New York law for imposing an element not found in Delaware law. As explained above, the Bankruptcy Court properly applied Delaware constructive trust law, which permits the imposition of constructive trusts relating to contract-based claims. See, e.g., ID Biomedical Corp., 1995 WL 130743, at *17; Grunstein, 2009 WL 4698541, at *7.

Further, the Court specifically held "there is no adequate remedy at law to be able to recover the $10 million spent on the home." Opinion at p. 123 [APP 0124]. The Court's imposition of a constructive trust is in the alternative to, rather than cumulative of, the money damage award under the Trustee's tortious interference claim. Accordingly, if Moreno satisfies the judgment against him on the Trustee's contract claims, then the constructive trust would be rendered moot. The existence of an alternative remedy in the form of money damages is not automatically deemed "adequate." See, e.g., Frederickson v. Blumenthal, 271 Ill.App.3d 738, 208 Ill.Dec. 138, 648 N.E.2d 1060, 1062 (Ill. App. Ct. 1995) ("We fail to understand why the plaintiff in this case should be forced to jump through the hoops of collection and post-judgment proceedings only to discover that defendant had withdrawn the funds from the account.... The question to be determined is whether the remedy at law compares favorably with the remedy afforded by the equity court."). This is particularly true where, as is the case here, the court is able to trace the specific funds to specific property. Pell v. E.I. DuPont de Nemours & Co. Inc., 539 F.3d 292, 309 (3d Cir. 2008) ("[A] plaintiff [may] seek restitution *in equity,* ordinarily in the form of a constructive trust or an equitable lien, where money or property identified as belonging in good conscience to the plaintiff [can] clearly be traced to particular funds or property in the defendant's possession."). As explained above, Moreno expressly admitted that he spent the specific $10 million due to GFES under the 2013 SPA specifically on his Dallas residence (and then recorded a homestead declaration), which was corroborated by documentary evidence. This is sufficient to justify imposition of a constructive trust.

***109** Defendants nonetheless continue to argue that the Trustee has not sufficiently traced the funds to Moreno's Dallas home. Objection at ¶¶ 76-80. Again, a truly remarkable argument. Moreno admitted the use. How much more

traceable does it get? As explained above, there was sufficient evidence in the record for the Court to reasonably conclude that the specific funds to be used to satisfy the 2013 SPA were instead used to purchase Moreno's Dallas residence. Trial Tr. 416:15-19 [APP 1126] ("And so what simply happened here, Jim, is the second tranche, I elected to repay myself loans that I had made, and used then [sic] for the purchase of a home in Dallas."). The Court observed that Moreno initially attempted to lie about how he used the funds, but then later admitted it when confronted by the evidence in the record. Opinion at p. 29 [APP 0030] (citing Trial Tr. 411:24-420:12 [APP 1124-1127]; PX 168 [APP 0875]). Again, the United States Supreme Court has held that a party's dishonesty permits an inference of guilt. See Reeves, 530 U.S. at 147, 120 S.Ct. 2097. Moreover, Moreno's admission is corroborated by the documentary evidence presented at trial from his estate planning professionals. PX 168 (Moreno's estate planning professionals identifying two options for use of the July Goldman funds; the first "gets Mike the money used to purchase the Dallas house"; the second "is distributed to Mike to purchase the Dallas house."). Additionally, as explained above, there was substantial evidence that the intent of the July loan was for $10M to be used to purchase GFES stock through MOR MGH, as required by Goldman, and thus those were the specific funds used to purchase the residence. The Bankruptcy Court's findings were supported by the record.

Accordingly, the Bankruptcy Court's legal conclusions are supported by applicable law and should be adopted by the District Court.

CONCLUSION

The District Court should accept the Bankruptcy Court's Proposed Findings of Fact and Conclusions of law and enter judgment in favor of the Trustee on his breach of contract and tortious interference with contract claims in accordance with the Bankruptcy Court's Order [D.I. 540] [APP 0129-0131], and any other relief the District Court deems just and proper.

REPLY BRIEF IN SUPPORT OF THE LIMITED OBJECTION UNDER FEDERAL RULE OF BANKRUPTCY PROCEDURE 9033 OF DEFENDANTS MICHEL B. MORENO AND MOR MGH HOLDINGS, LLC TO THE PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW SET FORTH IN THE BANKRUPTCY COURT'S OPINION (D.I. 535) AND ORDER (D.I. 540)

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Defendants Michel B. Moreno ("Moreno") and MOR MGH Holdings, LLC ("MGH Holdings") (collectively the "Movants" or "Defendants"),[1] file this reply (the "Reply"), in support for their Limited Objection (the "Objection") pursuant to Federal Rule of Bankruptcy Procedure 9033 to the *Opinion and Findings of Fact and Conclusions of Law* (D.I. 535) [APP 0001-127] (the "Opinion")[2] and corresponding Order (D.I. 540) [APP 0128- 131] (the "Order"). In support of the Limited Objection, the Defendants respectfully show as follows:

I. SUMMARY

***111** 1. The Bankruptcy Court considered three broad categories of claims at trial: (i) the PowerGen claims, (ii) the stock purchase agreement claims (the "SPA claims"), and (iii) preferential transfer claims against other defendants,

which the Trustee sought to recover from Moreno personally.[3] The Opinion narrates the events of 2012 and 2013 without differentiating findings between these categories of claims. It is telling that the Trustee, confronted with the incongruousness of particular recommended rulings with the fact findings made, now alters its own trial narrative by arguing that the facts relating to each category of claims are somehow distinct, though admittedly parallel.

2. Throughout the past 40 months of litigation, the Trustee has consistently tied all of Moreno's conduct together, regardless of its connection to the SPAs or the PowerGen opportunity. Only now, after the Bankruptcy Court has ruled in Moreno's favor on the core PowerGen claims, does the Trustee argue that the PowerGen claims and SPA claims are "two conceptually separate claims ... arising from two discrete, yet parallel factual patterns."[4]

3. This new narrative is belied by the evidentiary record and the Bankruptcy Court's Opinion. The PowerGen concept, like the SPAs, was a means for Moreno to provide a new source of liquidity for Green Field, such that one avenue cannot be explored without a complete understanding of the other.[5] For example, the Goldman Sachs loan documents relied upon by the Bankruptcy Court as evidence of Moreno's tortious interference with MOR MGH's SPA obligations expressly contemplated capital infusions into Turbine Generation Services, LLC ("TGS"), the entity Moreno established to hold the PowerGen business and pursue a new joint venture with GE Oil & Gas, LLC.[6] To consider Moreno's acts and omissions with respect to the SPAs in a vacuum, without considering the Bankruptcy Court's detailed findings regarding Moreno's efforts to raise capital for Green Field through the PowerGen opportunity, is to completely ignore critical portions of the evidentiary record and the Bankruptcy Court's Opinion on both core and related non-core claims.

4. Because the Bankruptcy Court's findings and conclusions on the SPA claims (Counts 11, 12 and 14) either contradict the Bankruptcy Court's findings on the PowerGen claims or are unsupported by the great weight of evidence presented, the Defendants filed the Objection.[7] The Objection and its supporting brief detail the contradictions. Without repeating the arguments already raised in the Objection and supporting brief, the objectionable portions of the Bankruptcy Court's Opinion can be summarized as follows:

***112** (i) Contractual Damages. Before trial, in denying the Trustee's summary judgment motion, the Bankruptcy Court held that "the damages will be ascertained from an analysis of the economic condition of GFES as an entirety at the time of the non-payments."[8] After trial, the Bankruptcy Court explained on the one hand, that Moreno obtained nearly $50 million of new capital for Green Field through the PowerGen opportunity by borrowing money from GE and other third parties, and that those funds allowed Green Field to pay $17 million in semi-annual interest to bond holders and catch up on outstanding trade debt. On the other hand, the Bankruptcy Court noted Green Field's failure to pay $6 million in interest to Shell, but failed to take into account Moreno's testimony that Green Field would not have made those payments, whether it had the SPA funding or not, because Shell was terminating its customer relationship with Green Field. The evidence of Green Field's "economic condition," as an entirety, does not support damages to Green Field of nearly $17 million and, thus, must be rejected by this Court.

(ii) Misinterpretation of Goldman Sachs Loans. The Opinion, as echoed by the Trustee in its Response, misconstrues the Goldman Sachs loans and related evidence. Review of the loan documents and related evidence reveals no factual or legal support for an "earmarking" conclusion, nor is there a basis to find or conclude that Moreno lied and diverted funds away from Green Field.[9]

(iii) Moreno's Liability Under the SPAs. The Bankruptcy Court proposed findings and conclusions on tortious interference. To reach those conclusions, the Bankruptcy Court proposed findings of Moreno's malicious intent and quest for personal gain. However, the Bankruptcy Court first found and concluded that Moreno was transparent in his dealings with creditors and board members, committed no breaches of fiduciary duty, and did not cause Green Field to fraudulently transfer anything either to Moreno or for his benefit.[10] Indeed, the Bankruptcy Court held that Moreno's efforts on PowerGen provided for $50 million in liquidity to Green Field that allowed Green Field to honor its obligations to bondholders and trade creditors.[11] No one objected to these findings. It is impossible to conceive a scenario where Moreno was so transparent with his creditors and board members and received nothing by

transfer, while simultaneously intending to harm Green Field by causing MOR MGH to withhold funding in furtherance of Moreno's personal gain. Where the Opinion is inconsistent with the unopposed findings and conclusions, this Court should reject contradictory proposed findings and conclusions. On this evidentiary record, the proposed findings of malicious intent and self-interest cannot be squared with the rest of the Bankruptcy Court's unopposed Opinion and, as such, must be rejected.

(iv) Proposed Imposition of a Constructive Trust. The Objection also raised a number of grounds to reject the proposed imposition of a constructive trust. Those reasons are detailed in the Objection and supporting brief, and are explained further below.

(v) Other Inconsistent Findings. In addition to the foregoing, the Objection specified miscellaneous proposed findings and conclusions that appear to have been included in the Opinion inadvertently. For example, one proposed finding indicates that Green Field was transitioning into the power generation market, but the uncontroverted testimony from Green Field's former President was that Green Field never actually went into this line of business. Similarly, the Opinion includes findings that Moreno "orchestrated" a waiver of the PowerGen business for his own benefit, but the Bankruptcy Court found and concluded that Green Field never even obtained an interest in the PowerGen business, and that Moreno only entertained the opportunity as a means to obtain liquidity for Green Field. These and other similar proposed findings should be rejected as inconsistent with the record and the other unopposed portions of the Opinion.

***113** 5. Based on the record and the arguments presented through the Objection, this Court should reject the Bankruptcy Court's inconsistent proposed findings and conclusions relating to Counts 11, 12 and 14, and enter findings and conclusions consistent with the rest of the Bankruptcy Court's 126 page Opinion. Such a ruling would result in a final judgment in favor of the Defendants.

II. ARGUMENTS AND AUTHORITIES

A. Legal Standard

6. As a procedural matter, the Trustee has not objected to any portion of the Opinion, and the Defendants have only objected to the specific portions of the Opinion concerning Counts 11, 12, and 14, as well as the proposed imposition of a constructive trust. In other words, there are no objections to the portions of the Opinion where the Bankruptcy Court found in favor of the Defendants on the PowerGen claims and preferential transfer claims, nor has the Trustee appealed those core findings.[12]

7. The analysis is different for the proposed findings entered in connection with the non-core Counts 11, 12 and 14. As discussed in the Defendants' Rule 9033 Objection and supporting brief, this Court must consider the entire Opinion, while giving the Bankruptcy Court's proposed findings and conclusions on Counts 11, 12 and 14 **no presumption of validity**. *In re Kaiser Aluminum Corp.,* 343 B.R. 88, 93 (D. Del. 2006); *see also In re Montgomery Ward & Co.*, 2004 U.S. Dist. LEXIS 2330, 2004 WL 323095, at *1 (D. Del. Feb. 13, 2004), *rev'd on other grounds*, 428 F.3d 154 (3d Cir. 2005). Much of the Trustee's Response to the Defendants' Objection recites the Bankruptcy Court's Opinion and the evidentiary record relied upon in the objectionable portions of the Opinion. The Trustee did nothing to reconcile the Opinion or the additional evidence cited in the Objection and supporting brief. Instead, the Trustee now argues that the fact patterns between the PowerGen claims and the SPA claims are distinct, implying that no such reconciliation is needed. This is both inaccurate and unpersuasive. Considering the Bankruptcy Court's Opinion, as a whole, this Court must reject the proposed findings and conclusions that contradict the portions of the Opinion that are not subject to an appeal or objection.

B. This Court Must Reject the Proposed Findings and Conclusions on Damages.

8. In their Objection, the Defendants raise several issues with the Bankruptcy Court's reasoning for proposing findings and conclusions of damages in excess of $16 million. Before trial, the parties filed cross motions for summary judgment. In the Bankruptcy Court's summary judgment ruling on the breach of contract claims, the Court explained:

> Here, the formation of the SPAs and performance by GFES are uncontested, so the Court's analysis focuses on Defendants' failure to perform and any resulting damages.
>
> ....
>
> The Trustee's breach of contract claims are founded upon the failure of GFES to receive the payments promised in the

> SPAs. **Missing from the argument, however, is how the failure to pay affected GFES's economic position.** The Trustee points out that Defendants' argument regarding Moreno's additional personal contributions outside the SPAs may be misstated, with many of those contributions not being "personal" at all, but instead requirements under the Tri-Party Agreement or the 2012 SPA. At this stage in the proceeding, the Court is unsure of how funneling the monies used for the Tri-Party Agreement to pay the SPAs would have otherwise benefitted GFES. From facts cited by each party, it is clear that in 2012 the fracking industry began to deteriorate, causing GFES to face substantial difficulties and to seek additional funding through the SPAs to provide the company with much needed liquidity. This pattern continued after the SPAs were signed (and even breached). **During GFES's effort to achieve liquidity, Moreno, wearing several hats for several different entities, sought funding in different ways**. The Court is unsure what the consequences would have been had MOR MGH and MMR satisfied the SPAs. **If, for example, MOR MGH and MMR satisfied the 2012 SPA, would GFES have been better off, or would the company have nevertheless been harmed by those monies being drawn from another related entity such as TPT**?
>
> ***114** The corporate structure of GFES and its interplay with Defendants is complicated. While the Court agrees with the Trustee that certain monies were not paid as required by the SPAs, **the Trustee has not presented enough evidence to show that awarding damages would make GFES whole.**

Opinion [D.I. 463], at 36-37 & 40-41 (emphasis added). Thus, the Bankruptcy Court denied summary judgment because the Trustee had presented no summary judgment evidence of "GFES's economic position" and how it was impacted by the SPA breaches.

9. The Trustee sought reconsideration of the summary judgment ruling. In a separate opinion, the Bankruptcy Court declined to reconsider its ruling, explaining further:

> The Trustee argues in the Motion that under New York law, which is the applicable law, when a party breaches a contract by failing to make a required payment, the non-payment is an "expectation damage" and the complaining party "is entitled to recover the unpaid amount due under the contract plus interest." *House of Diamonds v. Borgioni,* LLC, 737 F. Supp. 162, 172 (S.D.N.Y. 2017). The Trustee cites numerous cases which he argues hold that if "the breach of contract was a failure to pay money, the plaintiff is entitled to recover the unpaid amount due under the contract plus interest." *Winik Media LLC v. One Up Games, LLC,* 2017 WL 4539292, at * 3 (S.D.N.Y. 2017). The Trustee argues that because he is seeking direct damages only, he is entitled to the damages of $15,961,923, plus prejudgment interest of $6,612,941.36 which increases by $3,935.82 per day. The Trustee asserts confidently that because he seeks damages based upon the unpaid amount, he needs no further proof. The proof, says the Trustee, "begins and ends with establishing failure to pay in accordance with the terms of the contract." Reply Memorandum at 4 (D.I. 469).
>
> ....
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> The cases the Trustee cites in support of the Motion are just not persuasive. The Court does not read *Scavenger, Inc. v. GT Interactive Software Corp.,* 289 A.D. 2d 58, 734 N.Y.S.2d 141 (N.Y. App. Div. 2001) to establish automatic liability for a party that does not pay money and thereby breaches a contract. The Scavenger court, on appeal, addressed the amount of damages and whether additional damages were appropriate. The Scavenger court did not address the causation of damages. The Trustee's citation of *Winik Media* is also not convincing of the Trustee's argument. *Winik Media* stands for the proposition that a breach of contract claim requires proof of damages. **Here, the damages will be ascertained from an analysis of the economic condition of GFES as an entirety at the time of the non-payments. The question remains whether the breach of the 2012 SPA and 2013 SPA damaged GFES**. *Winik Media* also provides that a plaintiff must prove its damages with evidence, and that the plaintiff is entitled to damages that will put it in the same economic position it would have been if there had not been a breach of contract. Id. at *2-3. Whether GFES was or was not in the "same economic position" that it would have been without the breach of contract is an issue that remains for trial.

Memorandum Order on Trustee's Motion for Reconsideration [D.I. 473], at 2-4 (emphasis added).[13]

***115** 10. Based on these rulings before trial, Defendants were prepared to present evidence regarding Green Field's economic condition, and to explain why the SPA non-payments did not actually harm Green Field under the circumstances. At trial, however, the Trustee chose not to present any new evidence other than stipulated facts. The parties stipulated that Green Field did not make three interest payments to Shell of $2 million each in June, July, and August of 2013. [APP 0205] (Stip. Fact ¶ 79). The parties also

stipulated that the non-payment under the 2012 SPA required public notification to bondholders under the indenture, and that such public notification triggered a cross-default with Shell. [APP 0205] (Stip. Fact ¶ 83). The parties also stipulated that Shell issued its notice of default months later on October 8, 2013. [APP 0205] (Stip. Fact ¶ 84). Finally, the parties stipulated that the cross-defaults resulted in a downgrading to Green Field's bond credit rating. [APP 0205] (Stip. Fact ¶ 83).[14] None of this evidence was ever in dispute, even during the summary judgment phase of the litigation.

11. The Trustee presented these stipulated facts as the only evidence connecting the SPA defaults to Green Field's economic condition. Even though the Bankruptcy Court found this evidence to be unpersuasive before trial, the Bankruptcy Court's proposed findings on this point closely track those submitted by the Trustee,[15] and seem to ignore the Bankruptcy Court's rationale for denying summary judgment before trial based on the same evidence. As detailed in the Objection, however, the Opinion notably omits the critical evidence that demonstrates why the lack of funding under SPAs was not the cause for any "downward spiral" in Green Field's economic condition. Not only did this portion of the Bankruptcy Court's Opinion fail to explain how the receipt of $50 million from TGS may or may not have helped Green Field's economic condition during this period, but the Opinion completely omits Moreno's uncontroverted testimony at trial that Green Field would not have made those payments to Shell whether it had funding under the SPAs or not.[16] In other words, Green Field did not default to Shell as a result of the MOR MGH's non-payment under the SPAs. Rather, Green Field decided not to make the $2 million monthly interest payments to Shell because Shell intended to terminate its customer relationship with Green Field, causing a critical loss to future revenues for a company already struggling to maintain levels of liquidity. The Trustee did nothing to controvert this evidence, nor did the Trustee offer any other evidence of harm caused by the non-payment under the SPAs.

12. Defendants object to the proposed damage findings and conclusions in the Opinion because they fail to follow the Bankruptcy Court's own correct formula for assessing damages. Through its summary judgment opinions, quoted above, the Bankruptcy Court held that damages would be "ascertained from an analysis of the economic condition of [Green Field] as an entirety at the time of the non-payments." Because the Bankruptcy Court's analysis includes only $6 million in potential damages and omits highly relevant evidence about Green Field's economic condition that contradicts any correlation between the SPA non-payments and the Shell interest defaults, the Bankruptcy Court's damage analysis is flawed and cannot be accepted. This Court should reject the Bankruptcy Court's calculation of damages and conclude, as the Bankruptcy Court did before trial, that the Trustee did not carry its burden of proof on contractual damages.

C. This Court Must Reject Unfounded Findings That Moreno Acted for Personal Gain.

***116** 13. After assessing damages for MOR MGH's breach of contract, the Bankruptcy Court's Opinion turned to whether Moreno could be held personally liable under a tortious interference theory. The Bankruptcy Court explained that, because Moreno was not a stranger to the SPAs, tortious interference required proof that the corporate officer "is acting with malice" and "for his personal gain, rather than the corporate interests." [APP 116-117] (Opinion, at 115-116) (citations omitted). The Bankruptcy Court explained that "malice" is proven by "showing that the defendant acted with the intent to procure personal gain." [APP 117] (Opinion, 116) (citation omitted).

14. The Bankruptcy Court's proposed conclusion that Moreno acted for personal gain is based on the following proposed findings set forth in the Opinion:

(i) MOR MGH was established to hold only stock in Green Field, and little or no cash;[17]

(ii) Moreno made the decision to stop complying with the SPA obligations as soon as he knew PowerGen would be developed outside of Green Field;[18]

(iii) Moreno knew that a breach of the SPA would mean an inability for Green Field to pay Shell, thereby triggering a default under the bond indenture;[19]

(iv) Of the $85 million that Moreno or other non-Green Field entities borrowed from third-party lenders, Moreno only contributed $50 million to Green Field (through TGS). Moreno either used the remaining $35 million for himself or could not account for the funds;[20] and

(v) Moreno signed a certification to Goldman Sachs that $10 million of the funds borrowed were used to purchase stock under the 2013 SPA.[21]

15. These proposed findings, when considered with the entirety of the Opinion, do not demonstrate that Moreno acted with malice or for his own personal gain. This is not a case where Moreno leveraged his ownership in Green Field to borrow $85 million for his personal gain. The truth was quite the opposite. As the Bankruptcy Court found, Moreno signed personal guarantees and levered his ownership or control of *other* entities to borrow money from Goldman Sachs, Powermeister, and GE so that he could use those funds in a manner that would benefit Green Field. [APP 0105] (Opinion, 104). Using the PowerGen opportunity, Moreno caused $50 million in new loan proceeds (which Moreno personally guaranteed) to be funded into Green Field at a critical time during the company's operations. Consistent with the Bankruptcy Court's other findings and conclusions that Moreno worked diligently to raise funds for Green Field through GE Oil & Gas and TGS, everything Moreno did during this period was aimed at ensuring Green Field's success. The record simply does not support a finding of malicious intent, given the extensive record presented regarding Moreno's transparency with bondholders, board members and other interested parties. For these reasons, this Court should reject the proposed findings of Moreno's malicious intent and its conclusions regarding liability for tortious interference.

D. This Court Should Reject the Proposed Imposition of a Constructive Trust.

***117** 16. In the Objection and supporting brief, the Defendants have already demonstrated why a constructive trust is unwarranted under applicable law and the present facts. Among other reasons for rejecting the proposed constructive trust, the Bankruptcy Court did not apply the proper "clear and convincing" standard applicable to equitable remedies such as constructive trusts. Moreover, tortious interference is not a cause of action that is recognized to warrant equitable remedies such as a constructive trust, because a money judgment is widely considered to be an adequate remedy at law for contract claims. Even if the Court determines that tortious interference could give rise to an equitable remedy, the evidentiary record is insufficient to carry the Trustee's burden on key elements for imposing a constructive trust, including the requirement to trace the proceeds to a definable *res*. The Objection stated several reasons for rejecting the constructive trust remedy. The following arguments are raised in the Objection and warrant additional discussion in light of the Response.

(i) The Imposition of a Constructive Trust on Texas Homestead Property Violates the Texas Constitution.

17. In Texas, "homesteads are favorites of the law," and courts generally give "a liberal construction to the constitutional and statutory provisions that protect homestead exemptions." *See In re Bradley,* 960 F.2d 502, 507 (5th Cir. 1992) (citing *Tolman v. Overstreet,* 590 S.W.2d 635, 637 (Tex.Civ.App. -- Tyler 1979, no writ); *Kunkel v. Kunkel,* 515 S.W.2d 941, 946 (Tex.Civ.App.—Amarillo 1974, writ ref'd n.r.e.); *Garrett v. Katz,* 23 S.W.2d 436, 438 (Tex.Civ.App.—Dallas 1929), *modified on other grounds,* 27 S.W.2d 373 (Tex.Civ.App—Dallas 1930, no writ)). Indeed, courts applying Texas law are duty-bound to uphold and enforce the Texas homestead laws, "even though in so doing we might unwittingly 'assist a dishonest debtor in wrongfully defeating his creditor.' " *In re Bradley,* 960 F.2d at 507 (quoting *Cocke v. Conquest,* 120 Tex. 43, 35 S.W.2d 673, 678 (1931)). At least one panel of the Fifth Circuit has gone so far as to call Texas homestead exemptions "sacrosanct." *See Border v. McDaniel (In re McDaniel),* 70 F.3d 841, 843 (5th Cir. 1995).

18. The only authority provided to support the imposition of a trust on exempt homestead property is provided in footnote 23 of the Opinion:

> The Court notes that the Texas homestead exemption does not preclude the imposition of a constructive trust on Moreno's home in Dallas. *See McMerty v. Herzog,* 661 F.2d 1184, 1186 (8th Cir. 1981) ("In this case, the wrongfully diverted funds can be traced to Lake Crystal. Because Lake Crystal is the product of the diverted property, the homestead exemption does not apply.").

[APP 0123] (Opinion, 122 n.23).[22]

19. Further review of that case reveals that *McMerty* did not specifically address Texas homestead property. Rather, it addressed exemptions under Minnesota state law. Texas law on homestead exemptions is broader.[23]

20. In Texas, there is very limited authority to impose constructive trusts or equitable liens on homesteads. In *Jordan v. Hagler*, 179 S.W.3d 217 (Tex. App.—Ft. Worth 2005), the Court refused to impose a constructive trust on homestead property, because the Court concluded that the plaintiff had other available remedies at law. In *Smith v. Green*, 243 S.W. 1006 (Tex App. 1922), the Court limited the constructive trust to a mere portion ($11,500.00) of the sale proceeds from

the homestead, and only after the Court traced the misused funds to improvements made on the defendant's existing homestead. The *Smith* Court explained that the constructive trust could not be imposed on the existing homestead or any proceeds from the original homestead. In *First State Bank of Ellinger v. Zelesky,* 262 S.W. 190 (Tex. Civ. App.—Galveston 1924, no writ), the Court found that the defendant used embezzled funds to purchase property which subsequently became homestead. Because the *Zelesky* Court could trace the embezzled funds to the original purchase price, the Court was willing to apply the constructive trust doctrine to treat the defendant as though he was never the true owner of the property. *see also Bransom v. Standard Hardware,* 874 S.W.2d 919 (Tex. Ct. App.—Fort Worth 1994) (noting the availability of evidence to trace the embezzled funds to the original purchase of the property).

***118** 21. But those cases are the exceptions to the general rule and distinguishable from the facts presented in this case. In general, if embezzled or misused funds are used to improve existing homestead property, pay off a loan on existing homestead property, or simply cannot be traced to the homestead in a meaningful way, courts in Texas are not willing to impose or enforce constructive trusts or equitable liens on exempt homestead property. *See, e.g., Curtis Sharp Custom Homes v. Glover,* 701 S.W. 24, 28 (Tex. Ct. App.—Dallas 1985) ("Therefore, we hold that the equitable lien imposed in the first lawsuit against the wife's undivided one-half interest in the previously acquired Glover family homestead may not be enforced because of the protection afforded the homestead by TEX. CONST. art. 16, § 50.").

22. In the present case, the Court assumed without deciding that Moreno purchased the residence in Dallas using nothing more than the $10 million loaned from Goldman Sachs. "A party seeking to impose a constructive trust has the initial burden of tracing funds to the specific property sought to be recovered." *Wilz v. Flournoy,* 228 S.W.3d 674, 676 (Tex. 2007) (citations omitted). The evidence presented at trial is insufficient to conclude that Moreno never acquired an interest in his homestead property. There was no evidence of the date that Moreno acquired the property, what pre-existing homestead property he may have sold prior to acquiring his new homestead property, or what additional funds he may have used at the time to purchase the property other than funds borrowed from Goldman Sachs. Moreover, even if the Court concludes that the evidence presented was sufficient to carry the Trustee's initial burden, Texas law merely shifts the burden on Moreno to show that he is entitled to homestead protections. *See id.* (quoting *Eaton v. Husted*, 141 Tex. 349, 172 S.W.2d 493, 498 (Tex. 1943). Because this remedy was never pleaded or briefed, Moreno has not had an opportunity to present affirmative evidence to controvert the Trustee's tracing evidence. Moreover, Moreno's spouse acquired an undivided community property interest in the same property and, under Texas law, is entitled to the same broad and liberally-construed exemptions. Given the extreme nature of the constructive trust remedy, and the extent to which Texas courts apply homestead exemptions liberally, this Court must reject the proposed imposition of a constructive trust based on the record presented.

(ii) The Trustee Never Pleaded Constructive Trust or a "Recognized Cause of Action" Warranting the Imposition of a Constructive Trust.

23. A constructive trust could not be imposed on Moreno's personal residence because the Trustee failed to plead a constructive trust at or before trial. A court cannot award a remedy not sought or argued during trial. And New York law is clear that the plaintiff must plead and meet the evidentiary burden at trial to obtain a constructive trust. *See Valvo v. Spitale*, 305 A.D.2d 668, 669, 761 N.Y.S.2d 236 (N.Y. App. Div. 2003) ("To warrant the imposition of a constructive trust, a plaintiff must plead and prove four essential elements."); *Doxey v. Glen Cove Cmty. Dev. Agency*, 2006 28 A.D.3d 511, 512, 813 N.Y.S.2d 743 (N.Y. App. Div.) (same); *Satler v. Merlis*, 252 A.D.2d 551, 551, 675 N.Y.S.2d 644 (N.Y. App. Div. 1998) (same). The Trustee not only failed to satisfy his evidentiary burden to establish a constructive trust, he failed to even plead the remedy in the first instance. Moreno thus never presented either argument or evidence on the constructive trust issue, because it was not a live issue during trial. The unfair surprise and prejudice Moreno has suffered by the imposition of an unrequested constructive trust is patent. For these reasons alone, the Court should reverse its decision to impose a constructive trust. But even if the Trustee had sought and pled a constructive trust, the Trustee nevertheless did not and cannot satisfy the elements necessary to establish a constructive trust.

(iii) Constructive Trusts Are Intended to Remedy Fraud, But Fraud Was Never Pleaded Nor Proven.

***119** 24. The constructive trust remedy also fails because the Bankruptcy Court made no specific finding of fraud, yet New

York "[c]ourts have uniformly held that a constructive trust is a 'fraud-rectifying' remedy rather than an 'intent-enforcing' one.' " *In re Lefton*, 160 A.D.2d 702, 553 N.Y.S.2d 783, 785 (App. Div. 1990) (citing *Binenfeld v Binenfeld*, 146 A.D.2d 663, 537 N.Y.S.2d 41, 42 (App. Div. 1989)); *see also Bankers Sec. Life Ins. Soc'y v. Shakerdge*, 49 N.Y.2d 939, 428 N.Y.S.2d 623, 406 N.E.2d 440 (N.Y. 1980) ("[C]onstructive trusts are fraud-rectifying rather than intent-rectifying remedies."). For instance, in *Binenfeld v. Binenfeld*, the court upheld the denial of the appellant's counterclaim for a constructive trust on the personal residence of his deceased mother. 146 A.D.2d 663, 537 N.Y.S.2d 41, 42 (App. Div. 1989). The court stated that "[i]n the instant case the appellant does not allege that his deceased mother perpetrated an actual or constructive fraud upon him." *Id.* at 42 (internal quotation marks omitted). Instead, the appellant's "basic position [was] that his mother intended to convey the house to him, but failed to do so." *Id.* The court noted that New York "[c]ourts have uniformly held that a constructive trust is a 'fraud-rectifying remedy rather than an 'intent-enforcing' one." *Id.* (quoting *Bankers Sec. Life Ins. Soc'y*, 49 N.Y.2d at 940, 428 N.Y.S.2d 623, 406 N.E.2d 440). Finally, the court concluded that "[a]lthough the facts may reveal a case of unrealized expectations, we may not, without more, fashion a constructive trust.... Decedent may well have had a moral obligation to give the property to [the appellant] but such an obligation is not enough to set a court in motion to compel the devolution of property in a certain way." *Id.* at 42-43 (internal quotation marks and citation omitted).

25. Here, the Trustee never made any specific allegation of Moreno's fraud, just as the appellant made no allegation of fraud against his deceased mother in *Binenfeld*. Indeed, the Trustee did not even plead fraud in relation to the SPAs or Goldman Sachs loan proceeds, nor did the Trustee present fraud as a contested issue of fact to be determined at trial. [APP 0207] (D.I. 474, Exhibit B-1).

26. In the Opinion, the Bankruptcy Court proposed findings of fraud based on Moreno's perceived misuse of loan proceeds from Goldman Sachs and an inaccurate certification to Goldman Sachs regarding the use of loan proceeds. [APP 123-124] (Opinion, pgs. 122-23). Specifically, the Court Opined that:

> Moreno then **lied to Goldman Sachs** about the stock purchase. Trial Tr. 403:11- 404:20; PX 165. Moreno signed the Goldman Sachs certification on behalf of both MOR MGH and Green Field, thus **concealing the fraud from Green Field**. PX 165. This is the type of **fraudulent, unfair and unconscionable conduct that justifies imposition of a constructive trust**. Moreno was enriched by using $10 million to buy a home, and Green Field was impoverished because it was deprived of $10 million of funding. The impoverishment is directly related to the enrichment, and there is no justification for Moreno's actions. Further, there is no adequate remedy at law to be able to recover the $10 million spent on the home.

[APP 124] (Opinion, pg. 123) (emphasis added).

27. The Second Amended Complaint contains no claims for fraud or unjust enrichment as they relate to the 2012 and 2013 SPAs. Likewise, the Trustee declined to present fraud or unfair conduct as a contested fact issue before trial.[24] As relevant to the SPA issues, the only fact issue concerning the tortious interference claim (Count 14) was "[w]hether Moreno was acting for his own personal gain when he caused MOR MGH and MMR to breach the 2012 and 2013 SPAs." [APP 0207] (D.I. 474, Exhibit B-1, Issue No. 9).[25] Nowhere in these Statement of Contested Issues of Fact or the Statement of Issues of Law to Be Addressed at Trial [APP 0211-213] (D.I. 474, Exhibit C), did the Trustee give Moreno notice that fraud, unconscionability or unjust enrichment would be presented to the Court at trial. Accordingly, the Court must reject the Bankruptcy Court's proposed findings and conclusions on matters that were never properly pleaded or presented to the Bankruptcy Court for adjudication.

***120** 28. Moreover, further review of the trial record cited in support of these findings reveals that the evidentiary record does not support an "earmarking" conclusion—*i.e.,* there is insufficient evidence for a court in the Third Circuit to conclude that Goldman Sachs intended for $10 million of its loan proceeds to be earmarked for a stock purchase from Green Field,[26] and the Opinion contains no legal analysis of the "earmarking" doctrine. As detailed in the Objection and supporting brief,[27] the Trustee's assumption that $10 million of the Goldman Sachs loans were "earmarked" for Green Field is misplaced. Yet, the Bankruptcy Court's proposed conclusions on tortious interference and constructive trust are entirely contingent on the incorrect "earmarking" conclusion. Based on the record presented and applicable authorities discussed in the Objection, this Court must reject the "earmarking" findings and conclusions as well as the conclusion that Moreno acted maliciously or for personal gain.

29. Finally, the Bankruptcy Court and Trustee's reliance upon Moreno's certification as evidence of fraud or deception is

misplaced and lacking foundation. Through the certification, Moreno certified that $10 million was used to purchase stock in Green Field. Moreno learned months later, when asked by his attorney, MOR MGH never received those funds; they went to MOR DOH, the owner of TGS. The Trustee tried to present this certification as evidence of Moreno's fraud or deception, even though fraud or deception was never presented as a trial issue. Missing from the trial evidentiary record was any evidence that Goldman Sachs actually relied upon this certification in advancing money to Moreno. The documentary evidence shows that Goldman Sachs advanced $15 million to the DOH GRATs to allow Moreno to invest the proceeds in TGS.[28] The Trustee intentionally chose not to present any testimony from a Goldman Sachs representative on this point, despite having the opportunity to do so. Notwithstanding the lack of evidence on point, the Bankruptcy Court accepted the certification as evidence of Moreno's malicious intent. In doing so, the Bankruptcy Court disregarded Moreno's credible (and uncontroverted) explanation that this document was created by professionals and executed by mistake, not out of fraud. [APP 1123-24, 1318-19] (Trial Tr. 404:11-405:13; 406:21-408:4; 830:3-833:2).

30. Moreno provided explanations for why he believed he was justified in his use of loan proceeds and how he did not intend to defraud or even harm Green Field or Goldman Sachs. [APP 1318-19] (Trial Tr. 830:3-833:2). Throughout the trial, Moreno consistently explained that he relied upon his professionals, that the certification to Goldman Sachs was a mistake, that he believed (albeit mistakenly) his use of loan proceeds was authorized under the loan documents, and that he never intended to deprive Green Field of funding that it needed. [APP 1318-19] (Trial Tr. 830:3-833:2). The evidence offered by the Trustee does not demonstrate Moreno's fraudulent intent or his intent to conceal his activities—they merely corroborate Moreno's testimony that he relied upon his professionals, and that they all made mistakes.

31. "[A] constructive trust is a 'fraud-rectifying remedy rather than an 'intent-enforcing' one." *Bankers Sec. Life Ins. Soc'y*, 49 N.Y.2d at 940, 428 N.Y.S.2d 623, 406 N.E.2d 440. Without a finding of fraud, a constructive trust remedy is simply improper. Therefore, because the evidentiary record does not support a finding of fraud against Moreno, and fraud was never presented to the Bankruptcy Court as a trial issue, the imposition of a constructive trust on his personal residence was improper as contradicting New York courts that have "uniformly held that a constructive trust is a 'fraud-rectifying' remedy." *In re Lefton*, 553 N.Y.S.2d at 785.

(iv) The Trustee Lacks Standing to Establish a Constructive Trust.

***121** 32. Green Field was not a party to the Goldman Sachs loans. Moreover, the Opinion contains no legal analysis to reach any "earmarking" conclusion. The only party that could conceivably seek a constructive trust would have been Goldman Sachs.[29] Because Green Field never obtained an interest in the Goldman Sachs loan proceeds, the Trustee is not entitled to seek or obtain a constructive trust on anything ostensibly purchased with those proceeds. *See In re Lefton*, 160 A.D.2d 702, 553 N.Y.S.2d 783, 784 (App. Div. 1990) (citing *Gargano v. V.C.&J. Constr. Corp.*, 148 A.D.2d 417, 419, 538 N.Y.S.2d 955 (App. Div. 1989) and *Schwab v. Denton*, 141 A.D.2d 714, 529 N.Y.S.2d 825 (App. Div. 1988)). For this additional reason, a constructive trust cannot be imposed, and the Bankruptcy Court's proposed findings and conclusions must be rejected.

III. CONCLUSION

33. For the foregoing reasons, the Defendants ask this Court to reject the Bankruptcy Court's PPFCL as they relate to Counts 11, 12 and 14, rule in the Defendants' favor on such Counts, and decline to impose a constructive trust.

Dated: November 13, 2017

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CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that on the 13th day of November, 2018, I served a true and correct copy of the foregoing **Reply Brief in Support of the Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)** upon the parties listed below in the manner indicated:

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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

In re: GREEN FIELD ENERGY SERVICES, INC., *et al.*, Debtors.

Chapter 11

Case No. 13-12783 (KG)

(Jointly Administered)

ALAN HALPERIN, AS TRUSTEE OF THE GFES LIQUIDATION TRUST, Plaintiff,

v.

MICHEL B. MORENO; MOR MGH HOLDINGS, LLC; FRAC RENTALS, LLC; TURBINE GENERATION SERVICES, LLC; AERODYNAMIC, LLC; CASAFIN II, LLC, Defendants.

Adv. Proc. No. 15-50262 (KG)

Related to Adv. Docket Nos. 550, 551, 552, 553, 554, 555, 559, 561, 562, 563, 564, 565, 566, 567, 568, 569, 571 & 572

NOTICE OF COMPLETION OF BRIEFING

PLEASE TAKE NOTICE that briefing concerning the *Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 550] ("Limited Objection"), filed by defendants Michel B. Moreno and MOR MGH Holdings, LLC on October 23, 2018, is now complete and ready for consideration by the United States District Court for the District of Delaware. Pleadings relevant to the Limited Objection are as follows:

***122** 1. *Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 550] (filed on October 23, 2018);

2. *Motion for Leave to Exceed Page Limit Requirement with Respect to Suggestion in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 551] (filed on October 23, 2018);

3. *Suggestion in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 552] (filed on October 23, 2018);

4. *Motion to File Under Seal Appendix in Support of Suggestion in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 553] (filed on October 23, 2018);

5. [SEALED] *Appendix in Support of Suggestion in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 554] (filed on October 23, 2018);

6. *Motion of Plaintiff Alan Halperin, as Trustee of the GFES Liquidation Trust, to Strike Defendants' Limited Objection to the Bankruptcy Court's Proposed Findings of Fact and Conclusions of Law* [Adv. Docket No. 555] (filed on October 29, 2018);

7. *Defendants Michel B. Moreno and MOR MGH Holdings, LLC's Response in Opposition to the Motion of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, to Strike Defendants' Limited Objection to the Bankruptcy Court's Proposed Findings of Fact and Conclusions of Law* [Adv. Docket No. 559] (filed on November 6, 2018);

8. *Motion of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, for Leave to Exceed Page Limit Requirement with Respect to His Response to Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's*

Opinion (D.I. 535) and Order (D.I. 540) [Adv. Docket No. 561] (filed on November 6, 2018);

9. *Response of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, to Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 562] (filed on November 6, 2018);

***123** 10. *Motion of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, to File Under Seal the Supplemental Appendix in Support of His Response to Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 563] (filed on November 6, 2018);

11. [SEALED] *Supplemental Appendix in Support of His Response to Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 564] (filed on November 6, 2018);

12. *Order Granting Motion of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, for Leave to Exceed Page Limit Requirement with Respect to His Response to Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 565] (filed on November 8, 2018);

13. *Order Granting Motion of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, to File Under Seal the Supplemental Appendix in Support of His Response to Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 566] (filed on November 8, 2018);

14. *Reply Brief in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 567] (filed on November 13, 2018);

15. *Motion of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, to Strike Reply Brief in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540) or, in the Alternative, for Leave to File a Sur-Reply* [Adv. Docket No. 568] (filed on November 15, 2018);

16. *Response in Opposition to Motion of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, to Strike Reply Brief in Support of Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [Adv. Docket No. 569] (filed on November 16, 2018);

17. *Order Granting Defendants Leave to File the Reply Brief and Permitting Trustee to File His Sur-Reply* [Adv. Docket No. 571] (filed on November 20, 2018); and

***124** 18. *Request for Oral Argument* [Adv. Docket No. 572] (filed on November 20, 2018).

TRANSMITTAL SHEET TO U.S. DISTRICT COURT FOR THE

DISTRICT OF DELAWARE

TRANSMITTAL OF OBJECTION TO PROPOSED FINDINGS OF

FACT/CONCLUSIONS OF LAW PURSUANT TO F.R.B.P. 9033(a)

Bankruptcy Case No: 13-12783 Adversary Case No (if applicable): 15-50262

Cause of Transmittal: **Objection to Proposed Findings of Fact/Conclusions of Law Pursuant to FRBP 9033(a)**

Docket No. of Proposed Findings of Fact: 535

Docket No. of Objection to Proposed Findings of Fact: 550

Docket No. and Title of any additional documents relating to transmittal:

Docket No: 552, 562, 567, 573 Suggestion in Support of Limited Objection (552); Response to Limited Objection (562); Reply Brief in Support of Limited Objection (567); and Notice of Completion of Briefing (573)

Name of Movant: Alan Halperin, Trustee

Name of Movant's Counsel (if represented):

Patrick A. Jackson

Drinker Biddle & Reath LLP

222 Delaware Avenue

Wilmington, DE 19801

Deputy Clerk Transmitting: Robert J. Cavello

Notes:

This matter should be assigned a Miscellaneous Case Number rather than a Civil Action Number.

All Citations

Not Reported in B.R. Rptr., 2018 WL 6191949

Footnotes

1 This Opinion constitutes the findings of fact and conclusions of law of the Court pursuant to Rule 52 of the Federal Rules of Civil Procedure, which is incorporated into Rule 7052 of the Bankruptcy Rules of Procedure. Fed. R. Civ. P. 52(a)(3); Fed. R. Bankr. P. 7052.

2 The Court recognizes that Defendants preserved an objection to the Court's consideration of deposition testimony from live witnesses who had chosen to testify in the Court, although outside the subpoena range of the Court. The Court overrules the objection on the ground that Debtor and Defendants have made use of the depositions.

3 For purposes of this Memorandum Opinion, the Court considers the *Second Amended Complaint and Objection to Claims Pursuant to Bankruptcy Code Sections 502 and 503 and Federal Rule of Bankruptcy Procedures 3007* (the "Second Amended Complaint" or "Complaint"). D.I. 209.

4 Debtor's manufacturing subsidiary, Turbine Power Technologies, LLC ("TPT"), used technology—developed, owned and adapted by Ted McIntyre - to manufacture turbine powered fracturing pumps ("TFPs"), which Debtor used pursuant to an exclusive license agreement between TPT and Debtor. PowerGen refers to a prospective business of manufacturing and/or leasing turbine power generator units ("TPUs") powered by aero derivative turbine engines. It is undisputed that the technology used to develop, adapt and manufacture the TPUs was also owned by Ted McIntyre. However, unlike the TFPs, Green Field was never granted an exclusive license agreement to use the TPUs technology. Therefore, one of the central issues for trial was whether Green Field, directly or through its interest in TPT, had an interest in the technology necessary to manufacture and/or lease TPUs.

5 As used herein, "Stipulation No." means the undisputed facts which the Trustee and Defendants submitted through the Joint Statement of Admitted Facts, attached as Exhibit A to the Proposed Final Joint Pretrial Order. D.I. 501.

6 "Fracking" refers to the process of hydraulic fracturing which is a well stimulation technique in which rock is fractured by pressurized liquid in order to increase the rate at which fluids such as petroleum, water or natural gas can be recovered from subterranean natural resources.

7 The success of Green Field's early business plan—*i.e.,* to build over half a dozen frac spreads—relied largely on the company's ability to generate sufficient cash flow to fund both ordinary operations and new capital expenditures. Trial Tr.

537-38; 540-41; 1293-94. By the end of 2012, the fracking market had slowed, and Green Field's margins had evaporated. Trial Tr. at 1300, 1303:6-22, 1306-08; PX 121, PX 143. To fill the void left by these evaporating margins, Moreno and Green Field began to search for additional capital from lending sources, bondholders or new investors. Trial Tr. 530-38. *Id.* Eventually, this effort led Moreno to GE.

8 During a bondholder call on May 22, 2013, Moreno told bondholders that "As it sits today, power generation is outside of Green Field because it was a mandate from GE, obviously, to keep it off of the exposure of the bonds and so right now it is set up as a separate business. My hope is that we can tie the two together, and I'm working hard to make certain that happens." PX 157, Trial Tr. 786:15-23. At trial Moreno confirmed that this transcript from May 2013 was accurate.

9 The turbine sales were in connection with the $25M advance from GE to TGS and were fair market value transactions that converted hard assets into cash. Trial Tr. 1085:20-1086:23, 1091:7-1092:3, 1820:11-19, 1824:20-1825:1. The deposits were delivered under the Tri-Party Agreement and were paid by TGS to Green Field in Green Field's role as contract manager, to be held by Green Field in trust for the purposes of paying TPT once TPT manufactured and invoiced the power generation units. Trial Tr. 837:12-840:24; Confi Trial Tr. 16:4-8; Trial Tr. 466:2-6. Moreno agreed that the deposit amounts paid under the Tri-Party Agreement were unrelated to the obligations of MOR MGH under the two share purchase agreements. Trial Tr. 468:9-469:12. Moreno also testified that he understood the obligations of MOR MGH to be distinct from the obligations of TGS. Trial Tr. 846:11-22. The Court rejects Moreno's assertion that these transactions were intended to benefit Green Field. Trial Tr. Conf. 3/20 at 5:16-6:8; JX 3.

10 The Court finds Blackwell's testimony credible. Blackwell stated that he would know more about Green Field's financial affairs than anyone else. Blackwell Dep. at 209:23-210:3. Fontova agreed that Blackwell would know more about the financials of the company than he would. Fontova Dep. 120:9-17.

11 GE employees confirmed that the bond debt was a concern of GE's. Calhoun Dep. 171:22-173:3; Hosford Dep. 133:1-5, 133:9-20, 135:25-136:17; Padeletti Dep. 198:18-199:13.

12 The facts discussed in this subsection summarizes the extensive record presented at trial, which included live testimony from Michel Moreno and Rick Fontova and corroborating documents, including dozens of e-mails from GE (both internal and external), contemporaneous handwritten notes of Wayne Teetsel, spreadsheets and related documents. The Court also considered the deposition testimony of current and former GE employees such as Colleen Calhoun, Edoardo Padaletti, Michael Hosford and Sanjay Bishnoi, as well as Green Field officers and directors (Fontova, Blackwell and Kilgore). Finally, the Court considered deposition testimony of Wayne Teetsel, who represented Green Field's largest bondholder and took contemporaneous handwritten notes of his frequent phone calls with Moreno.

13 Moreno had been clear with GE that he was looking for a total $200 million investment— $100 million for Green Field and $100 million toward the new potential PowerGen joint venture. (DX 197).

14 Moreno changed the name back to Services, LLC, on May 9, 2013, days before GE advanced $25 million to TGS. PX 152. GE's position regarding Green Field's ownership had changed during the intervening period.

15 In December 2012, GE retained Boston Consulting Group to evaluate the size of the market for PowerGen. PX 205, Trial Tr. 1022. Kearns admitted that the BCG report "is not quite so optimistic in terms of the size of the market." *Id.* Moreover, in an email dated May 2, 2013, Sanjay Bishnoi of GE Capital advised Colleen Calhoun of GE that contrary to GE expectations the PowerGen turbines will ultimately have a higher cost due to lower fuel efficiency (thus depriving gas turbine PowerGen units a claimed significant competitive advantage over existing technology). PX 205. Importantly, Bishnoi also points out that the Boston Consulting Group report "suggests the market is smaller than what our work would suggest." DX 290, Trial Tr. 1198.

16 In the same opinion and order, the Court denied summary judgment on Count 21 against TGS (which claim the Trustee subsequently withdrew) and ruled that Defendants were entitled to summary judgment on the remaining amounts of the Frac Rentals Transfers ($524,828.21), Aerodynamic Transfers ($165,000.00); and Casafin Transfers ($151,983.00). Accordingly the Trustee cannot recover those amounts from Defendants.

17 The DOH GRATs owned 50% of DOH Holdings, which in turn owned 80% of Frac Rentals.

18 The Court previously decided in its SJ Opinion that New York law applies to the Trustee's contract-related claims, including breach of contract and tortious interference. D.I. 463 at pp. 36, 41.

19 Moreno had previously borrowed money based on the strength of his personal financial statement, which listed his total assets at $252 million. Trial Tr. 3/22 Conf. 6:11-8:15. He also acknowledged that TGS had no creditworthiness of its own, and thus relied entirely on Moreno's personal finances to borrow money on behalf of TGS. Trial Tr. 3/22 Conf. 15:24-16:3.

20 The Court observes that Moreno testified at trial that he referred interchangeably to the SPA obligations as his own and that of MOR MGH. Trial Tr. 385:22-386:10; *see also* PX 217 at p. 9; PX 143 at p. 6; PX 177 at p. 5.

21 MOR MGH and MMR collectively failed to purchase $6,707,081 of Green Field preferred shares under the 2012 SPA for the first and second quarters of 2013. MOR MGH failed to make the $10 million purchase under the 2013 SPA. Thus, in total, MOR MGH and MMR failed to make $16,707,081 in purchases of Green Field preferred shares. The amount owed by MMR ($745,158) was resolved by a settlement agreement in the amount of $100,000. Thus, the Court has reduced the total amount of damages owed by $100,000, leaving damages of $16,607,081.

22 Courts have held that because constructive trusts are remedies rather than causes of action, they need not be plead in the complaint. *Heston v. Miller*, No. CIV.A.5820, 1979 WL 174446, at *2 (Del. Ch. Oct. 11, 1979) ("The allegations of the complaint also support a claim of constructive fraud and for the imposition of a constructive trust, although the prayer for relief does not set forth such a demand."); *Bemis v. Estate of Bemis*, 114 Nev. 1021, 967 P.2d 437, 442 (Nev. 1998) ("[T]he remedy of constructive trust may be available notwithstanding a failure to plead fraud in the complaint[.]"); *see also Kahan v. Rosenstiel*, 424 F.2d 161, 174 (3d Cir. 1970) ("Plaintiff's complaint does not specifically ask for equitable relief; it contains only the general request for 'further relief as may be just.' Nonetheless, under Rule 54(c) of the Federal Rules of Civil Procedure, a court may have awarded any relief appropriate under the circumstances.").

23 The Court notes that the Texas homestead exemption does not preclude the imposition of a constructive trust on Moreno's home in Dallas. *See McMerty v. Herzog*, 661 F.2d 1184, 1186 (8th Cir. 1981) ("In this case, the wrongfully diverted funds can be traced to Lake Crystal. Because Lake Crystal is the product of the diverted property, the homestead exemption does not apply.").

1 The Movants herein are a subset of the numerous defendants joined in the adversary.

2 All capitalized terms not defined in this Motion shall have the meaning ascribed to them in the Opinion.

3 Movants' limited objections are consistent with the Motion and Brief of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to Amend Opinion (D.I. 535) and Order (D.I. 540) Pursuant to Federal Rule of Bankruptcy Procedure 9023, which moved for amendment only as to Counts 11, 12, and 14. No party moved under Fed. R. Civ. P. 59, which is made applicable by Fed. R. Bankr. P. 9023, for reconsideration of any other Counts. Accordingly, no claim that was found by this Court to be statutorily "core" is the subject of a motion and no party seeks reconsideration of the portion of the Opinion and Order that is a Judgment of this Court that was entered September 18, 2018.

4 Citations to Suggestion, §§ __, shall indicate a reference to the Suggestion in Support, as incorporated herein.

5 Many of the findings described below are repeated in the Conclusions of Law section of the Opinion. To the extent a proposed finding is specified in this Section A below, the Defendants object to such statement as it may be construed as a proposed conclusion of law, regardless of where the statement appears in the Opinion.

6 *See* Suggestion, § II.B(iv).

7 *See* Suggestion, § II.B(i).

8 *See* Suggestion, § II.B(ii).

9 Such findings or conclusions are directly contradicted by other more specific portions of the Opinion or lack evidentiary support. *See* Suggestion, § II.B(v).

9 Such findings or conclusions are directly contradicted by other more specific portions of the Opinion or lack evidentiary support. *See* Suggestion, § II.B(v).

10 The only findings of specific harm relate to Green Field's failure to pay $6 million of interest to Shell, resulting in a "downward spiral" toward bankruptcy. [APP 0118] (Opinion, 117). The Bankruptcy Court did not explain how a $6 million payment default could result in a damage model of $15.9 million. Moreover, Moreno testified without being controverted that Shell had advised Moreno of its intent to terminate its customer relationship even before Green Field's payment default. [APP 1129] (Trial Tr. 429:14-431:20). *See* Suggestion, §§ II.B(ii)&(iii).

11 This narrow view of select portions of the evidentiary record is contradicted by the broader conclusions in the Opinion where the Bankruptcy Court recognized Green Field's benefit from Moreno's efforts to borrow money from GE, Powermeister, and Goldman Sachs. Such a narrow view also ignores the plain terms of the loan documents. As discussed in greater detail in the Suggestion, Moreno used the Goldman Sachs loan proceeds as contemplated in the loan documents and notices of borrowing, which were not earmarked for purchase of Green Field stock but benefited Green Field both directly and indirectly. *See* Suggestion, § II.B(v) & (C)(vi).

12 The only specific harm found by the Bankruptcy Court was Green Field's failure to make three separate interest payments of $2 million to Shell in June, July and August of 2013, and the Bankruptcy Court's logistical conclusion that such default "would then send Green Field into a downward spiral toward bankruptcy." [APP 0118] (Opinion, 117). However, this portion of the Opinion disregards Moreno's uncontroverted testimony that Shell had previously communicated its intentions to dispose of its North American energy assets and terminate its customer relationship with Green Field by the end of 2013. [APP 1129] (Trial Tr. 429:14-431:20). *See* Suggestion, §§ II.B(ii)-(iii).

13 *See* Suggestion, II.B(v).

14 The loan agreements and related document show that Moreno used the proceeds appropriately, and the Trustee failed to carry its burden in proving that these proceeds were "earmarked" or that Moreno misused such funds. *See* Suggestion, § II.B(v).

15 *See* Suggestion, § II.B(v).

16 Such findings or conclusions are unsubstantiated and purport to shift the burden on Moreno to account for loan proceeds made by third party lender Goldman Sachs for varying purposes that allowed, but did not require, stock purchases from Green Field. *See* Suggestion, § II.B(v).

17 *See, e.g.,* Opinion, 63 ("Considering the weight of evidence, **the Court finds that Moreno was open and transparent with Green Field's creditors, and that the Trustee has not presented sufficient evidence – direct or circumstantial – to demonstrate that Moreno intended to defraud or otherwise harm Green Field or its creditors.** On the contrary, the evidence suggests, and the Court finds that Moreno was Considering the weight of evidence, the Court finds that Moreno was dealing with a very fluid situation during the course of his negotiations with GE, and as time ran out on Green Field's liquidity, Moreno did his best to keep Green Field's creditors apprised of how GE's ever-changing investment might impact Green Field and its ongoing business.") (emphasis added); *see also* Suggestion, § II.C(ii) & C(iv).

18 *See* Suggestion, § II.C(ii).

19 Clear and convincing is the proper standard. *See* Suggestion, II.C(i).

20 *See* Suggestion, § II.C(iv)&(v).

21 *See* Suggestion, § II.B(v).

22 This conclusion presupposes that the Trustee actually traced the $10 million loan proceeds to the purchase of the homestead in Dallas. *See* Suggestion, § II.C(v).

23 This conclusion assumes that Green Field was entitled to the $10 million that Goldman Sachs loaned to Moreno, even though (a) the July 5, 2013 loan agreement required the DOH GRATs to use the $15 million advanced on July 5, 2013,

to make an equity investment in TGS, not Green Field; and (b) the evidence demonstrates that TGS *did* use at least $10 million of capital to make deposits with Green Field under the Tri-Party Agreement. *See* Suggestion, § II.B(ii), (iii)&(v).

24 Because the constructive trust remedy and the related "recognized causes of action" were not presented to the Bankruptcy Court as trial issues in the joint pretrial order [APP 0181-306] (Dkt. 474), no evidence was presented by either party on whether Moreno's use of the loan proceeds was justified. In the Suggestion, Moreno demonstrates that such use of proceeds was entirely justified and appropriate under the circumstances. *See* Suggestion, II.B(v) & C(iv).

25 *See* Suggestion, §§ II.B(v) & C(iii).

1 The Movants herein are a subset of the numerous defendants joined in the adversary.

2 All capitalized terms not defined in this Suggestion shall have the meaning ascribed to them in the Objection or the Opinion.

3 On October 2, 2018, the Defendants filed a motion under Bankruptcy Rule 9023 (the "Motion to Reconsider"), [APP 0132-180] (D.I. 544), to modify or amend the Opinion with respect to Counts 11, 12, and 14. The arguments presented in the Motion to Reconsider are incorporated herein by reference.

4 Because the Trustee has not filed a timely notice of appeal, the Opinion and Order is now final with respect to those claims.

5 While the two loan agreements provide up to $25 million in credit to Moreno and $15 million in credit to the DOH GRATs, [APP-0685-757] (PX 156); [APP-0795-873] (PX 166); the Notices of Borrowing demonstrate that Goldman Sachs only advanced $10 million of the May loan to Moreno on May 15, 2013, and the DOH GRATs drew the full $15 million on July 5, 2013—both to make investments in TGS. [APP-0908-10] (Notice of Borrowing, May 15, 2013); [APP-0911-15] (Notice of Borrowing, July 5, 2013). The Trustee presented no evidence to account for the $20 million advanced by Powermeister.

6 The Trustee offered, and the Bankruptcy Court adopted, statements in the record such as Moreno's use of the SPA obligations as his own and statements to bondholders that Moreno intended to cure MGH Holdings' default. [APP-0032, 114, 116] (Opinion at 31, 113 & 115 fn.20). These statements are far from proving a fraud claim sufficient to obtain a remedy to pierce a corporate veil or treat MGH Holdings as Moreno's alter ego.

7 Even though it is not Moreno's burden to account for the use of his own personal funds, Moreno cites the Appendix for two Notices of Borrowing. Goldman Sachs advanced only $10 million of the $25 million loan in May, 2013, and the DOH GRATs drew the entire $15 million in July, 2013. Both Notices indicate that the proceeds were to be used toward TGS, and the Bankruptcy Court's conclusions on Page 104 of the Opinion [APP-0105] indicate that $50 million of borrowing (i.e., $25 million from GE and $25 million from Goldman) were paid from TGS to Green Field during this time. [APP-0026; APP-0435-36] (Opinion, 25; JX 3). The Trustee made no attempt to trace what DOH Holdings did with the $20 million advanced by Powermeister; yet the Bankruptcy Court's Opinion shifted this burden on Moreno to account for those funds, even though the Trustee presented no evidence of Green Field's interest in those funds.

8 The Defendants raised this objection at trial and renew their objection. [APP-0243] (Pretrial Order, D.I. 474-5 at 18) (objecting to [APP-0785-87] PX 163).

9 As described more fully in the Opinion, the DOH GRATs are two separate Grantor Annuity Retained Trusts, established in 2011 by Moreno and his wife. Each DOH GRAT owned an equal share of DOH Holdings, which in turn was the sole member of TGS. While the names appear similar, MGH Holdings was a separate entity, also established in 2011. The owners of MGH Holdings are the MGH GRATs. While the MGH GRATs were established for the limited purpose of holding the equity of Green Field, the DOH GRATs held substantial unrelated assets. [APP-0017-20] (Opinion, 16-19).

10 As discussed below, there is no basis to find or conclude that the Goldman Sachs loans were "earmarked" for Green Field. Moreover, even if Moreno did misuse Goldman Sachs loan proceeds, such a cause of action would belong to Goldman Sachs, not the Trustee for Green Field.

11 Ordinarily, it is the trustee's initial burden to demonstrate some interest in the property transferred. The earmarking doctrine is a defense that a defendant may raise after the trustee "makes a preliminary showing" that the funds transferred

were "property of the debtor." *See id.* at 401. In *Winstar*, the trustee made its preliminary showing by presenting evidence that the funds in question had passed through the debtor's bank account. *Id.*

12 McIntyre explained that he incurred significant trade debt that went unpaid for a long period of time, but which was brought current in May 2013, when GE and Goldman Sachs advanced money to Moreno, TGS, and DOH Holdings. [APP-1825-26] (Trial Tr. 1566:21-1569:15). Mr. McIntyre provided but one of many possible explanations of where the funds advanced by GE and Goldman Sachs may have gone, if not directly to Green Field. [APP-1825-26] (Trial Tr. 1566:21-1569:15). Moreno also testified that he had disclosed to Goldman Sachs how he intended to use the loan proceeds, that he had relied on his family office to manage the funds, and that he never intended to defraud Goldman Sachs or Green Field. [APP-1121, 1318] (Trial Tr. 399:4-13; 830:3-832:8).

13 While the Trustee presented evidence that Powermeister advanced $20 million to DOH Holdings in June of 2013, the Trustee made no effort to prove what happened to those proceeds. [APP-0444-523] (JX 41).

14 [APP-0143-46] (Motion to Reconsider, D.I. 544, § II.B(i)).

15 [APP-0148-57] (Motion to Reconsider, D.I. 544, § II.B(iii), (iv), (v)).

16 [APP-0146-48] (Motion to Reconsider, D.I. 544, § II.B(ii)

17 [APP-0157-60] (Motion to Reconsider, D.I. 544, § II.B(vii).

18 [APP-0157] (Motion to Reconsider, D.I. 544, § II.B(vi)). This Court should not impose a constructive trust where the Trustee cannot demonstrate that Green Field held a property interest in the funds at issue. *See In re Lefton*, 160 A.D.2d 702, 553 N.Y.S.2d 783, 784 (App. Div. 1990) ("Although a constructive trust may be imposed where property is parted with in reliance upon a promise to reconvey, 'none may be imposed by one who has no interest in the property prior to obtaining a promise that such an interest will be given to him.' ") (citations omitted).

19 [APP-0160-63] (Motion to Reconsider, D.I. 544, § II.B(viii)). In Texas, "homesteads are favorites of the law," and courts generally give "a liberal construction to the constitutional and statutory provisions that protect homestead exemptions." *See In re Bradley,* 960 F.2d 502, 507 (5th Cir. 1992) (citations omitted). Courts applying Texas law are duty-bound to uphold and enforce the Texas homestead laws, "even though in so doing we might unwittingly 'assist a dishonest debtor in wrongfully defeating his creditor.' " *Id.* at 507 (quotation omitted). At least one panel of the Fifth Circuit has gone so far as to call Texas homestead exemptions "sacrosanct." *See Border v. McDaniel (In re McDaniel),* 70 F.3d 841, 843 (5th Cir. 1995).

20 Other Circuits follow similar approaches and disfavor the use of the constructive trust doctrine to override the priority systems of the Bankruptcy Code. *See, e.g., Superintendent of Ins. v. Ochs (In re First Cent. Fin. Corp.),* 377 F.3d 209, 217-18 (2d Cir. 2004) (While noting that bankruptcy law does not override state constructive trust law, "we note that our obligation to apply New York constructive trust law does not diminish the need to 'act very cautiously' to minimize conflict with the goals of the Bankruptcy Code.") (citing *In re N. Am. Coin & Currency, Ltd.,* 767 F.2d 1573, 1575 (9th Cir. 1985)); *see also In re Haber Oil Co.,* 12 F.3d 426, 436 (5th Cir. 1994) ("the constructive trust doctrine can wreak ... havoc with the priority system ordained by the Bankruptcy Code"); *In re Omegas Group, Inc.,* 16 F.3d 1443, 1451 (6th Cir. 1994) ("A constructive trust is fundamentally at odds with the general goals of the Bankruptcy Code.") (internal quotation marks and citation omitted).

21 On the contrary, as discussed below, it appears that the Court may have inadvertently shifted the burden on Mr. Moreno to prove what he did with the funds he borrowed personally from Goldman Sachs and other sources.

22 The Trustee withdrew Count 13 (breach of fiduciary duty) prior to trial. [APP-0184] (D.I. 474, pg 3) ("The Trustee has also voluntarily withdrawn Counts 4, 5, 13, 15, 16, 17, 18, 20, 22, 25, and 26.").

23 For the reasons set forth in Section II.B(ii)&(iii), this Court should reject the proposed findings on damages.

24 *See, supra,* Section II.B(v).

25 The constructive trust remedy also fails because the Bankruptcy Court made no specific finding of fraud. *See In re Lefton*, 160 A.D.2d 702, 553 N.Y.S.2d 783, 785 (App. Div. 1990) (citing *Binenfeld v Binenfeld*, 146 A.D.2d 663, 537 N.Y.S.2d 41, 42 (App. Div. 1989)) ("Courts have uniformly held that a constructive trust is a 'fraud-rectifying' remedy rather than an 'intent-enforcing' one.' ").

26 *See, supra*, Section II.B(v).

27 The record shows that TGS transferred approximately $50 million to Green Field between May and September of 2013, including $10 million in deposits under the Tri-Party Agreement after July 5, 2013. [APP-0435-36] (JX 3); [APP-0105] (Opinion, 104).

1 The bankruptcy-related causes of action were resolved by the Bankruptcy Court, but are irrelevant for purposes of the Objection and this Response. The Bankruptcy Court ultimately found in favor of Moreno on Counts 19, 23, and 24 to the extent the Trustee sought to recover the preferential transfers against him personally as the entity for whose benefit such transfers were made, but entered final judgment in favor of the Trustee and against Frac Rentals, Aerodynamic, and Casafin on those claims in the amounts of $69,137.97, $110,000.00, and $466,414.94, respectively. The Bankruptcy Court also found in favor of the Trustee on Count 29 and disallowed any proofs of claim filed by Frac Rentals, Aerodynamic, and Casafin until such time that those entities pay the preferential transfer judgments against them.

2 Citations to "APP" refer to the *Appendix in Support of Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [D.I. 554] (the "Appendix"), which was supplemented by the Trustee in the *Supplemental Appendix* filed contemporaneously herewith. Citations to APP 0001-2152 are contained in the Appendix and citations to APP 2153-2492 are contained in the *Supplemental Appendix*.

3 The Bankruptcy Court also found that New York law controls both the breach of contract and tortious interference claims as a result of the choice of law provision in the SPAs. D.I. 463 at pp. 36,41 [APP 2093, 2098]; Opinion at pp. 109, 114 [APP 0110, 0115].

4 The Bankruptcy Court found that, because New York law applies to the contract claims, the New York prejudgment interest rate of 9% also applies. Opinion at p. 113 [APP 0114] (citing NY. C.P.L.R. § 5004; Marfia v. T.C. Ziraat Bankasi, 147 F.3d 83, 90 (2d Cir. 1998)). Prejudgment interest at the rate established by state law continues to accrue until final judgment is entered by the trial court. As of the date of this filing, prejudgment interest on the breach of contract claims amounts to $7,719,892.10. Interest continues to accrue at the daily rate of $3,935.82.

5 The difference in damages between the breach of contract and tortious interference claims is due to the fact that the Bankruptcy Court found that Moreno interfered not only with MOR MGH's breaches of the 2012 SPA, but also MMR's. Opinion at p. 115 [APP 0116]. As the Bankruptcy Court explained, MOR MGH and MMR collectively failed to purchase $6,707,081 of GFES preferred shares under the 2012 SPA. MOR MGH failed to make the $10 million purchase under the 2013 SPA. Thus, in total, MOR MGH and MMR failed to make $16,707,081 in purchases of GFES preferred shares. The amount owed by MMR ($745,158), as an entity, was resolved by a settlement agreement in the amount of $100,000; claims against Moreno for interfering with MMR's obligations were not released in that settlement. Thus, the Bankruptcy Court reduced the total amount of damages owed by $100,000, leaving damages of $16,607,081. As of the date of this filing, with respect to the tortious interference claim, prejudgment interest amounts to $8,081,652.62. Interest continues to accrue at a daily rate of $4,119.55.

6 With respect to equitable remedies, Delaware courts have found that the imposition of prejudgment interest is at the discretion of the court. Rollins Envtl. Servs., Inc. v. WSMW Industries, Inc., 426 A.2d 1363, 1366 (Del. Super. Ct. 1980). It is not uncommon for courts to impose prejudgment interest on constructive trusts. See, e.g., Collinson v. Miller, 903 So.2d 221, 226 (Fla. Dist. Ct. App. 2005) ("After considering the evidence, the trial court granted the Miller children's request for a constructive trust against the property purchased by Mrs. Collinson for that portion of the Miller children's claim related to the value of that home. The constructive trust was imposed in the amount of $568,650, representing $284,325 each for the two plaintiffs. The trial court also awarded the plaintiffs $227,112 in prejudgment interest. Thus Mrs. Collinson's property is now subject to an equitable lien of $795,762."); Cross Country Land Servs., Inc. v. PB Network Servs., Inc., No. CIV.01CV00568LTBPAC, 2006 WL 1517721, at *1 (D. Colo. May 30, 2006) ("Judgment shall enter in favor of Cross

Country and against KNS for prejudgment interest on the constructive trust amount of $344,810.60 at the statutory rate of 8% per annum from May 2, 2003 through the date that judgment is entered."). The Bankruptcy Court found that the constructive trust remedy is controlled by Delaware law. Pre-judgment interest on this remedial award would thus also be controlled by Delaware law. Delaware law applies prejudgment interest at a rate of 5% over the Federal Reserve Discount Rate. 6 Del. Code § 2301(a). The Federal Reserve Discount Rate on June 28, 2013, the date of breach of the 2013 SPA, was 1%. Thus, prejudgment interest would accrue at the rate of 6%. Accrued interest on the $10M constructive trust thus far is $3,216,986.30, with continuing daily accrual of $1,643.84.

7 Defendants have incorporated into their Objection, by reference, their Motion to Amend, and have included that motion in their designated record appendix. See APP 0132-0180. As a result, the Trustee too incorporates by reference all of the arguments made in his Opposition to Defendants' Motion to Amend [D.I. 546], and adds that memorandum to the *Supplemental Appendix* filed contemporaneously herewith. APP 2454-2492.

8 Capitalized terms not otherwise defined herein shall have the meaning ascribed to them in the Opinion.

9 The Written Consent was at the heart of the Trustee's claims against Moreno for fraudulent transfer, breach of fiduciary duty, and corporate waste, in which the Trustee alleged that the Written Consent constituted a transfer of a valuable opportunity to Moreno. The Bankruptcy Court found in favor of Defendants on those claims, largely because the Trustee was unable to prove damages or that GFES had a legal interest in the opportunity. See generally Opinion at pp. 88-109 [APP 0089-0110]. Although the Court did not impose liability on Moreno, there can be no colorable dispute that until the date of the Written Consent, there was still a possibility that GFES could pursue the PowerGen opportunity; indeed, Moreno was still negotiating with GE to try to execute a joint venture with GFES. However, following the Written Consent, any such participation was foreclosed.

10 As explained above, GFES was required to make $2 million monthly interest payments as a result of Shell's modification to its loan to GFES, which allowed GFES to fully draw on the $100 million facility back in May 2012.

11 Although it needed not do so, the Court observed additional evidence supporting the more general premise that "Green Field would have been in a better economic position had MOR MGH complied with its SPA obligations." Opinion at p. 111 [APP 0112]. Specifically, the Court observed that the breaches of the SPAs caused GFES to miss its interest payments due to Shell, which triggered cross-defaults under the Shell Contract and Bond Indenture and, ultimately, to GFES filing for bankruptcy. Id. Moreno admitted that had the SPAs been fulfilled, GFES would have been able to make the required interest payments. Id. (citing Trial Tr. 469:20-470:3 [APP 1135]).

12 As explained above, the damages with respect to the tortious interference claim are greater (in the amount of $16,607,081) due to the Bankruptcy Court's conclusion that Moreno interfered not only with MOR MGH's obligations under the SPAs, but also MMR's. Opinion at p. 115 [APP 0116].

13 Again, this showing is required to the extent that, under New York law, a party that is not a "stranger" to the contract can only be held liable for tortious interference with that contract if he or she acts for their own personal gain. Opinion at pp. 115-16 [APP 0116-0117]. The Court found that Moreno did in fact cause the breaches precisely to further his own personal interests. Opinion at pp. 116-20 [APP 0117-0121]. Moreover, the Court observed that Moreno testified at trial that he referred interchangeably to the SPA obligations as his own and that of MOR MGH. Opinion at p. 115 n.20 [APP 0116] (citing Trial Tr. 385:22-386:10 [APP 1118]; PX 217 at p. 9 [APP 0899]; PX 143 at p. 6 [APP 0664]; PX 177 at p. 5 [APP 0883]).

14 On a September 6, 2013 GFES bondholder conference call, Moreno stated: "Finally, one of the defaults that obviously occurred in the quarter, there was a $6 million Equity commitment that I was personally going to have to fulfill in the quarter. That didn't happen, obviously it didn't happen for a couple of reasons that I'll share with you guys. One, obviously is I've been funding a large part of the start-up expenses personally on PowerGen and I think I'm at around $12 million now, plus or minus, so a lot of my personal capital has gone to that." PX 177 at p. 5 [APP0883].

15 According to the Advisory Committee Notes to Federal Rule of Bankruptcy Procedure 9033, the *de novo* review standard was adopted from Federal Rule of Civil Procedure 72(b). Fed. R. Bankr. P. Advisory Committee's Notes. Therefore, case law interpreting Rule 72, which governs review of magistrate judge recommendations, is instructive here. See, e.g.,

Milford Hous., LLC v. Village of Milford (In re Milford Hous. LLC), No. 15-CV-11119, 2017 WL 1100944, at *4 (E.D. Mich. Mar. 24, 2017) ("District judges review reports and recommendations from bankruptcy courts in much the same way that reports and recommendations from magistrate judges are considered.").

16 Defendants have only submitted an objection to the Court's finding of Moreno's causation of MOR MGH's breaches of the SPAs. Defendants completely ignore, and therefore do not object to, the Court's finding with respect to Moreno's causation of MMR's breaches of the 2012 SPA, which is also relevant to the Trustee's tortious interference claim and, as explained above, enhances the damages under that claim by $645,158. Opinion at p. 115 [APP 0116]. Defendants' failure to object is for good reason and the facts supporting Moreno's causation of MMR's breaches should be adopted by the District Court.

17 Citations to the "Objection" refer to *Suggestion in Support for the Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [D.I. 552].

18 Although Defendants object to this specific fact, it cannot be denied that Moreno made this statement at trial and referred to the obligations or MOR MGH as his own in the documents cited by the Bankruptcy Court. See Trial Tr. 385:22-386:10 [APP 1118]; PX 217 at p. 9 [APP 0899]; PX 143 at p. 6 [APP 0664]; PX 177 at p. 5 [APP 0883].

19 Moreover, "guaranteeing" to theoretically pay a loan obligation in the future is much more contingent and uncertain than immediately paying a contractual obligation that is owed. Indeed, Moreno needed to be sued by the lending entities in order for them to collect on the alleged guarantees. Trial Tr. Conf. 3/20 at 3:12-4:10 [APP 1098].

20 As explained above, the Bankruptcy Court reduced this damages amount by $100,000 for the tortious interference claim to account for the Trustee's settlement of his breach of contract claim against MMR in that amount.

21 Defendants passively argue that consideration of evidence relating to the Goldman loans was "highly prejudicial." Objection at ¶ 36. Of course the evidence proffered by the Trustee is prejudicial in favor of the Trustee's case; that is the very reason it was introduced in the first place. It is only prejudice that would be "unfair" that warrants exclusion of relevant evidence. See, e.g., Rega v. Armstrong. No. CV 08-156, 2016 WL 3406048, at *2 (W.D. Pa. June 21, 2016) ("The evidence is certainly prejudicial since it undermines Defendant's theory of the case, but all evidence is inherently prejudicial; it is only *unfair prejudice* substantially outweighing probative value that permits exclusion of relevant evidence under Rule 403."). "Unfair prejudice means an undue tendency to suggest decision on an improper basis, commonly, though not necessarily, an emotional one." Id. There is nothing unfair about the Bankruptcy Court's consideration of evidence relating to the Goldman loans simply because it demonstrates Moreno's dishonest and bad faith behavior. The 2013 SPA itself specifically stated that it was "in connection with a borrowing from Goldman Sachs Bank USA." PX 162 [APP 0779]. Consideration of evidence relating to that loan is necessary in order for the Court to assess Moreno's intent with respect to the breaches of the 2013 SPA.

22 Defendants argue that this testimony is vague as to whether it refers to the May or July tranche of the Goldman loans. Objection at ¶ 48. However, in the context of the other evidence presented at trial, it is clear that the purchase of preferred stock under the 2013 SPA, which was executed on June 28, 2013, could only have been a condition to the July tranche of the Goldman loan. See, e.g., PX 162 [APP 0779-07841.

23 Moreno's statement that the money went to MOR DOH can be dovetailed with his estate planners' proposal of how to get the money to Moreno - first to MOR DOH, then to MOR MGH, then used by Moreno to purchase his home. PX 168 [APP 0875].

24 To the extent relevant, the Notice of Borrowing relating to the first tranche from Goldman does *not*, as Defendants contend, suggest that only $10 million was advanced to Moreno. See Objection at ¶ 38. Rather, it specifically states that "[t]he Borrower requests that Lender make an advance under the Loan Agreement **in the amount of $25 million** to be advanced on May 15, 2013." APP 0909 (emphasis added).

25 Notably, Defendants did not object to any other legal conclusions in the Opinion.

26 Defendants incorporate by reference the arguments made in their Motion to Amend Opinion, otherwise referred to as their Motion to Reconsider [D.I. 544]. Objection at ¶ 60. To the extent the District Court considers the arguments contained in that brief, the Trustee incorporates by reference the arguments in his Answering Brief to Defendants' Motion to Amend Opinion [D.I. 546] [APP 2454-2492]. For example, Defendants argue that (i) the Trustee is required to demonstrate a "property interest" in the funds at issue in order to obtain a constructive trust; and (ii) Texas homestead law precludes imposition of a constructive trust. Objection at ¶ 60 nn. 18, 19. For the reasons stated in the Trustee's Answering Brief, neither of these arguments has any merit. See APP 2486-2490.

27 Defendants appear to advocate for both Delaware and federal law to apply. Objection at ¶ 61. They do not articulate any meaningful difference between Delaware and federal law with respect to constructive trusts, nor do they articulate what standard would apply under federal law. To the extent they seek to apply federal law, that argument is unfounded. "As with proof of the existence of a constructive trust, the burden of proof on the issue of whether a constructive trust should be imposed is a matter of state, not federal law." In re Brockway Pressed Metals, Inc., 363 B.R. 431, 454 (Bankr. W.D. Pa. 2007), subsequently aff'd sub nom. In re Brockway Pressed Metal, Inc., 304 F. App'x 114 (3d Cir. 2008); see also In re Washington Mut., Inc., 450 B.R. 490, 501 (Bankr. D. Del. 2011) ("[T]he Bankruptcy Code does not preclude the application of constructive trust law."). Defendants rely on In re Columbia Gas Sys., 997 F.2d 1039, 1056 (3d Cir. 1993), but that case is distinguishable. In that case, applying state law would have prohibited the court from imposing a constructive trust, which the court found necessary to comply with the relevant federal regulatory scheme. Id. Federal common law "provides a more expansive definition of an implied trust." Id. Here, Defendants appear to argue that the Court should have applied federal common law because doing so would have prohibited the Trustee from obtaining a constructive trust. That argument is inconsistent with the Third Circuit's holding in Columbia Gas and, in any event, constructive trusts are entirely consistent with the Bankruptcy Code.

28 The Court found at summary judgment that New York law applies to the Trustee's contract claims, and reiterated that finding in the Opinion. D.I. 463 at pp. 36, 41 [APP 2093, 2098]; Opinion at pp. 109, 114 [APP 0110, 0115]. Defendants do not argue that application of New York law to the contract claims was in error. Thus, the parties and the Court are in agreement that Delaware law is proper with respect to the remedy of a constructive trust. In any event, equitable remedies are not subject to the same choice of law provision as contractual claims themselves. See, e.g., Vigortone Ag Prod., Inc. v. PM Ag Prod., Inc., 217 F.Supp.2d 858, 863 (N.D. Ill. 2001) ("Illinois law applies to Provimi's fraud and equitable relief claims and Delaware law applies to its breach of contract claim."); Innovative BioDefense, Inc. v. VSP Techs., Inc., No. 12 CIV. 3710 (ER), 2013 WL 3389008, at *5 (S.D.N.Y. July 3, 2013) ("Claims for unjust enrichment or quantum meruit 'are non-contractual, equitable remedies' and are therefore outside the scope of the parties' choice-of-law provision."); NVR, Inc. v. Harry A. Poole, Sr. Contractor, Inc., No. CIV.A. ELH-14-241, 2015 WL 1137739, at *6 (D. Md. Mar. 13, 2015) ("It is not entirely clear that the extra-contractual, equitable remedy of contribution is subject to the choice of law provision in the Contract.").

29 "Texas law gives its citizens an exemption in up to 10 acres of real property in an urban area, in one or more contiguous tracts, and any improvements thereon, without dollar limitation." In re Bading, 376 B.R. 143, 146 (Bankr. W.D. Tex. 2007) (citing Tex. Prop. Code §§ 41.001(a), 41.002(a)).

1 The Movants herein are a subset of the numerous defendants joined in the adversary.

2 All capitalized terms not defined in this Suggestion [D.I. 552] shall have the meaning ascribed to them in the Objection or the Opinion.

3 *See* Suggestion [D.I. 552], at 1-2; *see also* [APP 5-6] (Opinion, at 4-5). In its Response, the Trustee suggests that there were only two categories of claims presented at trial—the "PowerGen" claims and the "SPA" claims. *See Response of Plaintiff Alan Halperin, Trustee of the GFES Liquidation Trust, to Limited Objection Under Federal Rule of Bankruptcy Procedure 9033 of the Defendants Michel B. Moreno and MOR MGH Holdings, LLC to the Proposed Findings of Fact and Conclusions of Law Set Forth in the Bankruptcy Court's Opinion (D.I. 535) and Order (D.I. 540)* [D.I. 562] (the "Response").

4 *See* Response [D.I. 562], at 1.

5 [APP-0037-38] (Opinion, 36-37) (citing [APP-1148] Trial Tr. 523, [APP-1157-58] 559-62, [APP-1159] 567-68); *see also* [APP 0118] (Opinion, 117).

6 Indeed, later in its Response, the Trustee quotes Moreno to argue that Moreno's focus on PowerGen was one of the primary reasons why he could not raise the capital necessary to fund the SPA obligations. Response [D.I. 562], at 28-29. Thus, there is simply no merit to the suggestion that one set of claims has nothing to do with the other.

7 D.I. 550.

8 *Memorandum Order on Trustee's Motion for Reconsideration* [D.I. 473], at 2-4.

9 The Trustee's Response does not directly address to the point raised in Defendants' Objection beyond restating what was expressed in the Opinion and a reference to Section 5.15 (the Further Assurances covenant) in the July loan [APP 822]. This reference hardly overrides the fact that the express purpose of the July loan was limited to investments in ***TGS***, not Green Field, and is not evidence that Goldman Sachs actually intended for its loan proceeds to be used to fund MOR MGH's obligations under the 2013 SPA. Thus, Defendants stand behind their initial Objection on this point and have nothing further to add on the earmarking argument. *See Suggestion* [D.I. 552], ¶¶ 35-59.

10 *See, e.g.,* [APP 0084-109] (Opinion, 88-98) (ruling in Moreno's favor on fraudulent transfer claims, and finding that Moreno dealt transparently with the board of directors and bondholders).

11 [APP 0105] (Opinion, 104) ("Only by taking those actions [of borrowing money from GE and Goldman Sachs] was Moreno able to insert approximately $50 million for the benefit of Green Field.").

12 Should the Trustee appeal those findings, this Court must consider such findings for "clear error." *Manus Corp. v. NRG Energy, Inc. (In re O'Brien Envtl. Energy, Inc.),* 188 F.3d 116, 122 (3d Cir. 1999) (citing *Interface Group-Nevada, Inc. v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.),* 145 F.3d 124, 130 (3d Cir. 1998)) ("In reviewing the decision of the Bankruptcy Court, ... we review the Bankruptcy Court's legal determinations de novo, its factual findings for clear error, and its exercise of discretion for abuse thereof.").

13 The Trustee suggests that Defendants did not object to the Bankruptcy Court's legal holdings. Response [D.I. 562], at 19. This is inaccurate. The Objection focused less on the Bankruptcy Court's citation to case law—which is the same authority considered and rejected as unpersuasive by the Bankruptcy Court in the decisions quoted above—and more on the Bankruptcy Court's application of facts to applicable authorities. This Court reviews all legal issues *de novo* and may reach the same conclusion that the Bankruptcy Court reached before trial—*i.e.,* that *House of Diamonds, Scavenger* and *Winik* do not impose automatic liability and require proof of causation and actual harm. Such evidence was not presented at trial.

14 It is important to note that the Opinion (which closely tracks the Trustee's proposed findings) misstates the stipulated facts and Moreno's testimony. *Compare* [APP 0112] (Opinion, 111) *with* [APP 0205] (Stip. Fact ¶ 83) and [APP 1135] (Trial Tr. 469:20 – 470:3). The Opinion proposed finding that "Moreno acknowledged that had the SPA been fulfilled, Green Field would have been able to make the required interest payments under the Shell Contract," and that "Green Field would have avoided its cross-defaults under the Shell Contract and Bond Indenture" if it had made payments to Shell. [APP 0112] (Opinion, 111). But, in point of fact, further review of the trial transcript reveals that Moreno never acknowledged that payment under the SPAs would have resulted in payment to Shell, and there is no evidence in the record that Shell declared a default due to Green Field's failure to pay interest. Thus, it would be incorrect to enter a finding that the non-payment of the SPA directly caused Shell to declare a default. The record does not support and, in fact, contradicts such a finding.

15 *Compare* [APP 0112-113] (Opinion, 111-112) *with* [APP 0404-405] (Trustee's Proposed Findings, 87-88).

16 *See* Suggestion [D.I 552], ¶¶ 31-32 (citing [APP 1128-29] (Trial Tr. 424:21 – 426:9, 430:11 – 431:20)).

17 Defendants do not dispute this fact.

18 This proposed finding appears to be inadvertently entered. It hinges on a finding that Green Field transferred PowerGen to TGS, which was part of the Trustee's fraudulent transfer claims. By ruling in the Defendants' favor on Counts 1 and 2 (fraudulent transfer counts), the Bankruptcy Court never found that anything was transferred. Rather, the Bankruptcy Court concluded that Green Field never held a property interest in the PowerGen opportunity and, thus, had nothing of value to transfer or waive.

19 This finding has no support in the record and is actually contradicted by the evidentiary record. As detailed in the Objection, Moreno testified that, in light of Shell's notification of termination, Green Field would not have paid Shell whether it had the money from the SPAs or not.

20 As discussed in detail in the Objection, the terms of the loan documents cannot be ignored. These funds were never actually loaned to or earmarked for Green Field. Nothing in any of the loan documents includes a specific requirement that the funds be invested in Green Field. Most of the funds were intended for investment in TGS.

21 The Trustee and the Bankruptcy Court's reliance on this document as proof of Moreno's dishonesty or deception is misplaced. Nowhere in the record is there any corroborating evidence from Goldman Sachs that Goldman Sachs, itself, relied on the certification in deciding to advance funds. According to the actual loan documents and Notice of Borrowing, Goldman Sachs advanced funds to the owner of MOR DOH for the purpose of investing the funds in TGS. [APP 0795-0873 (PX 166), APP 0911-0915]. Following that loan advance, TGS made $10 million in deposits with Green Field to hold while Green Field's subsidiary (TPT) completed work for TGS at a substantial mark-up, which would benefit Green Field as a 50% owner of TPT. [APP 0435-0436] (JX 3).

22 Notably, this footnote closely tracks the submission from Trustee's counsel. [APP 0415] (Trustee's Proposed Findings, 98). No other briefing was submitted to the Bankruptcy on this issue. Thus, the issue was not fully (or even partially) briefed.

23 In Texas, "homesteads are favorites of the law," and courts generally give "a liberal construction to the constitutional and statutory provisions that protect homestead exemptions." *See In re Bradley,* 960 F.2d 502, 507 (5th Cir. 1992) (citations omitted). Courts applying Texas law are duty-bound to uphold and enforce the Texas homestead laws, "even though in so doing we might unwittingly 'assist a dishonest debtor in wrongfully defeating his creditor.' " *Id.* at 507 (quotation omitted). At least one panel of the Fifth Circuit has gone so far as to call Texas homestead exemptions "sacrosanct." *See Border v. McDaniel (In re McDaniel),* 70 F.3d 841, 843 (5th Cir. 1995).

24 *See* Plaintiff's Statement of Contested Issues of Fact, Proposed Joint Final Pretrial Order [APP 0207] (D.I. 474, Exhibit B-1). The Trustee presented only nine (9) fact issues for the Court's consideration. None of those issues can be construed as asking the Bankruptcy Court to determine that Moreno lied, committed fraud or engaged in some unconscionable or unfair conduct.

25 The only references to fraud in the Plaintiff's Statement of Contested Issues of Fact concern ***Green Field's*** intent in connection with the alleged fraudulent transfer of the PowerGen business or opportunity.

26 As discussed in the Objection and supporting brief, the stated purpose for the loan under the loan documents and notice of borrowing clearly limit the use of loan proceeds to investment in TGS, not for investment in Green Field.

27 *See* Suggestion [D.I. 552], ¶¶ 35-59.

28 [APP 0912-0915] (Notice of Borrowing) ("Purpose of Funding: To make an equity investment of $15,000,000 in Turbine Generation Services, L.L.C. in accordance with Section 2.9 of the Loan Agreement."); *see also* [APP 0819] (Loan Agreement, § 2.9) ("The Borrowers shall use the proceeds of the Loan to make an equity investment in Turbine Generation Services, L.L.C....").

29 As Moreno testified, he has settled with Goldman Sachs. [APP 1098].

End of Document

13

KeyCite Yellow Flag - Negative Treatment
Distinguished by In re RISCmanagement, Inc., Bankr.D.Mass., February 5, 2004

287 B.R. 363
United States Bankruptcy Court,
E.D. Virginia,
Norfolk Division.

In re HOLMES ENVIRONMENTAL, INC., Debtor.
Holmes Environmental, Inc., Plaintiff,
v.
Suntrust Banks, Inc. and Hazmed, Inc., Defendants.

Bankruptcy No. 02–70034–S.
|
Adversary No. 02–07029–S.
|
July 18, 2002.

Synopsis
Chapter 11 debtor brought motion to reject executory contract and complaint for turnover of proceeds. The Bankruptcy Court, Stephen C. St. John, J., held that: (1) proceeds from government contract in possession of escrow agent were res of express trust created by debtor and could not be considered estate property; (2) escrowed funds could not be set aside as preference; (3) subcontractor was entitled to new value defense; (4) post-petition transfer of funds from government to escrow agent to be paid to subcontractor could not be avoided; and (5) escrow agreement could not be rejected as executory.

Motion and relief requested denied.

West Headnotes (25)

[1] **Bankruptcy** Property held by debtor as trustee, agent, or bailee

When a debtor does not own an equitable interest in property he holds in trust for another person, that interest is not property of the estate for purposes of the Bankruptcy Code. Bankr.Code, 11 U.S.C.A. § 541.

5 Cases that cite this headnote

[2] **Bankruptcy** Effect of state law in general

What constitutes an equitable interest subject to exclusion from the bankruptcy estate is a question of state law. Bankr.Code, 11 U.S.C.A. § 541.

[3] **Trusts** What law governs

Whether a trust has been established is generally a question to be resolved under the law of the state that is the situs of the trust fund.

[4] **Contracts** Agreements relating to actions and other proceedings in general

In Virginia, the true test for determination of proper law of a contract is the intent of parties, and such intent, whether express or implied, will be given effect except under exceptional circumstances evincing a purpose in making the contract to commit a fraud on the law.

1 Case that cites this headnote

[5] **Bankruptcy** Deposits and securities; bonds

Proceeds from government contract in possession of escrow agent, representing payments for work performed by subcontractor, as creditor, were res of express trust created by Chapter 11 debtor and could not be considered estate property, even though debtor asserted that execution of instrument of assignment was necessary to create express trust; intent to create trust was evident since subcontractor would not have entered into subcontract and performed work thereon unless debtor had made its promise prior to filing to create trust and escrow to ensure subcontractor would be paid for its work. Bankr.Code, 11 U.S.C.A. § 541; 26 U.S.C.A. § 15(b); 41 U.S.C.A. § 15 et seq.

1 Case that cites this headnote

[6] **Bankruptcy** Deposits and securities; bonds

When determining whether an escrow account is part of a debtor's estate, the nature and circumstances of the escrow agreement control; factors to consider when making this determination include, but are not limited to, whether the debtor initiated or agreed to the creation of the escrow, what if any control the debtor exercises over it, the incipient source of it, the nature of the funs put into it, the recipient of its remainder, the target of all its benefit, and the purpose of its creation. Bankr.Code, 11 U.S.C.A. § 541.

1 Case that cites this headnote

[7] **Trusts** Sufficiency of Language Used

In Virginia, while it is essential to the creation of a trust that there be an explicit declaration of trust, or circumstance, which show beyond a reasonable doubt that a trust was intended to be created, no formal, technical, or particular words are necessary; rather, it is sufficient if an intention to create a trust, and the subject matter, purposes, and beneficiary are stated with reasonable certainty.

1 Case that cites this headnote

[8] **United States** Claims within prohibition

As compliance with the Assignment of Claims Act is unnecessary to perfect a lien between individual private parties, such compliance is also unnecessary to create a trust between individual private parties, provided there has been an adequate manifestation of the parties of the intent to create a trust arrangement. 41 U.S.C.A. § 15(b).

[9] **Trusts** Nature of constructive trust

In Virginia, constructive trusts occur not only where property has been acquired by a fraud or improper means, but also where it has been fairly and properly acquired, but it is contrary to principles of equity that it should be retained, at least for the acquirer's own benefit.

[10] **Bankruptcy** Deposits and securities; bonds

Constructive trust existed between subcontractor, as creditor, and contractor, as Chapter 11 debtor, over escrowed proceeds of government contract, that operated to place proceeds earned by subcontractor outside of estate property of debtor, since there was segregated, identifiable res and debtor substantially prior to its bankruptcy filing agreed to set aside property in trust for benefit of subcontractor. Bankr.Code, 11 U.S.C.A. § 541.

[11] **Bankruptcy** Claims

While the bankruptcy process by its application may operate to greatly reduce otherwise legitimate claims, this may not occur where a debtor substantially prior to its bankruptcy filing agrees to set aside property in trust for the benefit of a third party. Bankr.Code, 11 U.S.C.A. § 541.

[12] **Bankruptcy** Property held by debtor as trustee, agent, or bailee

Bankruptcy Ownership of interest transferred

Funds in express trust created by contractor, as debtor, and subcontractor, as creditor, more than 90 days prior to bankruptcy, were not property of Chapter 11 estate and could not be set aside as preference. Bankr.Code, 11 U.S.C.A. § 547.

1 Case that cites this headnote

[13] **Bankruptcy** Preferences

Bankruptcy Ownership of interest transferred

To be avoidable as a preference, a transfer must deprive the debtor's estate of something of value which could otherwise be used to satisfy creditors; when an escrow or trust is created,

the only interest left in the escrowed funds is a contingent right to any surplus after payment of the claims against the fund. Bankr.Code, 11 U.S.C.A. § 547.

[14] **Bankruptcy** Particular cases

Subcontractor, as creditor, was entitled to new value defense, to claim of preferential transfer by contractor, as Chapter 11 debtor, since subcontractor proved specific value of its performance under subcontract at time of alleged preferential transfers. Bankr.Code, 11 U.S.C.A. § 547(c)(4).

1 Case that cites this headnote

[15] **Bankruptcy** Preferences

The purpose of preferential transfer provision is to protect the debtor from a creditors' race to the courthouse and to ensure the Bankruptcy Code's policy of distributing the debtor's estate equally among its similarly situated creditors; when these purposes are not served, a trustee may not avoid certain transfers that otherwise meet the elements of a preference. Bankr.Code, 11 U.S.C.A. § 547(b).

[16] **Bankruptcy** New Value

To establish the new value defense to a claim of a preferential transfer, the creditor must prove that it is a creditor to, or for, whose benefit such transfer was made, that it and the debtor had the requisite intent to make a contemporaneous exchange for new value, and the exchange must be in fact contemporaneous and for new value. Bankr.Code, 11 U.S.C.A. § 547(g).

1 Case that cites this headnote

[17] **Bankruptcy** Contemporaneous character; time element

In the context of the new value defense to a claim of a preferential transfer, intent to make a contemporaneous exchange for new value may be gleaned from, inter alia, the agreement or the course of dealings between parties. Bankr.Code, 11 U.S.C.A. § 547.

2 Cases that cite this headnote

[18] **Bankruptcy** Contemporaneous character; time element

In the context of the new value defense to a claim of a preferential transfer, the alleged new value must be measured as of the time the preferential transfer took place. Bankr.Code, 11 U.S.C.A. § 547.

[19] **Bankruptcy** New Value

In the context of the new value defense to a claim of a preferential transfer, the new value exception may be satisfied by an indirect transfer of value via a third party to a debtor rather than a direct transfer of value from creditor to debtor. Bankr.Code, 11 U.S.C.A. § 547.

[20] **Bankruptcy** Post-petition transactions

Post-petition transfer of funds from government to escrow agent to be paid to subcontractor, as creditor, could not be avoided by Chapter 11 debtor, even though debtor asserted that escrow or trust was not created until actual payment of proceeds by government; transfer of beneficial interest in monies to be earned by subcontractor on government contract occurred pre-petition because debtor substantially prior to bankruptcy filing made irrevocable election through escrow agreement, and subcontract which manifested present intention that monies earned by subcontractor were to be set aside under express trust under Virginia law exclusively for payment to subcontractor. Bankr.Code, 11 U.S.C.A. § 549.

2 Cases that cite this headnote

[21] **Bankruptcy** Executory nature in general

Escrow agreement, that was made in conjunction with subcontract and for purpose of providing vehicle to ensure subcontractor would be paid for its work performed on government subcontract, was not executory, and could not be rejected

by contractor, as Chapter 11 debtor, since work under subcontract was complete, except for debtor's submission of invoices to government for any unbilled work done by subcontractor. Bankr.Code, 11 U.S.C.A. § 365.

1 Case that cites this headnote

[22] **Bankruptcy** "Business judgment" test in general

Once a contract is found to be executory, it must then be determined whether rejection is advantageous to the debtor; when making this determination, the sound business judgment rule is applied, where, under this maxim, the same deference is given to a decision to reject an executory contract as is given to other business management actions. Bankr.Code, 11 U.S.C.A. § 365.

1 Case that cites this headnote

[23] **Bankruptcy** Executory nature in general

In the context of executory contract provision, when determining whether a contract is so unperformed that failure to complete performance would be a material breach, it is appropriate to look to state law. Bankr.Code, 11 U.S.C.A. § 365.

1 Case that cites this headnote

[24] **Bankruptcy** Executory nature in general

Where a contract has been assigned and the underlying contract is sufficiently performed so as not to be executory, then the assignment may not be rejected as executory. Bankr.Code, 11 U.S.C.A. § 365.

[25] **Bankruptcy** Executory nature in general

In the context of executory contract provision, contracts are generally not executory where the only obligation remaining is to pay money. Bankr.Code, 11 U.S.C.A. § 365.

Attorneys and Law Firms

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MEMORANDUM OPINION AND ORDER

STEPHEN C. ST. JOHN, Bankruptcy Judge.

These matters came on for hearing and trial, respectively, on May 28, 2002 on the Motion to Reject Executory Contract ("Motion") and the Amended Complaint for Turnover of Proceeds pursuant to 11 U.S.C. § 542 ("Amended Complaint"), each filed by the debtor. After the conclusion of the hearing and trial, the Court took both the Motion and the Amended Complaint under advisement. This Memorandum constitutes this Court's findings of fact and conclusions of law pursuant to Federal Rule of Bankruptcy Procedure 7052.[1]

FINDINGS OF FACT

Holmes Environmental, Inc. ("Holmes") filed for relief pursuant to Chapter 11 of the United States Bankruptcy Code in this Court on January 2, 2002.[2] On February 28, 2002, Holmes filed the Motion, which sought the entry of an order rejecting a certain escrow agreement between Holmes and Hazmed, Inc. ("Hazmed"). The Motion alleged, among other things, that on or about March 23, 2001, Holmes and Hazmed entered into an escrow agreement, which provided for a payment arrangement in connection with work performed by Hazmed under a subcontract agreement between Holmes and Hazmed. Motion, ¶ 5. ("Escrow Agreement"). Holmes also alleged that, incident to the Escrow Agreement, Holmes executed an instrument of assignment ("Instrument of Assignment") which, among other things, assigned proceeds payable by the United States of America Army Corps of Engineers, Louisville District

("Corps") to Suntrust Bank, Inc. ("Suntrust") in connection with a certain contract between Holmes and the Corps, pursuant to which the subcontract agreement with Hazmed was executed ("Subcontract"). Motion, ¶ 6. Asserting that the Subcontract between Holmes and Hazmed expired by its terms on December 21, 2001, Holmes determined it to be in its best interest to reject the Escrow Agreement. Motion, ¶¶ 7, 8. Hazmed responded in opposition to the Motion, contending that the Escrow Agreement and the Instrument of Assignment are not executory agreements. A hearing on the Motion was scheduled for April 11, 2002.

Meanwhile, Holmes filed a Complaint against Hazmed and Suntrust on March 14, 2002. The original Complaint alleged that monies funded into escrow with Suntrust by the Corps pursuant to the Escrow Agreement constitute property of estate to which Hazmed has no title or lien. ***368** Holmes prayed that this Court order Suntrust to turnover all of the escrowed funds to Holmes.[3] The Amended Complaint was filed by Holmes on April 18, 2002.[4] The Amended Complaint, in addition to seeking entry of an order authorizing Suntrust to turnover the monies held by it pursuant to the Escrow Agreement, alleged that the Instrument of Assignment pursuant to the Federal Assignment of Claims Act under which Holmes assigned to Suntrust for deposit into the escrow account the payments due Holmes under the contract with the Corps was not executed until October 8, 2001. Holmes further alleged that payment under the contract with the Corps was not remitted to Suntrust until January 15, 2002, after the date of filing of the petition in bankruptcy by Holmes. Accordingly, Holmes alleges that the execution of the Instrument of Assignment by Holmes was a transfer of the interest of Holmes in property within ninety days of the filing date and therefore is avoidable pursuant to 11 U.S.C. § 547. Alternatively, Holmes alleges the transfer of the funds due under the Corps contract to Suntrust on January 15, 2002 was on account of a pre-petition debt and therefore an avoidable post-petition transfer pursuant to 11 U.S.C. § 549.

Hazmed disputes the allegations of the Amended Complaint. First, Hazmed contends the Instrument of Assignment was executed on March 23, 2001 and not on October 8, 2001 as alleged by Holmes. Hazmed also answers the Amended Complaint by asserting the funds held by Suntrust under the Escrow Agreement are subject to an express trust and are not property of the estate under 11 U.S.C. § 541. Alternatively, Hazmed argues the funds held by Suntrust are subject to a constructive trust and therefore are not estate property. Lastly, should the Court find any of the transfer here to be preferential, Hazmed asserts that it is entitled to a new value defense under 11 U.S.C. § 547(C)(4) to the extent of the value of the services provided to Holmes by Hazmed subsequent to the execution of the Instrument of Assignment.[5]

Little appears to be factually disputed between Holmes and Hazmed other than the date of execution of the Instrument of Assignment. Holmes is an environmental remediation and training contractor with its principal place of business in Norfolk, Virginia. Amended Complaint, ¶ 1. Ethel Holmes ("Ms. Holmes") is president of Holmes. She was approached by Ms. Jackie Sales, president of Hazmed ("Ms. Sales"), about the possibility of bidding various construction management contracts with the Corps. Holmes and Hazmed executed a teaming agreement dated September 29, 2000, where Holmes and Hazmed agreed to attempt to procure contract work from the Corps. Holmes and Hazmed worked together on a bid proposal through the fall of 2000 and Holmes submitted a bid to the Corps for a certain ***369** construction management job. In December 2000, Holmes was awarded a contract by the Corps ("Corps Contract"). Thereafter, Holmes and Hazmed entered into the Subcontract, where Hazmed would perform a portion of the work of the Corps Contract as a subcontractor. Bearing the date of February 8, 2001, the Subcontract was executed at a closing in Richmond, Virginia by Ms. Holmes on behalf of Holmes and Ms. Sales on behalf of Hazmed on March 22, 2001. The Subcontract contemplated an initial period of performance through December 21, 2001. Section 16.3 of the Subcontract provided for creation of an assignment of receivables to an escrow account:

> Contractor agrees to execute an assignment of receivables to an escrow account for the invoices processed under the Prime Contract. The bank will be instructed to pay the Subcontractor's invoices per disbursement schedule. A copy of each invoice will also be submitted to the bank along with a copy of the applicable disbursement schedule, indicating the amounts due and payable to each party. All bank service cost or fees associated with escrow account will be divided between the Contractor and Subcontractor according to the division of work.

Pl.Ex. 1, Def.Ex. 1, ¶ 16.3

The Escrow Agreement was executed on March 23, 2001 by Holmes and Hazmed. Ms. Sales insisted on an escrow agreement because her investigation of the finances of Holmes indicated Holmes did not have substantial financial

strength. The Escrow Agreement recites the award of the Corps Contract, the making of the Subcontract and that Holmes "has assigned to Escrow Agent, pursuant to the provisions of the Assignment of Claims Act of 1940, as amended, ... certain payments to be made by U.S. Army Corps of Engineers Louisville District under the Prime Contract for the purpose of facilitating the payment to Vendor pursuant to the terms of the Agreement [the Subcontract]." Pl.Ex. 2, Def. Ex. 2, p. 1. The Escrow Agreement appointed Suntrust as escrow agent and provided the following as to its disbursement of monies paid by the Corps on the Corps Contract:

> 1. Appointment of Escrow Agent. [Holmes] and [Hazmed] hereby appoint Escrow Agent to act as the agent of such parties in accordance with the provisions of the Agreement and this Escrow Agreement, Escrow Agent accepts such appointment.
>
> 2. Submission of Invoices. [Hazmed] agrees that upon shipment to [Holmes] and issuance of its invoice to [Holmes], that it will promptly forward to the Escrow Agent a copy of the invoice. [Holmes] agrees that upon issuance of bill of lading or other commercial instrument evidencing delivery to a common carrier of the material purchased from [Hazmed], [Holmes] shall promptly invoice USACE Louisville District and provide a copy to [Hazmed] and the Escrow Agent, together with a letter in the form of Exhibit A (the Payment Instruction).
>
> 3. Receipt of Funds. Escrow Agent shall promptly deposit all payments received under the Prime Contract into a non-interest bearing account.
>
> 4. Disbursements. Upon receipt of payment under the Prime Contract, Escrow Agent will compare the payment Instructions received from [Holmes] against [Hazmed] invoice. Unless a discrepancy exists between the Payment Instructions received from [Holmes] and [Hazmed's] invoice, or unless Escrow Agent has ***370** been notified by either [Hazmed] or [Holmes] of a discrepancy or of a default under the Agreement, Escrow Agent will disburse to [Hazmed], within 2 business days, the amount due [Hazmed]. Any funds remaining in the escrow account after payment to [Hazmed] will be paid to [Holmes] within 2 business days. Escrow Agent will notify [Holmes] and [Hazmed] of any discrepancy between the Payment Instructions and [Hazmed's] invoice or of any disagreement, adverse claim or demand it has received notice of and hold funds in accordance with Section II, paragraph 7 of this Agreement.

Id. ¶¶ I. 1–4. The Escrow Agreement also provided it was made and intended to be constructed under the laws of the Commonwealth of Virginia. Id., ¶ IV, 3.

While there is clarity as to the time and place of the execution of the Subcontract and the Escrow Agreement by Holmes and Hazmed, the circumstances of the execution of the contemplated Instrument of Assignment are in dispute. The Instrument of Assignment was the document to be forwarded to the Corps pursuant to the Assignment of Claims Act irrevocably assigning to Suntrust all monies due or to become due under the Corps Contract.[6] Ms. Sales testified that the Instrument of Assignment was executed on March 23, 2001 in Richmond, Virginia simultaneously with the execution of the Subcontract and the Escrow Agreement. Yet, on cross-examination, Ms. Sales also testified that the chief financial officer for Hazmed, Frank Costa ("Costa") visited Holmes' offices on October 8, 2001 for two purposes, being the conduction of due diligence in the course of Hazmed's consideration of whether to purchase Holmes as well as bringing an instrument of assignment to be executed by Holmes. Ms. Holmes, on the other hand, recalls no other documents being signed at the March 23, 2001 closing other than the Subcontract and the Escrow Agreement. She believes the Instrument of Assignment was not executed until October 8, 2001, when Costa brought the document to Holmes for execution. The Instrument of Assignment Ms. Holmes recalls signing bears no corporate seal and is signed as "Ethel Holmes By: Holmes Environmental, Inc. Ethel M. Holmes, President." Pls. Ex. 3. This Instrument of Assignment also bears the typed date of March 23, 2001. Ms. Holmes and Costa forwarded this executed Instrument of Assignment to the Corps. On October 25, 2001, the Corps forwarded to Suntrust a Notice of Assignment, which was acknowledged ***371** on October 23, 2001 by Janet M. Henderzahs, Contracting Officer on behalf of the Corps ("Acknowledged Notice of Assignment."). This Acknowledged Notice of Assignment was executed on behalf of Suntrust by Emily J. Hare, corporate trust officer.

The mystery is deepened by the existence of copies of the Instrument of Assignment and the Notice of Assignment which are at variance with the Acknowledged Notice of Assignment and the Instrument of Assignment forwarded to the Corps in October 2001 ("October Instrument of Assignment"). This Instrument of Assignment offered into evidence by Hazmed appears to be the identical form

document as the October Notice of Assignment and also bears the typed date of March 23, 2001. This document bears the corporate seal of Holmes and instead is executed "Holmes Environmental, Inc. By: Ethel M. Holmes, President." Def. Ex. 3. This document also bears no attestation signature. Ms. Sales testified this copy was not among the business records of Hazmed but was received from the Corps at her request. She offered no explanation of the circumstances under which she received this document. Furthermore, Deborah Dodson, corporate trust officer of Suntrust, sent a letter dated April 28, 2001 forwarding an executed Escrow Agreement and a Notice of Assignment bearing Deborah Dodson's name as signatory.[7] Pl.Ex. 13. Dodson's letter also notes: "[t]he contractor is responsible for signing the Instrument of Assignment and sending it, along with the Notice of Assignment, to the paying office of the Corps of Engineers. Please note that the Instrument of Assignment will need a Corporate Seal and a signature to attest to your position."

The course of the performance of the Corps Contract is not disputed. Work commenced and invoices were submitted to the Corps for payment. Hazmed would initially prepare the invoices and forward them to Holmes, who would add the hours worked by Holmes personnel to the invoice. Some were returned because of deficiencies in the submitted paperwork. Meanwhile, all of the monies from the invoices which were being paid by the Corps were sent directly to Holmes and were not paid into the escrow established at Suntrust.[8] Hazmed's concerns about the financial condition of Holmes proved to be well-founded, as Holmes, after receipt of the proceeds of the invoices for completed work on the Corps Contract, failed to pay Hazmed the full amounts it was due under the Subcontract.[9]

Despite these payment problems, Hazmed expressed an interest in possibly purchasing Holmes. Hazmed pursued these negotiations and conducted certain due diligence in the process of evaluating the appropriate purchase price for Holmes. These talks were ultimately unsuccessful as Holmes and Hazmed could not agree on a purchase price.

All of the paperwork relating to the Corps Contract for Holmes was handled by Bernard Key ("Key"), the bookkeeper for Holmes. Similarly, much of the responsibility for processing the documentation concerning the Corps Contract at Hazmed was done by Costa. Ironically, ***372** both have now been discharged by their respective employers. Key apparently left the financial records of Holmes in some disarray, as a new outside bookkeeper is now attempting to reconstruct many of the financial records of Holmes.

Holmes' financial condition all the while continued to deteriorate. By October 8, 2001, Holmes owed creditors in excess of $300,000.00 as well as having an arrearage on its tax payments of $130,000.00 to $140,000.00. Because of the payment problems with Holmes in late 2001, Hazmed initiated a motion for judgment against Holmes in state court. Holmes filed for relief in this Court on January 2, 2002. The Corps on January 15, 2002, made a disbursement of monies due under the Corps Contract to Suntrust, which Suntrust deposited into the escrow account established by the Escrow Agreement. This payment by the Corps, which represented payment on several months of invoices, totaled $351,254.26. Ms. Holmes admitted at trial that, of the amount on deposit at Suntrust, only the sum of $21,622.00 represented monies owed to Holmes and, accordingly, the remainder of $329,632.26 are monies owed to Hazmed for its performance of work under the Subcontract. From April 1, 2001 through September 30, 2001, Hazmed invoiced Holmes for reimbursement of costs incurred in the performance of he Subcontract in the amount of $77,986.84. Pl.Ex. 10. From October 2, 2001 through January 31, 2002, Hazmed invoiced Holmes for reimbursement of costs incurred in their performance of the Subcontract in the amount of $31,990.04. *Id.*[10] Apparently, the work on the Corps Contract has now been fully performed, but monies remain unpaid as the Corps is awaiting certain information in order to pay the final invoices submitted on the Corps Contract.

This one disputed factual issue of when the Instrument of Assignment was executed requires resolution, as Holmes' contention that the transfer of monies to Suntrust is a preference avoidable under 11 U.S.C. § 547 initially rises or falls based on this Court's conclusion as to when the Instrument of Assignment was executed. Holmes contends the Instrument of Assignment was signed not until October 8, 2001, within ninety days of its filing for bankruptcy. Hazmed instead contends the Instrument of Assignment was signed on March 23, 2001 simultaneously with the execution of the Escrow Agreement and the Subcontract, well outside of the ninety day preference window.[11]

Despite the directly contradictory testimony of Ms. Holmes and Ms. Sales as to the date of execution of the Instrument of Assignment, this much appears certain: the Corps did not acknowledge the receipt of a Notice of Assignment of Claims until October 23, 2001. Pls. Ex. 13. This is also

apparent from the fact the initial payments under the Corps Contract during the spring and summer of 2001 were made directly to Holmes and not to the escrow established at Suntrust. Had the Corps received either an Instrument of Assignment or a Notice of Assignment prior to October 23, 2001, it presumably would have acted upon these instruments and begun forwarding payments on the Corps Contract to Suntrust and not to Holmes. Accordingly, the Court is satisfied the ***373** Corps did not actually receive an executed Instrument of Assignment until sometime in October 2001. However, this conclusion does not preclude finding that the Instrument of Assignment was executed on March 23, 2001, as Ms. Sales testified, but never forwarded to the Corps by Holmes. This theory may be supported by an "Administrative Progress Report for the week ending 04/28/01–05/11/01," made by Costa, which notes "I have followed up with Ethel Holmes regarding the completed Instrument of Assignment and Notice of Assignment for the Louisville Corps contract." Def. Ex. 3.[12]

However, while the execution of the Instrument of Assignment on March 23, 2001 and the subsequent failure of presumably Key to forward it to the Corps has some support in the evidence, it appears the greater weight of the evidence supports the conclusion that the Instrument of Assignment was executed on October 8, 2001, as testified by Ms. Holmes. Ms. Sales specifically testified that Costa went to Holmes' office, among other things, to bring an Instrument of Assignment to be signed. The evidence of the other copy of the Instrument of Assignment executed slightly differently from the Instrument of Assignment executed on October 8, 2001 is simply too fragmentary to contradict this finding. While Ms. Sales stated she obtained this copy of the Instrument of Assignment from the Corps, she provided no other details of this investigation, such as why and when she requested this document, who at the Corps provided same or what file at the Corps contained this version of the Instrument of Assignment.[13]

Ms. Sales likewise fails to provide any additional details to her conclusive recollection that the Instrument of Assignment was executed on March 23, 2001 at the closing in Richmond, Virginia. Comparing this uncertainty against the greater certainty that the Acknowledged Instrument of Assignment was executed on October 8, 2001 on the occasion of Costa's trip to Holmes, it appears the weight of the evidence at trial persuades this Court that the Instrument of Assignment was not executed until October 8, 2001.

It remains, however, to determine what legal import, if any, this factual conclusion has in determining whether (1) a preferential transfer or post-petition transfer has occurred which are voidable; (2) whether the proceeds of the Corps Contract now held by Suntrust, or any portion thereof, is property of the estate of Holmes pursuant to 11 U.S.C. § 541; and (3) is the Escrow Agreement an executory contract pursuant to 11 U.S.C. § 365 which Holmes may reject. Holmes contends that a transfer of the interest of Holmes in property occurred at the time of the execution of the Instrument of Assignment on October 8, 2001 and that all of the other elements of an avoidable preferential transfer are shown by the evidence. Holmes also alternatively contends the payment of monies by the Corps to Suntrust on January 15, 2002 after filing of its petition in bankruptcy constitutes an avoidable post-petition transfer pursuant to 11 U.S.C. § 550. Holmes finally contends that sufficient ***374** duties remain to be performed by Holmes and Hazmed under the Escrow Agreement that it remains executory and thus may be rejected by Holmes pursuant to 11 U.S.C. § 365. Hazmed disagrees in each instance, contending that the circumstances here show that either an express or constructive trust in the escrowed monies was created for the benefit of Hazmed, which prevents the funds held by Suntrust to be property of the estate pursuant to 11 U.S.C. § 541 and further precludes the finding that any of the transfers here were preferential. Hazmed also believes that the remaining duties under the Escrow Agreement are insignificant and the Escrow Agreement therefore is no longer executory and therefore may not be avoided pursuant to 11 U.S.C. § 365. We address each of these arguments in turn.

I

Property of the Estate and An Avoidable Preference

A.

Express Trust

[1] [2] [3] [4] [5] The Bankruptcy Code defines the scope of property within the bankruptcy estate broadly, and includes within the estate "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1)(West.Supp.2002). Despite this breadth, expressly excluded from the estate is any "[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ..." 11 U.S.C.

§ 541(d)(West.Supp.2002). The purpose of this exclusion is to ensure that the trustee "take no greater rights [in the property] than the debtor himself had." *Old Republic Nat. Title Ins. Co. v. Tyler (In re Dameron),* 155 F.3d 718, 721 (4th Cir.1998), (quoting *Mid–Atlantic Supply, Inc. v. Three Rivers Aluminum Co.,* 790 F.2d 1121, 1124 (4th Cir.1986)). Therefore, when a "debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate' " for purposes of the Bankruptcy Code. *In re Dameron,* 155 F.3d at 721, (quoting *Begier v. IRS,* 496 U.S. 53, 59, 110 S.Ct. 2258, 110 L.Ed.2d 46(1990)). What constitutes an "equitable interest" subject to exclusion from the bankruptcy estate is a question of state law. *Butner v. United States,* 440 U.S. 48, 55, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979). As the Fourth Circuit Court of Appeals has observed: "[w]hile federal law creates the bankruptcy estate, *Butner* and the cases following it establish that state law, absent a countervailing federal interest, determines whether a given property falls within this federal framework." *American Bankers Ins. Co. v. Maness,* 101 F.3d 358, 363 (4th Cir.1996). Whether a trust has been established is generally a question to be resolved under the law of the state that is the *situs* of the trust fund. *Kupetz v. United States (In re California Trade Technical Schools, Inc.),* 923 F.2d 641, 646 (9th Cir.1991), (citing, *Altura Partnership v. Breninc, Inc. (In re B.I. Financial Services Group, Inc.),* 854 F.2d 351, 354 (9th Cir.1988)). Here, Holmes and Hazmed stipulated in the Escrow Agreement that it would be governed by the laws of the Commonwealth of Virginia. The intent of the parties for determination of a contract will be given effect except under exceptional circumstances evincing a purpose in making the contract to commit a fraud on the law. *Tate v. Hain,* 181 Va. 402, 410, 25 S.E.2d 321, 324 (1943). Accordingly, we must look to Virginia law to determine whether a trust was created here under the circumstances of these transactions between Holmes and Hazmed.

In re Dameron has succinctly summarized the law of trusts of Virginia:

> Virginia law recognizes three basic forms of trust. *See* ***375** *Leonard v. Counts,* 221 Va. 582, 272 S.E.2d 190, 194–95 (1980) (discussing express, constructive, and resulting trusts). Of these, the two that are potentially relevant to the instant case are the express (or actual) trust and the constructive trust. An express trust is created when the parties affirmatively manifest an intention that certain property be held in trust for the benefit of a third party. *See Peal v. Luther,* 199 Va. 35, 97 S.E.2d 668, 669 (1957); *Broaddus v. Gresham,* 181 Va. 725, 26 S.E.2d 33, 35 (1943). An express trust may be created "without the use of technical words." *Broaddus,* 26 S.E.2d at 35. All that is necessary are words, *see id.* at 35 (citation omitted), or circumstances, *see Woods v. Stull,* 182 Va. 888, 30 S.E.2d 675, 682 (1944) (citation omitted), "which unequivocally show an intention that the legal estate was vested in one person, to be held in some manner or for some purpose on behalf of another ...," *Broaddus,* 26 S.E.2d at 35: *see also Schloss v. Powell,* 93 F.2d 518, 519 (4th Cir.1938). In contrast to an express trust, a constructive trust "arise[s] by operation of law, independently of the intention of the parties...." *Crestar Bank v. Williams,* 250 Va. 198, 462 S.E.2d 333, 335 (1995) (citation omitted). Such trusts "occur not only where the property has been acquired by a fraud or improper means, but also where it has been fairly and properly acquired, but it is contrary to the principles of equity that it should be retained...." *Leonard,* 272 S.E.2d at 194–95 (citation omitted). With either form of trust, Virginia law recognizes the beneficiary as "equitable owner of the trust property." *Broaddus,* 26 S.E.2d at 36 (quoting Austin W. Scott, Scott on Trusts § 12.1, at 86).

In re Dameron, 155 F.3d at 722.

In re Dameron is illustrative of circumstances where an express trust was found to have been created which precluded the inclusion of monies as estate property. There the debtor was a former attorney who received funds from various lenders to be held for disbursements to designated third parties following real estate closings. *Id.* at 718. Following the freezing of Dameron's accounts in a state court action, various lenders commenced an involuntary Chapter 11 petition and an adversary proceeding to recover their monies advanced to Dameron and held in the frozen accounts. Contending that the language of the real estate closing instructions created an escrow and an express trust, the Lenders sought exclusion of their advanced monies from the property of the estate.

The Fourth Circuit Court of Appeals agreed: "The language of the parties' agreements and the circumstances under which the Lenders advanced their funds to Dameron leave no doubt that the parties intended Dameron to act merely as intermediary." *In re Dameron,* 155 F.3d at 722. The Court also recognized that escrow agreements are, in fact, a type of express trust. *In re Dameron,* 155 F.3d at 723.

[6] Courts in other jurisdictions have considered whether particular escrow arrangements are sufficient to exclude monies from the bankruptcy estate. Some courts have found that, in determining whether an escrow account is part of

the debtor's estate, the nature and circumstances of the escrow agreement control. *O'Neil v. Shipman (In re Pratt and Whitney, Inc.),* 143 B.R. 19, 22 (Bankr.D.Conn.1992). Factors that courts have found relevant "in this determination include, but are not limited to whether the debtor initiated and/or agreed to the creation of the escrow, what if any control the debtor exercises over it, the incipient source of it, ***376** the nature of the funs put into it, the recipient of its remainder (if any), the target of all its benefit, and the purpose of its creation.' " *Id.,* (citing *Cedar Rapids Meats, Inc. v. Hager (In re Cedar Rapids Meats, Inc.),* 121 B.R. 562, 567 (Bankr.N.D.Iowa 1990)). In analyzing escrow arrangements, courts have recognized that escrow agreements are distinguished from mere contracts:

> [A]n escrow is something more than a contract—it is a method of conveying property. When property is delivered in escrow the depositor loses control over it and an interest in the property passes to the ultimate grantee under the escrow agreement.

Anderson County Bank v. Newton (In re All Chemical Isotope Enrichment, Inc.), 127 B.R. 829, 838 (Bankr.E.D.Tenn.1991), (citing *Carlson v. Farmers Home Administration (In re Newcomb),* 744 F.2d 621, 624 (8th Cir.1984)).

As one court has observed, "[f]unds held in escrow or trust present difficult property of the estate questions for courts." *Cedar Rapids Meats, Inc. v. Hager (In re Cedar Rapids Meats, Inc.),* 121 B.R. 562, 566 (Bankr.N.D.Iowa 1990). Cases have divided on the question of whether escrow funds are property of the estate. *Id.* However, "in cases where the agreement acted as an assurance or guarantee fund, courts have found that the escrow funds are not property of the estate." *Id. See, e.g., In re Dolphin Titan,* 93 B.R. 508, 511–12 (Bankr.S.D.Tex.1988) (monies placed in an escrow fund to assure payment of worker's compensation claims was not estate property); *In re Palm Beach Hgts. Dev. & Sales Corp.,* 52 B.R. 181, 183 (Bankr.S.D.Fla.1985) (monies placed by debtor in an escrow fund to guarantee the debtor would complete certain drainage and road improvement work was not property of the bankrupt estate).

The reasoning for such a conclusion has been succinctly summarized: "[f]or the court to release the fund to the Debtor would be contrary to the agreement between debtor and [the creditor], and convert Debtor's contingent right [to the fund] into a non-contingent right." *Dolphin Titan,* 93 B.R. at 512, (citing *In re Creative Data Forms, Inc.,* 41 B.R. 334, (Bankr.E.D.Pa.1984)).

We must analyze the circumstances here to conclude not only whether a trust was created by the escrow arrangement between Suntrust, Holmes and Hazmed, but perhaps more significantly, *when* a trust was created. Holmes appears to agree that ultimately a trust was formed here, but not until the Corps Contract payments were paid over to Suntrust on January 15, 2002, after the bankruptcy case was filed, or, at the earliest on October 8, 2001, when the October Instrument of Assignment was executed and ultimately forwarded to the Corps. Hazmed disagrees, believing the execution of the Escrow Agreement was sufficient to create an express trust for the monies ultimately paid over to Suntrust by the Corps.

[7] A closer examination of the law of trusts in Virginia and elsewhere is necessary to resolve these questions. In Virginia, while it is essential to the creation of a trust that there be an explicit declaration of trust, or circumstance which show beyond a reasonable doubt that a trust was intended to be created, no formal, technical, or particular words are necessary. *Executive Comm. v. Shaver,* 146 Va. 73, 79, 135 S.E. 714, 715 (1926). Rather, it is sufficient if an intention to create a trust and the subject matter, purposes, and beneficiary are stated with reasonable certainty. *Id. See also Broaddus v. Gresham,* 181 Va. 725, 731, 26 S.E.2d 33,35(1943), (quoting *Hammond v. Ridley's Ex'r.,* 116 Va. 393, 398, 82 S.E. 102, 103 (1914)) (a ***377** trust may only be created by words or circumstances "which unequivocally show an intention that the legal estate was vested in one person, to be held in some manner or for some purpose on behalf of another"), and *Schloss v. Powell,* 93 F.2d 518, 519 (4th Cir.1938). ("There is no doubt that money can be placed in the hands of one person for payment to another under such circumstances that a trust arises in favor of the latter which he may enforce; and this end may be accomplished by an express declaration of trust or by circumstances indicating an intention of the depositor to place the fund irrevocably beyond his control and devote it to the indicated purpose.")

The Virginia case law then requires an assessment of the intent of the parties; was there a sufficient manifestation of the intention of Holmes to place the portion of the Corps Contract earned directly by the efforts of Hazmed in March when the Subcontract and Escrow Agreement were executed, as Hazmed urges, or as Holmes argues, was there no intention to place the monies earned on the Corps Contract by Hazmed beyond Holmes' control until October when the October Instrument of Assignment was executed? A reading of the Subcontract and the Escrow Agreement appear to manifest the intention of Holmes that the monies earned by

the provision of services under the Subcontract by Hazmed would be paid to Hazmed directly through their mutual agent, Suntrust Bank. Hazmed insisted upon the arrangement because Holmes finances were suspect and Hazmed feared it would not be paid for its work on the Corps Contract if all the contract proceeds were paid directly to Holmes.[14] Because the Corps will not recognize an assignment except as permitted by the Assignment of Claims Act, 41 U.S.C. § 15, *et seq.,* ("Assignment Act") no mechanism existed to pay Hazmed directly for its work except to assign the Corps Contract to a bank or trust institution. 26 U.S.C. § 15(b) (1996).[15]

The Escrow Agreement by its very terms contemplates the setting aside of the monies earned by Hazmed as a direct result of its labors on the Corps Contract. After submission of its invoice for work performed by it on the Corps Contract to Holmes, Hazmed would forward a copy of ***378** the invoice to Suntrust as escrow agent. Pls.Ex. 2, ¶ 2. Holmes was to invoice the Corps and provide payment instructions to Suntrust. *Id.* Suntrust was charged with deposit of all payments received from the Corps Contract into a non-interest bearing account. Pls.Ex. 2, ¶ 3. Upon receipt of proceeds from the Corps, Suntrust would compare the payment instructions received from Hazmed. Pls.Ex. 2, ¶ 4. Suntrust would pay the amount due Hazmed unless a discrepancy existed between the payment instructions and the Hazmed invoices. *Id.* Any remaining amounts in the account would then be paid to Holmes. *Id.* While the Escrow Agreement does not use the terms "trust" or "in trust," it contemplates that the portion of the contract proceeds earned directly from Hazmed's labors would be paid to a third party, set aside, segregated and disbursed directly by the third party to Hazmed. Holmes would have no interest in the segregated funds except a reversionary interest in the monies not earned by Hazmed. These provisions, in combination with the references in the Escrow Agreement to the making of the Subcontract and the Instrument of Assignment,[16] are sufficient under Virginia law to establish an express trust of the monies earned under the Corps Contract by the efforts of Hazmed. The intention to place these monies beyond the control of Holmes appears plain.

Despite this language, Holmes argues that no trust could be formed under Virginia law unless and until the Instrument of Assignment was executed and monies actually transferred into the escrow account. Indeed, many cases stand for the proposition that in order to create a trust *inter vivos* in which the trustee is other than the settlor, the settlor ordinarily must make an *inter vivos* transfer of the trust property to the trustee. *See, e.g. Ballard v. McCoy,* 247 Va. 513, 517, 443 S.E.2d 146, 148 (1994)(citing Restatement (Second) of Trusts § 17 (1959) and Austin W. Scott & William F. Fratcher, The Law of Trusts § 17 (4th ed.1987)). The Restatement also recognizes that generally if a conveyance is not effective to transfer the intended trust property, a trust is not created.[17] Restatement (Second) of Trusts § 32 (1959). A distinction, however, appears to be made in instances where the trust is created non-gratuitously. The Restatement also provides that a trust may be created by a promise by one person to another person whose rights thereunder are to be held in trust for a third person. Restatement (Second) of Trusts § 17 (1959). The Comments to the Restatement elaborate:

> If a person makes an enforceable promise to pay money or to make a conveyance of property to another person as trustee, a trust may be created, the rights of the promisee being held by him as trustee, provided that the parties manifest an intention to create a present trust of the promisee's rights.
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> Restatement (Second) of Trusts, cmt § 17(3) (1959). The Comments to the tentative draft no. 1 of the Restatement ***379** (Third) of Trusts further clarify the distinction between enforceable and non-binding promises as to the timing of when a trust arises:
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> > Where a property owner makes a non-binding promise to create a trust in the future, no trust is thereby created. If the property owner later establishes the trust by *inter vivos* or testamentary transfer or by declaration, the trust is created by the transfer or declaration (see Comments d and e) and not by the promise. Similarly, when a property owner makes a contractually binding promise to establish a trust by *inter vivos* or testamentary transfer or by declaration and later performs by making the promised transfer or declaration, ordinarily the trust is created at the time of performance, whether the transfer or declaration is made voluntarily or involuntarily. In this situation the trust and the trustee's fiduciary duties ordinarily come into existence at the time of the settlor's performance and not at the time the binding promise is made.
> >
> > If, however, a person make or causes to be made an enforceable promise to pay money or transfer property to another as trustee, and if the person (with the expressed or implied acceptance of the intended trustee) also manifests an intention immediately to create a trust of

> the promisee's rights, a trust is created at the time of the contract, with a chose in action (the rights under that contract) then being held for the beneficiaries by the trustee.
>
> Restatement (Third) of Trusts, cmt § 10 (Tentative Draft No. 1 (1996)).[18]

While no Virginia case law appears to have addressed this specific exception to the general rule requiring delivery of the trust property, this Court believes the Virginia courts would follow the Restatement and conclude the present intention of Holmes to create a trust in the proceeds of the Corps Contract was sufficient to find an express trust was created at the execution of the Subcontract and the Escrow Agreement. Circumstances here leave little doubt that the creation of the trust with Suntrust was well supported by consideration. The evidence is not disputed that this payment arrangement was the *sine qua non* of the relationship of Hazmed with Holmes. The testimony of Ms. Sales makes it plain that Hazmed would not have entered into the Subcontract and performed the work thereon unless Holmes had made its promise to create the trust and escrow to ensure Hazmed would be paid for its work performed.[19]

This conclusion is further buttressed by an examination of the purpose of the Assignment Act, which provided the impetus for making of the Instrument of Transfer. The terms of the Instrument of Transfer provide it is being made in accordance with the Assignment Act. The Assignment Act was enacted to (1) prevent persons of influence from buying up claims against ***380** the United States, which might then be improperly urged upon officers of the Government, (2) to prevent possible multiple payment of claims, to make unnecessary the investigation of alleged assignments, and to enable the Government to deal only with the original claimant, and (3) to save the United States defenses which if had to claims by an assignor by way of set-off, counter-claim, etc., which might not be applicable to an assignee. *U.S. v. Shannon,* 342 U.S. 288, 291–292, 72 S.Ct. 281, 283–284, 96 L.Ed. 321 (1952).

[8] Accordingly, "[i]ts focus is not on the perfection of liens and security interests, but rather the establishment of procedural requirements of assignees planning to assert claims against the government." *In re Robert E. Derecktor of R.I., Inc.,* 142 B.R. 29, 30 (Bankr.D.R.I.1992). Thus, the Assignment Act imposes no additional requirements to achieve or preserve validity of a lien. *Id.; In re Richardson,* 216 B.R. 206, 213 (Bankr.S.D.Ohio 1997); *In re Metric Metals International, Inc.,* 20 B.R. 633, 635 (S.D.N.Y.1981).

As compliance with the Assignment Act is unnecessary to perfect a lien between individual private parties, it is logical to conclude that such compliance would be unnecessary to create a trust, provided there has been an adequate manifestation of the parties of the intent to create a trust arrangement. Here the filing of the Instrument of Assignment with the Corps was doubtless necessary to induce the Corps to pay the Corps Contract proceeds to Suntrust for the benefit of Hazmed and not directly to Holmes. However, the timing of the execution of the Instrument of Transfer does not negate the clear intent of Holmes to set aside the monies earned by Hazmed on the Corps Contract as manifested in the Subcontract and the Escrow Agent. While the Instrument of Transfer was necessary to protect the Corps under the Assignment Act and to induce it to pay Suntrust, it was not necessary to create the trust established by the Escrow Agreement. Rather, the intent to set aside the monies earned by Hazmed is adequately displayed in these earlier documents.

Holmes also relies upon decisions which suggest that a valid escrow may not be created until delivery of the escrowed property is made. In particular, Holmes cites to *Hooker Atlanta Corp. v. Hocker (In re Hooker Investments, Inc.),* 155 B.R. 332 (Bankr.S.D.N.Y.1993).

Atlanta Corporation sued Hooker to void as fraudulent the sale of an option contract and to recover monies paid as a broker's commission from an escrow account funded by Hooker. The court was required to consider "whether Hooker's deposit of $500,000.00 into the Lawyer's Title escrow account divested Hooker of control over those funds such that the subsequent transfer to [the broker] when the conditions of escrow were fulfilled could not be considered a transfer of the debtor's interest in property." *Id.,* 155 B.R. at 338. The court there concluded that an irrevocable transfer occurred when the monies in question were placed into escrow. From this, Holmes advocates there could be no escrow created here until execution of the Instrument of Assignment in October 2001 and that a valid escrow requires delivery of the property, which did not occur until after filing of the bankruptcy petition here. The principles articulated by the court in *Hooker,* while valid in the context there, are not applicable to the case at bar. At issue in *Hooker* was whether a debtor had retained control of an escrow created directly from the debtor's funds; here, instead, Holmes created an express trust from monies to be paid in the future by the Corps. *Hooker* provides no principles ***381** which vary this Court's conclusion that Holmes evidenced its intent in

March 2001 with the execution of the Subcontract and the Escrow Agreement to irrevocably place the amounts earned by Hazmed in its performance of duties on the Subcontract beyond Holmes' control, except for Holmes' duty to verify to Suntrust exactly what amount had been earned by Hazmed.

[9] **[10]** **[11]** What Holmes seeks to do here is to contradict the provisions of the Escrow Agreement and to convert their contingent right to receive any of the Corps Contract proceeds remaining after payment of all amounts due to Hazmed into ownership of one hundred percent of the fund.[20] This result would provide an enormous windfall to Holmes of $329,632.26, while reducing the undisputed amount owed to Hazmed to an unsecured, non-priority claim. While the bankruptcy process by its application may operate to greatly reduce otherwise legitimate claims, this may not occur where a debtor substantially prior to its bankruptcy filing agrees to set aside property in trust for the benefit of a third party. Holmes agreed in March 2001 that Hazmed could be paid for its work performed on the Corps Contract without the financial risk of having the contract proceeds being paid first to Holmes. Hazmed bargained for this protection and Holmes manifested its intent that Hazmed be so paid when it executed the Subcontract and the Escrow Agreement. The Corps Contract proceeds now in the hands of Suntrust representing the payments for the work performed by Hazmed are therefore the *res* of an express trust created by Holmes, and may not be considered estate property pursuant to section 541 of the Bankruptcy Code.[21]

***382** B.

Preference

[12] Having concluded that an express trust was created in March 2001 at the execution of the Subcontract and the Escrow Agreement, and the monies paid into escrow by the Corps are therefore not estate property, it logically follows that no preferential transfer occurred here. As Justice Marshall has explained:

> Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata share of the debtor's property. See, *e.g.,* 11 U.S.C. § 726(b) (1982 ed.); H.R.Rep. No. 95–585, *supra,* at 177–178, U.S.Code Cong. & Admin.News 1978, pp. 5963, 6138. Section 547(b) furthers this policy by permitting a trustee in bankruptcy to avoid certain preferential payments made before the debtor files for bankruptcy. This mechanism prevents the debtor from favoring one creditor over others by transferring property shortly before filing for bankruptcy. Of course, if the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated. The reach of § 547(b)'s avoidance power is therefore limited to transfers of "property of the debtor."

Begier v. Internal Revenue Service, 496 U.S. 53, 58, 110 S.Ct. 2258, 2262–63, 110 L.Ed.2d 46 (1990). Here the funds in the escrow account representing the monies earned by the performance of Hazmed on the Corps Contract are not estate property; therefore, no preference can occur.

[13] Furthermore, no transfer occurred in the instant matter within the ninety day preference period. This Court has determined that an express trust of the monies earned by Hazmed on the Subcontract was created in March 2001 when the Escrow Account and the Subcontract were executed. Thus, "[t]o be avoidable a transfer must deprive the debtor's estate of something of value which could otherwise be used to satisfy creditors." *Carlson v. Farmers Home Administration (In re Newcomb),* 744 F.2d 621, 626 (8th Cir.1984), (citing 4 Colliers on Bankruptcy ¶¶ 547,08[2], .20,21 (15th Ed.1984)). When an escrow or trust is created, the only interest left in the escrowed funds is a contingent right to any surplus after payment of the claims against the fund. *Musso v. N.Y. State Higher Education Services Corp. (In re Royal Business School, Inc.),* 157 B.R. 932, 940 (Bankr.E.D.N.Y.1993), (citing *Hooker Atlanta Corp. v. Hocker (In re Hooker Investments, Inc.),* 155 B.R. at 338; *In re Coco,* 67 B.R. 365, 369 (Bankr.S.D.N.Y.1986)); *In re O.P.M. Leasing Services, Inc.,* 46 B.R. 661 (Bankr.S.D.N.Y.1985). As such, the trust was created well before the ninety preference period prior to the filing here on January 2, 2001.[22]

***383** This conclusion is further supported by consideration of when a transfer occurs for purposes of a preference. The Eighth Circuit Court of Appeals has explained when a transfer occurs when a trust or escrow is created:

> For purposes of preferential pre-petition transfers, a transfer is deemed made when it "takes effect between the transferor and the transferee" only if it is "perfected at, or within 10 days after, such time." Qq.S.C. 547(e)(2). A transfer of personalty is perfected "when a creditor on a simple contract cannot acquire a judicial lien that is

> superior to the interest of the transferee." 11 U.S.C. 547(e)(1)(B). The transfer that occurred when the escrow was created is a type of transfer for which no further perfection is possible or necessary. In terms of the Bankruptcy Code, the transfer was "perfected" when it took effect between the parties. *See generally, 4 Collier on Bankruptcy* ¶ 547.44 at 547–133 (15th ed.1984). Since it was perfected simultaneously, the transfer involved here is deemed made when the escrow was created.

Carlson v. Farmers Home Administration (In re Newcomb), 744 F.2d at 621, 626, n. 6. *See also Makoroff v. Allegheny Graphics, Inc. (In re Allegheny Label, Inc.),* 128 B.R. 947, 953 (Bankr.W.D.Pa.1991). Here the express trust was created greater than ninety days prior to bankruptcy, and the funds sought are not property of the estate of Holmes. Accordingly, the complaint to set aside the trust created here as a preference must fail.

C.

New Value

[14] Having concluded that no preference took place, the defense of new value raised by Hazmed is therefore moot. However, in the event an appellate court should conclude otherwise, this Court will memorialize its findings concerning the defense of new value asserted by Hazmed.

[15] Section 547(b) of the Code empowers a trustee to avoid certain transfers, known as "preferences," made within a ninety day period prior to the debtor's filing.[23] 11 U.S.C. § 547(b) (2001); ***384** *Advo–Sys., Inc. v. Maxway Corp.,* 37 F.3d 1044, 1045 (4th Cir.1994). As its legislative history bears out, the purpose of § 547(b) is two-fold: (1) to protect the debtor from a creditors' race to the courthouse and (2) to ensure the Code's policy of distributing the debtor's estate equally among its similarly situated creditors.[24] When these purposes are not served, however, a Trustee may not avoid certain transfers that otherwise meet the elements of a preference. *See Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling, Inc.),* 837 F.2d 224, 227 (5th Cir.1988). One such exception is known as the new value defense, provided for in § 547(c):

> The trustee may not avoid under this section a transfer—
>
> (1) to the extent such transfer was—
>
> (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
>
> (B) in fact a substantially contemporaneous exchange;

11 U.S.C. § 547(c)(1).

[16] In *Cocolat, Inc. v. Fisher Development, Inc. (In re Cocolat, Inc.),* 176 B.R. 540 (Bankr.N.D.Cal.1995), the court aptly stated the rationale of the new value defense:

> The purpose of the "new value" defense is to protect transactions that do not result in a diminution of the bankruptcy estate. A transfer does not diminish the estate if the estate receives "new value" on account of and equal to the amount of the transfer.

Id. at 548; *see also In re Fuel Oil Supply & Terminaling,* 837 F.2d at 228 ("This defense 'is grounded in the principle that the transfer of new value to the debtor will offset the payments, and the debtor's estate will not be depleted to the detriment of other creditors.' " (quoting *In re Auto–Train Corp.,* 49 B.R. 605, 612 (Bankr.D.D.C.1985))); Thomas J. Palazzolo, Note, *New Value and Preference Avoidance in Bankruptcy,* Wash. U.L.Q.. 875, 881 (1991) ("The exception's apparent rationale is that the transfer of new value offsets the preference. Thus, the debtor's estate is not depleted to the other creditors' detriment."). To establish the new value defense, the creditor essentially must prove ***385** three elements. *See* 11 U.S.C. § 547(g) (noting that the creditor bears the burden of proving the non-avoidability of a transfer under § 547(c)). First, the creditor must demonstrate that it is a "creditor to or for whose benefit such transfer was made." *Id.* § 547(c)(1)(A). Second, the creditor must show that it and the debtor had the requisite intent to make a contemporaneous exchange for new value. Third, the exchange must be in fact contemporaneous and for new value. *See In re Barefoot,* 952 F.2d 795, 800 (4th Cir.1991) ("In order for a creditor to successfully make out the [new value] defense, the creditor must prove both that the transfer was intended by the debtor and the creditor to be a contemporaneous exchange for new value and that in fact the transfer was a substantially contemporaneous exchange."). In the instant case, the first element is satisfied as Hazmed is a creditor for whose benefit the transfers at issue were made.

The second element regarding intent is typically the most crucial element in a new value defense. *See, e.g., In re Presidential Airways, Inc.,* 228 B.R. 594, 599 (Bankr.E.D.Va.1999) ("[T]he critical factor is whether the

parties intended a contemporaneous exchange."). In *Lubman v. C.A. Guard Masonry Contractors, Inc. (In re GEM Constr. Corp.),* No. 98–33110, Adv. 99–3047, 2000 WL 33321298 (Bankr.E.D.Va. Jan. 5, 2000) (unpublished), the court denied summary judgment on the new value defense in part because the parties disputed whether the transaction was contemporaneous. *Id.* at *4.

[17] Intent may be gleaned from, *inter alia,* "the agreement or the course of dealings between parties ...." *Everlock Fastening Sys., Inc. v. Health Alliance Plan (In re Everlock Fastening Sys., Inc.),* 171 B.R. 251, 255 (Bankr.E.D.Mich.1994). The requisite intent is evident from the Subcontract and the Escrow Agreement. These documents contemplate Hazmed will perform services and supply goods to perform those tasks under the Corps Contract as delegated to Hazmed by Holmes. In exchange for these goods and services, Hazmed is to be paid by the payment of the Corps Contract proceeds into the escrow established at Suntrust by the Escrow Agreement. Suntrust in turn would pay Hazmed the actual amount owed for its goods and services from the escrowed monies.

The final element is the determination of whether the exchange was contemporaneous and for new value. Section 547(c)(1) excepts transfers from the Trustee's avoidance powers only " 'to the extent' the transfer was a contemporaneous exchange for new value." *In re Robinson Bros. Drilling,* 877 F.2d at 34. The plain language of the Code establishes that new value contemplates a specific value that may be articulated in terms of "money or money's worth":

> "[N]ew value" means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.

11 U.S.C. § 547(a)(2) (2001); *accord Sulmeyer v. Suzuki (In re Grand Chevrolet, Inc.),* 25 F.3d 728, 733 (9th Cir.1994); *Creditor's Comm. v. Spada (In re Spada),* 903 F.2d 971, 976 (3d Cir.1990); *In re Robinson Bros. Drilling,* 877 F.2d at 34 ("Moreover, the Bankruptcy Code's definition of the term 'new value' implies that the creditor must prove the specific valuation in 'money or money's worth in goods, services, or new credit.' "); *Jet Fla., Inc. v.* ***386** *Am. Airlines, Inc. (In re Jet Fla. Sys.),* 861 F.2d 1555, 1559 (11th Cir.1988) (noting that the language of § 547(a)(2) "necessarily requires a specific dollar valuation of the 'new value'-the 'money's worth'-that the debtor received in the exchange"). In *Jet Florida Systems,* the Eleventh Circuit Court of Appeals concluded that the court therefore "must measure the value given to the creditor and the new value given to the debtor in determining the extent to which the trustee may void a contemporaneous exchange." *In re Jet Fla. Sys.,* 861 F.2d at 1558–59 (noting further that § 547(c)(1) "indicates that a creditor seeking [its] protection ... must prove with specificity the new value given to the debtor").

[18] It is the creditor, as part of its new value defense, who must bear the burden of proving the specific valuation of the alleged new value. 11 U.S.C. § 547(g)(2002); *In re Robinson Bros. Drilling,* 877 F.2d at 34; *In re Jet Fla. Sys.,* 861 F.2d at 1559. Moreover, the alleged new value must be measured as of the time the preferential transfer took place. *In re Grand Chevrolet,* 25 F.3d at 733; *In re Robinson Bros. Drilling,* 877 F.2d at 33 (noting in the context of a § 547(c)(1) defense that "[c]onsequently, that the lien on the well may have had no value at the time of the adversary hearing was of no importance, so long as it had value at the time of transfer"); *In re Jet Fla. Sys.,* 861 F.2d at 1559 n. 5 ("The proper inquiry under § 547(c)(1) should be directed at the valuation of the transfer *when made.*"); *In re Cocolat,* 176 B.R. at 547.

In the instant case, Hazmed claims the new value it conferred was its performance under the Subcontract. To succeed, Hazmed must, in specific terms, prove the specific value of its performance under the Subcontract at the time of the preferential transfers.

[19] Judge Derhy has explained the analysis required in the Fourth Circuit in evaluating new value exceptions:

> The Fourth Circuit has adopted the *Garland* rule in analyzing § 547(c)(4). *In re Meredith Manor, Inc.,* 902 F.2d 257, 259 (4th Cir.1990) (citing *In re Thomas W. Garland, Inc.,* 19 B.R. 920 (Bankr.E.D.Mo.1982)). The *Garland* case modified the net result rule of § 547(c)by requiring new value to come *after* a preferential transfer. *In re Thomas W. Garland, Inc.,* 19 B.R. at 926. The Fourth Circuit consequently looks at the ninety day preference period and calculates the difference between the total preferences and the total advances, *provided that each advance is used to offset only prior preferential transfers. In re Meredith Manor, Inc.,* 902 F.2d at 259 (emphasis added). *Accord, e.g., In re Transport Associates, Inc.,* 171 B.R. 232, 238 (Bankr.W.D.Ky.1994)("It protects a transfer from preference attack to the extent that a creditor *thereafter* replenishes the estate."); *In re IRFM, Inc.,* 144 B.R.

886, 892 (Bankr.C.D.Cal.1992), *aff'd,* 52 F.3d 228 (9th Cir.1995)("§ 547(c)(4)'s subsequent advance rule makes preferential transfers avoidable until offset by subsequent advances of new value."); *In re Amick,* 163 B.R. 589, 593 (Bankr.D.Idaho 1994)("[T]he grant of new value should apply to offset any preference, so long as the preferential payment was made before the new value was given."). *Trinkoff v. Porters Supply Co., Inc. (In re Daedalean, Inc.),* 193 B.R. 204, 215 (Bankr.D.Md.1996). The new value exception may be satisfied by an indirect transfer of value via a third-party to a debtor rather than a direct transfer of value from creditor to debtor. *Lubman v. C.A.* ***387** *Guard Masonry Contractor, Inc. (In re Gem Construction Corp. of Virginia, Inc.),* 262 B.R. 638, 646 (Bankr.E.D.Va.2000).

Applying this analysis to the instant matter, the total preferences allegedly occurring during the ninety day preference period[25] is measured by the value of the escrowed monies on deposit with Suntrust, which is in the sum of $351,254.26, less the $21,622.00 of the escrowed monies representing the amount of the contract proceeds that are directly the result of the provision of goods and services under the Corps Contract by Holmes and not by Hazmed.

Accordingly, the maximum amount of the alleged preference to Hazmed occasioned by the October 8, 2001 execution of the Instrument of Transfer is $351,254.26 less $21,622.00, or $329,632.26. The transfers of goods and services made after October 8, 2001 (the date of the alleged preference) is detailed in Exhibit 10 of Holmes, consisting of the various invoices of Hazmed to Holmes.

After October 1, 2001[26] and until completion of the Subcontract on January 31, 2002, Hazmed billed Holmes the sum of $317,992.04 for goods and services provided by Hazmed on the Corps Contract.[27] There appears to be no contest here that the value of the goods and services provided by Hazmed after October 1, 2001 is $317.992.04, particularly since the Corps has now paid these component invoices and deposited the Corps Contract proceeds into the escrow account at Suntrust. Holmes has not chosen to dispute any of work performed by Hazmed after October 2001. None of the post-October invoices of Hazmed have been paid over to Hazmed. Thus, should a reviewing court subsequently find a trust here was not created until October 8, 2001 and that a preferential transfer did then occur, Hazmed is entitled pursuant to § 547(c)(4) of the Bankruptcy Code to a new value defense in the amount of $317,992.04, limiting the maximum amount of any preference recovery here to $11,640.22.

II

Post–Petition Transfer

[20] Holmes also seeks to avoid the Escrow Agreement by its contention that the actual transfer of monies into the escrow account did not occur until January 15, 2002, some thirteen days after the bankruptcy filing here. Therefore, Holmes believes the transfer of the monies to Suntrust as escrow agent is a post-petition transfer which may be avoided under the provisions of 11 U.S.C. § 549.

11 U.S.C. § 549(a) provides, in pertinent part that "... the trustee may avoid a ***388** transfer of property of the estate —(1) that occurs after the commencement of the case; and (2)(A) that is authorized only under section 303(f) or 542(c) of this title; or (B) that is not authorized under this title or by the court." 11 U.S.C. § 549(a)(2002). Therefore, "the initial inquiry must be addressed to the threshold issue, which is whether or not the funds deposited in escrow by the debtor were properties of the estate on the date of the commencement of the case." *Gassen v. Universal Building Materials, Inc. (In re Berkley Multi–Units, Inc.),* 69 B.R. 638, 641 (Bankr.M.D.Fla.1987). If the funds in question are not property of the estate, the contention of the post-petition transfer condemned by § 549(a)(1) of the Bankruptcy Code is without merit. *Id.*

Here no post-petition transfer occurred because under any scenario the transfer of the beneficial interest in the monies to be earned by Hazmed on the Corps Contract occurred pre-petition. As this Court has found, the execution of the Escrow Agreement and the Subcontract in March 2001 evidenced the intent of Holmes to create a present trust of the monies to be earned by Hazmed in the performance of the Subcontract.[28] By agreeing to ultimately segregate these monies when paid, Holmes created an express trust under Virginia law for the benefit of Hazmed and removed these monies as property of the estate pursuant to § 541 of the Bankruptcy Code. Accordingly, there is no post-petition transfer. However, even if the transfer did not occur until the October 8, 2001 execution of the Instrument of Transfer, then the trust creation was pre-petition as well.

Holmes contends there can be no escrow or trust created until the actual payment of the Corps Contract proceeds

by the Corps to Suntrust which occurred post-petition. This argument ignores the fact that the Escrow Agreement and the Subcontract manifest a present intention that the monies earned by Hazmed are to be set aside exclusively for payment to Hazmed.[29] Here in March 2001 Holmes evidenced its irrevocable election to have Hazmed paid directly via Suntrust for its work performed on the Subcontract. Accordingly, any transfer which occurred did so substantially prior to the bankruptcy filing of Holmes, and the provisions of 11 U.S.C. § 549 provide no remedy here.[30]

***389** III

Executory Contract

[21] Holmes seeks the approval of this Court pursuant to 11 U.S.C. § 365 to reject the Escrow Agreement. This motion requires visitation of "one of the most difficult areas of bankruptcy law'—the rejection of executory contracts permitted by Section 365 of the Bankruptcy Code." *Dye v. Sandman Associates, L.L.C.,* 251 B.R. 473, 480 (W.D.Va.2000), (quoting Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook,* 62 U.Colo.L.Rev.1, 1 (1991)). Section 365(a) of the Bankruptcy Code provides that a debtor "subject to the Court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a) (2002). One of the potential rewards to a debtor of rejecting an executory contract lies in the fact that, once a contract is rejected, a damage claim arising as a result of the rejection becomes an unsecured claim against the debtor. *Stewart Foods, Inc. v. Broecker,* 64 F.3d 141, 144 (4th Cir.1995). Thus, if this Court were to permit Holmes to reject the Escrow Agreement, any claim of Hazmed arising from the rejection would be an unsecured claim to be paid pro-rata along with the other unsecured non-priority claims against Holmes. Hazmed likewise would lose any claim to the *res* of funds now accumulated in the escrow account maintained by Suntrust pursuant to the Escrow Agreement.

[22] Despite bestowing this substantial authority on the debtor, the Bankruptcy Code provides no definition of what constitutes an "executory contract." Courts and scholars have devoted much effort to defining this critical term, with substantial conflict emerging in the case law and commentary. While this debate may rage on elsewhere, the Fourth Circuit Court of Appeals has provided guidance, defining an executory contract as one "under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." *Gloria Manufacturing Corp. v. International Ladies' Garment Workers' Union,* 734 F.2d 1020, 1022 (4th Cir.1984), (quoting Vern Countryman, *Executory Contracts in Bankruptcy, Part I,* 57 Minn. L.Rev. 439, 460 (1973)). *See also Andrews v. Riggs Nat'l Bank of Washington, D.C. (In re Andrews),* 80 F.3d 906, 914 (4th Cir.1996). Once a contract is found to be executory, it must then be determined whether rejection is advantageous to the debtor. *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.),* 756 F.2d 1043, 1046 (4th Cir.1985). In this determination, the "sound business judgment rule" is applied. *Id.,* 756 F.2d at 1046–47. Under this maxim, the same deference is given to a decision to reject an executory contract as is given to other business management actions.

[23] In determining whether a contract is so unperformed that failure to complete performance would be a material breach, it is appropriate to look to state law. *Dye v. Sandman Associates, L.L.C. (In re Sandman Associates, L.L.C.),* 251 B.R. 473, 482 n. 18 (W.D.Va.2000), (*citing Dunkley v. Rega Properties, Ltd. (In re Rega Properties, Ltd.),* 894 F.2d 1136, 1139 (9th Cir.1990)). Given the parties choice of law that Virginia law should govern the Escrow Agreement,[31] the Court must look to Virginia law to determine whether the Escrow Agreement is so far unperformed that the non-performance of any remaining ***390** duties by either Holmes or Hazmed would constitute a material breach. Judge Jones has provided a concise summary of Virginia law in this regard:

> Not every failure to perform a contractual obligation is a material breach that excuses performance by the non-breaching party. Rather, "the act failed to be performed must go to the root of the contract." *Neely v. White,* 177 Va. 358, 14 S.E.2d 337, 341 (1941). "A material breach is a failure to do something that is so fundamental to the contract that the failure to perform that obligation defeats an essential purpose of the contract." *Horton v. Horton,* 254 Va. 111, 487 S.E.2d 200, 204 (1997). Viewing the principle another way, a breach of a contract cannot be material if the breaching party has rendered substantial performance, which is performance not in every detail, but in all essential parts. *See* 15 Richard A. Lord, *Williston on Contracts,* § 44.54 (4th ed.2000).

[24] **[25]** Applying these teachings to the instant matter, the Escrow Agreement is not executory. It is undisputed that the work under Subcontract is complete, except for the submission by Holmes of invoices to the Corps for any unbilled work done by Hazmed. The Escrow Agreement was made in conjunction with the Subcontract and for the purpose of providing a vehicle to ensure Hazmed would be paid for its work performed on the Subcontract. Where a contract has been assigned and the underlying contract is sufficiently performed so as not to be executory, then the assignment may not be rejected as executory. *In re Braley,* 39 B.R. 133, 134 (Bankr.D.Vt.1984)("As the underlying loan contracts are not executory, performance by FHA having been completed, the existence of the Braley's duty to pay off the debt is the only performance that remains outstanding. The assignment is merely the vehicle through which repayment is to occur."). Furthermore, contracts are generally not executory where the only obligation remaining is to pay money. *In re Zenith Laboratories, Inc.,* 104 B.R. 667, 672 (Bankr.D.N.J.1989); *In re Kash & Karry Wholesale, Inc.,* 28 B.R. 66, 69 (Bankr.D.S.C.1982).

Holmes argues that mutual duties remain to be performed under the Escrow Agreement. However, the evidence here indicates little remains to be done under the Escrow Agreement but to pay over the monies owed to Hazmed for its work performed under the Subcontract and to forward any remaining invoices to Holmes. This is especially true given the admission, unchallenged by Hazmed at trial, that Holmes is entitled to but $21,622.00 of the monies now held in escrow. Accordingly, there are no duties remaining unperformed as to the monies now in escrow for either Holmes or Hazmed. The evidence that additional invoices need be submitted by Holmes to procure payment of the last unpaid monies under the Corps Contract, which presumably could activate the provisions requiring submission of the relevant invoices of Hazmed and payment instructions from Holmes to Suntrust, falls short as well. The breach by either Holmes or Hazmed of these requirements would not "go to the root of the contract," *Neely v. White,* 14 S.E.2d at 340, nor "defeat an essential purpose of the contract," *Horton v. Horton,* 487 S.E.2d at 204. The failure of either party to do these things likewise would be insufficient to excuse performance by the other nor create a reversion in the escrowed monies to Holmes.[32]

***391** Illustrative is the escrow agreement considered in *TTS, Inc. v. Citibank, N.A. (In re TTS, Inc.),* 158 B.R. 583 (D.Del.1993). There an escrow agreement created to provide deferred compensation to an employee was claimed by the debtor to be executory and subject to rejection. Among the remaining duties of the parties was the obligation of the employee to provide certification of death or retirement to the escrow agent. Such an ongoing duty was found not to be material:

> [The employee's] obligations regarding certification to the escrow agent before the escrow account is paid out is not a "material obligation" with respect to [the debtor]. [The employee's] failure to so certify consequently would not constitute a material breach of the escrow agreement which would entitle [the debtor] to recover the escrow account.

Id., 158 B.R. at 588.

Performance under the Subcontract and the Escrow Agreement has been so substantial that the Escrow Agreement may not be deemed executory, and therefore, § 365 of the Bankruptcy Code provides no basis for rejection here by Holmes.

Summary

1. The monies owed to Hazmed for its performance of services and the provision of goods under the Subcontract are subject to an express trust created for the benefit of Hazmed and are not property of the bankrupt estate of Holmes pursuant to Section 541 of the Bankruptcy Code.

2. As the monies earned by Hazmed on the Subcontract are not estate property, no preferential transfer occurred. No transfer here occurred within ninety days of the bankruptcy filing of Holmes, as the express trust in favor of Hazmed was created in March 2001.

3. In the event a reviewing appellate court should find that a preference did occur here, Hazmed is entitled to a new value defense in the amount of $317,992.04, representing the transfer of goods and services made by Hazmed for the benefit of Holmes on the Corps Contract subsequent to October 1, 2001.

4. There are no material duties remaining to be performed on the Escrow Agreement. Therefore, the Escrow Agreement is not executory and may not be rejected pursuant to 11 U.S.C. § 365.

It is, therefore, ORDERED that the Motion is denied and the Amended Complaint is DISMISSED.

All Citations

287 B.R. 363

Footnotes

1 This Court's law clerk, Jason S. Naunas, has previously accepted future employment at one of the law firms appearing as counsel here for Hazmed. Accordingly, Mr. Naunas is recused from these matters and has not participated in any manner in the adjudication of the Motion or the Amended Complaint.

2 Because of the failure of the debtor to timely cure certain filing deficiencies, pursuant to the provisions of Local Bankruptcy Rule 5005–1(E) this case was dismissed on January 22, 2002. The debtor moved to vacate the dismissal order and on March 1, 2002, an order was entered by this Court vacating the earlier dismissal and reinstating the case. The Motion was filed after the Court had orally granted the motion to vacate but prior to the entry of its written order on March 1, 2002.

3 At the hearing on the Motion on April 11, 2002, the parties represented to the Court that the Complaint was then pending and resolution of the Motion and the Complaint involved consideration of the same factual evidence. For reasons of judicial economy, the Court accelerated the initial pre-trial conference on the Complaint and established May 28, 2002, as the trial date for the Complaint and the continued hearing date on the Motion.

4 The Amended Complaint was permitted by a consent order entered on May 8, 2002.

5 Suntrust has filed an answer to the Amended Complaint admitting it received a remittance in the amount of $351,254.26 and is without information to admit or deny the other allegations of the Amended Complaint. As the stakes holder here, Suntrust merely prays that this Court take no action in these proceedings to its detriment.

6 The Instrument of Assignment provides as follows:

> For value received, and in accordance with the Assignment of Claims Act of 1940, as amended (31 U.S.C. Sec. 3727, 41 U.S.C. Sec. 15), the undersigned contractor, Holmes Environmental, Inc. Having its principal office Bel–Aire Building, 1600 E. Little Creek Road, Suite 308, Norfolk, VA 23518 as Assignor, does hereby assign irrevocably unto SunTrust Bank, having a principal office at 919 East Main Street, Attn: Escrow Administrator, Richmond, A 23219 as Assignee, all monies due or to become due under contract number DACA–01–D–0002, dated December 22, 2000, between Assignor and the United States of America, U.S. Army Corps of Engineers and any amendments thereof or additions thereto.
>
> Assignor states that no previous Assignment has been made, and no additional Assignment will be made under the said contract; and authorizes payment of monies now due or to e made to Assignee.
>
> In Witness Whereof, Assignor has caused this Assignment to be executed this 23rd day of March, 2001, in its corporate name of Ethel Holmes its President, and its corporate seal to be affixed by Ethel M. Holmes, its Secretary, and duly attested by said officer by due authority.

7 This copy of the Notice of Assignment does not appear to bear any actual signature and, in handwritten form, corrects the signatory from “Debra Dawson” to “Deborah Dodson.”

8 Ms. Holmes testified that April, May, June and July 2001 payments were made directly to Holmes and not paid into the escrow at Suntrust.

9 Ms. Holmes admitted that Holmes still owes Hazmed approximately $160,000.00 from invoices paid on the Corps Contract directly to Holmes.

10 Ms. Sales testified that Hazmed is owed a total of $722,359.26 by Holmes. Hazmed has not as yet filed a proof of claim in this case.

11 Obviously, even if the Instrument of Assignment was executed on October 8, 2001, it remains to be determined whether the necessary elements to establish a preference have been proven, or if any of the defenses of Hazmed prevent recovery.

12 This document continues, noting that "Ethel [Holmes] indicated that she was having Bernard [Key] forward the documents to the contracting officer at Louisville." Def. Ex. 3.

13 Given the fact the Corps appeared to act promptly in acknowledging the Notice of Assignment after its receipt in October 2001, Ms. Sales' contention the deviant Instrument of Assignment was obtained from the files of the Corps begs the obvious question, if the Corps had an Instrument of Assignment prior to October 2001, why did it not acknowledge it and begin paying the Corps Contract proceeds to Suntrust?

14 This fear provided to be well-founded as Holmes still owes Hazmed approximately $175,000.00 from work performed by Hazmed and paid directly to Holmes by the Corps.

15 Section 15(b) of the Assignment of Claims Act of 1940 provides as follows:

> (b) The provisions of subsection (a) shall not apply in any case in which the moneys due or to become due from the United States or from any agency or department thereof, under a contract providing for payments aggregating $1,000 or more, are assigned to a bank, trust company, or other financial institution, including any Federal lending agency, provided:
>
> (1) That, in the case of any contract entered into after October 9, 1940, no claim shall be assigned if it arises under a contract which forbids such assignment.
>
> (2) That, unless otherwise expressly permitted by such contract, any such assignment shall cover all amounts payable under such contract and not already paid, shall not be made to more than one party, and shall not be subject to further assignment, except that any such assignment may be made to one party as agent or trustee for two or more parties participating in such financing.
>
> (3) That in the event of any such assignment, the assignee thereof shall file written notice of the assignment together with a true copy of the instrument of the assignment with—
>
> (A) the contracting officer or the head of his department or agency;
>
> (B) the surety or sureties upon the bond or bonds, if any, in connection with such contract; and
>
> (C) the disbursing officer, if any, designated in such contract to make payment.

41 U.S.C. § 15(b) (2002).

16 The Escrow Agreement references the making of the Instrument of Assignment in past tense, stating "[Holmes] has assigned to Escrow Agent, pursuant to the provisions of the Assignment of Claims Act of 1940, as amended ... certain payments to be made ..."

17 Section 32(1) of the Restatement (Second) of Trusts provides, in pertinent part:

> "[I]f the owner of property makes a conveyance *inter vivos* to another person to be held by him in trust for a third person and the conveyance is not effective to transfer the property, no trust of the property is created."

Restatement (Second) of Trusts, § 32(1) (1959).

18 The Comments to Section 15 of the Tentative Draft No. 1 of the Restatement (Third) of Trusts further elaborates on this concept:

> A promise to create a trust in the future is different from the situation in which the promisee of another's enforceable promise either declares that he or she holds the rights as promisee in trust or transfers those rights to another as trustee. In the latter types of cases, a trust is created at the time of the promisee's declaration or transfer. The trust

> property in such a case is a chose in action; that is, the trust property is the promisee's rights under the promissory note or other contract.
>
> Restatement of Trusts (Third), Cmt. § 15 (Tentative Draft No. 1 (1996)).

19 The Subcontract expressly references the establishment of an escrow account to pay Hazmed. Subcontract, §§ 16.3, 16.4.

20 Based on undisputed testimony of Ms. Holmes, Holmes has earned $21,622.00 or 6.15 percent of the $351,254.26 now on deposit at Suntrust.

21 While the Court has concluded an express trust was created in March 2001 by the execution of the Escrow Agreement and the Subcontract, even if the Instrument of Transfer was necessary for a trust creation as Holmes contends, it appears that a constructive trust was created under Virginia law. In Virginia, constructive trusts occur not only where property has been acquired by a fraud or improper means, but also where it has been fairly and properly acquired, but it is contrary to principles of equity that it should be retained, at least for the acquirer's own benefit. *Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron),* 206 B.R. 394, 400 (Bankr.E.D.Va.1997)(quoting *Leonard v. Counts,* 221 Va. 582, 272 S.E.2d at 190, 195 (1980)). The failure to transfer property for consideration intended to be in trust may create a constructive trust Austin W. Scott and William Fratcher, *The Law of Trusts,* § 31.4 (4th Ed.1987). The Fourth Circuit Court of Appeals and this court has recognized constructive trusts as property claims in bankruptcy. *See, e.g. Mid–Atlantic Supply Inc. of Va. v. Three Rivers Aluminum Co. (In re Mid–Atlantic Supply, Inc.),* 790 F.2d 1121, 1124–25 (4th Cir.1986); *Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron),* 206 B.R. at 400; *Citizens Fed. Bank v. Cardian Mortgage Corp. (In re Cardian Mortgage Corp.),* 122 B.R. 255, 259 (Bankr.E.D.Va.1990); *In re Crotts,* 87 B.R. 418, 420–21 (Bankr.E.D.Va.1988). While Holmes contends the decision in *XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.),* 16 F.3d 1443 (6th Cir.1994) has influenced the Fourth Circuit Court of Appeals to reconsider the allowance of a constructive trust claim in bankruptcy, this court finds no decisions which suggest an abandonment of the *Mid-Atlantic Supply* holding that a constructive trust may be proven in bankruptcy where an identifiable *res* of money exists. See *In re Greenbelt Road Second Limited Partnership,* 1994 WL 592766 at *3 (4th Cir.1994)(unpublished decision)("the debtor's commingling putative trust funds with his own accounts if fatal to the imposition of a constructive trust"). Here where there is unquestionably a segregated, identifiable *res,* this Court believes that, should it subsequently be found by an appellate court that the execution of the Instrument of Transfer was necessary to create an express trust, nonetheless a constructive trust composed of the Corps Contract proceeds earned by Hazmed was created in March 2001. This constructive trust would also operate to place the portion of the escrowed Corps Contract proceeds earned by Hazmed outside of the estate property of Holmes under § 541 of the Bankruptcy Code.

22 There is authority that a trust created other than from funds of the debtor within ninety days of film is not preferential because the funds in question did not constitute property of the debtor. In *Greenwald v. Square D Co. (In re Trans–End Technology, Inc.),* 228 B.R. 181 (Bankr.N.D.Ohio 1998), the court considered whether payments made to a subcontractor within ninety days of the contractor's bankruptcy filing were preferential. Finding that the funds in question were subject to a statutory trust created by Michigan law, the court there concluded "that the [Michigan] Trust Fund Act applies to the transfers at issue thereby preventing the funds from becoming property of the Debtor's bankruptcy estate" and, accordingly, no preferential transfer occurred even though the statutory trust was created and the monies paid to the subcontractor within the ninety day preference period. *Id.,* 228 B.R. at 185. *See also Selby v. Ford Motor Company,* 590 F.2d 642, 649 (6th Cir.1979) and *Huizinga v. U.S.,* 68 F.3d 139, 145 (6th Cir.1995). The court in *Trans–End* considered arguments by the trustee seeking avoidance that the broad powers of 11 U.S.C. § 547 can reach a trust created during the ninety day preference period, citing to *Alithochrome Corp. v. East Coast Finishing Sales Corp. (In re Alithochrome Corp.),* 53 B.R. 906 (Bankr.S.D.N.Y.1985) and *Torres v. Eastlick (In re North American Coin & Currency Ltd.),* 767 F.2d 1573, 1576, n. 2 (9th Cir.1985), amended by 774 F.2d 1390 (9th Cir.1985). In considering these decisions, the court found them distinguishable, in that "the trusts were either created from the debtor's property or the court found that no trust had been created." *In re Trans–End Technology, Inc.,* 228 B.R. at 184. In contrast, the funds in question in *Trans–End* were paid by Ford [the project owner] to the debtor and therefore "[t]he trust arising in this case did not arise out of the debtor's funds." *Id.* As this Court has determined that an express trust was created in March 2001 by the execution of the Escrow Agreement and the Subcontract, the court need not rely on this authority to resolve the instant matter.

23 Section 547(b) provides:

> [T]he trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (2001).

24 First by permitting the trustee to avoid pre-bankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally. The operation of the preference section to deter "the race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section-that of equality of distribution.

H.R. Rep. No. 95–595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138.

25 While no money was actually transferred during the ninety day preference period to Hazmed, it is the contention of Holmes that the making of the Instrument of Assignment on October 8, 2001 is the transfer which is preference which would enable Hazmed to claim its portion of the escrowed monies.

26 While the alleged preferential transfer took place on October 8, 2001, the invoice of Hazmed provide a total for the month of October dating from October 1, 2001. Because of the insubstantial difference of eight days, the Court will measure the new value transfers from October 1, 2001.

27 The invoices are as follows:

October 1–October 31, 2001	$ 93,791.32
November 1–November 30, 2001	$ 76,833.45
December 1–December 31, 2001	$ 62,824.72
January 1–January 31, 2002	$ 67,160.58
January 1–January 31, 2002	$ 298.83

January 1–January 31, 2002	$ 256.41
January 1–January 31, 2002	$ 16,824.93
Total	$317,992.04

For reasons not explained at trial, Hazmed sent four separate invoices for work performed on the Corps Contract in January 2002.

28 See Part I., *supra.*

29 See Part I., *supra.*

30 The single decision which the Court has located which found an escrow fund transfer post-petition to be avoidable under Section 549 of the Bankruptcy Code is *Gassen v. Universal Building Materials, Inc. (In re Berkley Multi–Units, Inc.),* 69 B.R. 638 (Bankr.M.D.Fla.1987). There a purchase of real property was closed into escrow. At the final closing, title problems to the real property prevented disbursement of the escrowed monies from being disbursed. The commencement of a bankruptcy intervened. The court found the post-petition turnover of the escrow funds to be a transfer violative of § 549, because "there is hardly any doubt that the Debtor at the time had the right to elect not to proceed with the transaction and had the right to elect not to proceed with the transaction and had a legal right to recover the funds placed in escrow and back out of the transaction." *Id.,* 69 B.R. at 642. The circumstances in the instant matter are markedly different. Here the trust created was not revocable. Segregation and direct payment of the Corps Contract proceeds earned by Hazmed was an express condition of the entry into the Subcontract by Hazmed. Holmes gave up control of the monies earned by Hazmed on the Corps Contract except for its role is verification to the escrow agent of the amounts actually earned by Hazmed. As such, the express trust created here is distinguishable from the events which led to a finding of an avoidable post-petition transfer in Berkley Multi–Units.

31 Pls.Ex. 2, ¶ IV, 3.

32 In the event either Holmes or Hazmed failed to provide, respectively, invoices or payment instructions to Suntrust, the escrow agent presumably would implead the monies into court and request a declaration of the parties' entitlement thereto.

14

884 A.2d 513
Superior Court of Delaware,
New Castle County.

INTERIM HEALTHCARE, INC, Catamaran Acquisition Corp. and Cornerstone Equity Investors, IV, L.P., Plaintiffs,
v.
SPHERION CORPORATION, Defendant.

C.A. No. 00C–09–180–JRS.
|
Submitted: July 20, 2004.
|
Decided: Feb. 4, 2005.

Synopsis

Background: Purchasers of home health care company sued seller to recover for multiple alleged breaches of stock purchase agreement and recovery under indemnification provisions.

Holdings: After bench trial, the Superior Court, New Castle County, Slights, J., held that:

[1] purchasers were not denied benefit of their bargain so as to be entitled to expectancy damages, particularly with respect to liabilities for post-audit Medicare reimbursement amounts;

[2] seller made no actionable misrepresentations in its financial statement regarding reserves reflecting potential liability for Medicare reimbursement adjustments;

[3] seller made no misrepresentations regarding allegedly underperforming franchisee loans;

[4] failure to disclose potential liability on malpractice claim entitled purchaser to indemnification for fees and expenses incurred in bringing insurance coverage action;

[5] seller's obligation to disclose all threatened litigation was breached; and

[6] seller was liable to indemnify purchaser for losses sustained as result of claims and loan write-offs in connection with failed student funding program.

Ordered accordingly.

West Headnotes (23)

[1] **Evidence** Greater weight; evenly balanced evidence

If the evidence presented by the parties during trial is inconsistent, and the opposing weight of the evidence is evenly balanced, then the party seeking to present a preponderance of the evidence has failed to meet its burden.

5 Cases that cite this headnote

[2] **Evidence** Nature and Existence of Ambiguity in General

Court will not consider parol evidence when construing an unambiguous agreement.

[3] **Evidence** Negotiations, communications, and understandings

When two parties have made a contract and have expressed it in a writing to which they have both assented as to the complete and accurate integration of that contract, evidence of antecedent understandings and negotiations will not be admitted for the purpose of varying or contradicting the writing.

5 Cases that cite this headnote

[4] **Evidence** Completeness of Contract or Agreement; Merger and Integration

To ensure compliance with the parol evidence rule, the court first must determine whether the terms of the contract it has been asked to construe clearly state the parties' agreement.

1 Case that cites this headnote

[5] **Contracts** Existence of ambiguity

Contract is not rendered ambiguous simply because the parties disagree as to the meaning of its terms, but rather, a contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings.

10 Cases that cite this headnote

[6] **Contracts** Application to Contracts in General

Upon concluding that a contract clearly and unambiguously reflects the parties' intent, interpretation of the contract must be confined to the document's "four corners."

7 Cases that cite this headnote

[7] **Contracts** Language of Instrument

Court will interpret a contract's terms according to the meaning that would be ascribed to them by a reasonable third party.

4 Cases that cite this headnote

[8] **Evidence** Sales or exchanges of property

Stock purchase agreement for sale of home health care company was clear and unambiguous in all its aspects, and therefore no extrinsic evidence would be considered in construing the agreement.

1 Case that cites this headnote

[9] **Indemnity** Contract liability

Reliance is not an element of a claim for indemnification arising from a breach of contract.

48 Cases that cite this headnote

[10] **Corporations and Business Organizations** Warranties and agreements to repurchase

To the extent that corporate seller of its home health care division warranted a fact or circumstance to be true in the stock purchase agreement, purchasers were entitled to rely upon the accuracy of the representation regardless of what their due diligence may have or should have revealed, so that, in that regard, seller accepted the risk of loss to the full extent of its indemnification commitments in the event its covenants were breached.

5 Cases that cite this headnote

[11] **Corporations and Business Organizations** Damages or amount of recovery

Purchasers under stock purchase agreement for sale of home health care company were not denied benefit of their bargain so as to be entitled to any expectancy damages for alleged breach of express promises regarding value of the company; the agreement was a highly negotiated matter between sophisticated parties knowledgeable about foreseeable regulatory, market, and other risks attendant to such a going concern, particularly after extensive due diligence inquiry into such matters as the company's history of Medicare reimbursement practices, methodologies, and experience.

2 Cases that cite this headnote

[12] **Contracts** Ousting Jurisdiction or Limiting Powers of Court

Although the parties may, in their contract, specify a remedy for a breach, that specification does not exclude other legally recognized remedies; an agreement to limit remedies must be clearly expressed in the contract.

3 Cases that cite this headnote

[13] **Corporations and Business Organizations** Construction, operation, and effect in general

Stock purchase agreement for sale of home health care company did not expressly provide for expectancy damages, but neither did it

specifically exclude them, and therefore the indemnification provisions in the agreement did not set forth the sole remedy available upon breach.

1 Case that cites this headnote

[14] **Contracts** Language of Instrument
Contracts Extrinsic circumstances
Contracts Construction by Parties

Standard of interpretation of a written instrument, except where it produces an ambiguous result, or is excluded by a rule of law establishing a definitive meaning, is the meaning that would be attached to such instrument by a reasonably intelligent person acquainted with all operative usages and knowing all the circumstances prior to and contemporaneous with the making of the instrument, other than oral statements by the parties of what they intended it to mean.

2 Cases that cite this headnote

[15] **Contracts** Mistakes in writing, grammar, or spelling
Contracts Punctuation

When construing the meaning of contractual terms, court will not allow sloppy grammatical arrangement of the clauses or mistakes in punctuation to vitiate the manifest intent of the parties as gathered from the language of the contract.

4 Cases that cite this headnote

[16] **Contracts** Construction as a whole

Meaning which arises from a particular portion of an agreement cannot control the meaning of the entire agreement where such inference runs counter to the agreement's scheme or plan.

1 Case that cites this headnote

[17] **Administrative Law and Procedure** Plain, literal, or clear meaning; ambiguity or silence

Only if the intent of Congress is not clearly expressed in a statute will a court consider an agency's construction of the statute.

[18] **Corporations and Business Organizations** Damages or amount of recovery

Even if there had been a breach of representations and warranties, in stock purchase agreement for sale of home health care company, regarding potential post-sale liabilities upon audits of Medicare reimbursement cost reports, the damages were not shown with requisite specificity to warrant recovery from seller under agreement's indemnification provisions, since purchaser's global settlement of adjustments to cost reports provided no breakdown or itemization of matters that were arguably within scope of the indemnity obligation.

[19] **Corporations and Business Organizations** Warranties and agreements to repurchase

Seller of home health care company made no misrepresentations or other breaches of warranty, such as would subject it to liability under indemnification provisions of purchase agreement, through its disclosure in financial statements of reserves reflecting potential liability for Medicare reimbursement adjustments following audits of cost reports; process of setting reserves itself involved complex estimates based on numerous considerations, and multiple disclaimers reflecting that fact appeared throughout the pertinent documents.

1 Case that cites this headnote

[20] **Corporations and Business Organizations** Warranties and agreements to repurchase

Seller of home health care company did not breach any warranty to purchaser, such as might subject seller to liability to indemnify purchaser, by not having written down or reserved against

underperforming loans that seller had made to two of its franchisees; accepted accounting practices supported manner in which seller carried the loans in its financial records and did not require any particular disclosure to purchaser regarding possible failure of the loans.

[21] **Corporations and Business Organizations** Performance or breach

Failure by seller of home health care company to adequately disclose potential liability in malpractice action was a breach of its obligations under stock purchase agreement, which required seller to indemnify purchaser for legal fees and expenses incurred in prosecution of insurance coverage action incidental to the malpractice claim.

1 Case that cites this headnote

[22] **Corporations and Business Organizations** Performance or breach

Corporations and Business Organizations Damages or amount of recovery

Obligation of seller of home health care company to disclose all threatened litigation was breached by seller, thus subjecting it to liability to indemnify purchaser for attorney fees, costs, and settlement proceeds incurred in litigation with one of seller's franchisees, who in fact had many times prior to the sale threatened litigation against seller based on alleged territorial infringement and other claims.

[23] **Corporations and Business Organizations** Damages or amount of recovery

Seller of home health care company was required, under special indemnification provisions in stock purchase agreement and according to formula therein, to indemnify purchaser for post-sale losses sustained as result of claims and loan write-offs in connection with seller's failed program for funding therapy students' training.

***515** Decision After Non–Jury Trial. **Judgment for Plaintiffs.**

Attorneys and Law Firms

Sean J. Bellew, Cozen O'Connor, Wilmington, DE; Robert W. Hayes, ***516** Sarah E. Davies and Mary Craine Lombardo, Cozen O'Connor, Philadelphia, PA, for Plaintiffs.

Allen M. Terrell, Jr. and Alyssa M. Schwartz, Richards, Layton & Finger, Wilmington, DE, for Defendant.

Opinion

SLIGHTS, Judge.

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***517** This lawsuit involves claims arising from alleged breaches of an intensely negotiated stock purchase agreement for the sale of Interim Healthcare, Inc. ("Interim") by defendant, Spherion Corporation ("Spherion"), to plaintiffs, Catamaran Acquisition Corp. ("Catamaran") and Cornerstone Equity Investors, IV L.P. ("Cornerstone") (the transaction will be referred to hereinafter as "the Sale"). The plaintiffs, Interim (as acquired),[1] Catamaran and Cornerstone, allege that Spherion breached several representations and warranties in the Agreement by failing adequately to disclose numerous pre-Sale liabilities of Interim and by misrepresenting the financial condition of Interim in the financial statements supplied to the plaintiffs during due diligence. Plaintiffs seek damages under the indemnification provisions of the Agreement and also seek expectancy/benefit-of-the-bargain damages for the difference between what they paid for Interim ***518** and the actual value of Interim at the time of the Sale.

After a three week bench trial and post-trial submissions by the parties, this is the Court's findings of fact and conclusion of law. In short, the Court has found in favor of the plaintiffs on Counts I and II of their Amended Complaint and awards damages to plaintiffs in the amount of $1,070,719.47. The Court has found in favor of Spherion on Counts III of the Amended Complaint, Count I of the Court of Chancery Complaint (previously transferred to this Court), and on plaintiffs' claim for expectancy damages.

This Opinion, necessarily lengthy given the size of the trial record and the complexity of the claims, is organized as follows: Part One describes the parties, the background facts and the Court's findings of fact where the parties disagree. Part Two summarizes the claims and defenses and sets forth the Court's analyses and conclusions of law. Finally, Part Three summarizes the Court's conclusions and directions for the entry of the appropriate verdict and judgment on the docket.

I.

A. The Parties

Prior to September 26, 1997, Spherion (formerly known as Interim Services, Inc.), a Delaware corporation, operated two principal divisions, a commercial staffing division and a healthcare division. The healthcare division initially focused on providing temporary nurses to hospitals.[2] Eventually, the healthcare segment of Spherion's business grew with its entry into the home healthcare, physical therapy, and other health-related markets.[3] By the time Spherion sold its healthcare business in 1997, Interim had become the second largest

independent home healthcare company in the United States.[4] As of December 27, 1996, Interim "operated a network of 391 home care offices in 45 states and 4 Canadian provinces."[5]

Of Interim's 391 home care offices, 285 of them were operated by Interim franchisees.[6] The remaining home care offices were owned by Spherion and operated by Interim directly. The majority of Interim's revenues (approximately 75%) were derived from reimbursements for services from private payers (individual patients and private health insurers). The remaining approximately 25% of Interim's revenues were derived from Medicare program reimbursements.[7]

Cornerstone is a private equity firm based in New York.[8] Over its twenty year history, Cornerstone has focused its investment activities in four basic areas: technology, retail, consumer business services and healthcare.[9] Cornerstone's investors (approximately 30 in number) are primarily state pension funds and large corporate pension funds.[10] Cornerstone ***519** formed Catamaran in 1997 as the vehicle through which it would acquire Interim.[11]

B. The Medicare Cost Reimbursement Program

As indicated, a significant percentage of Interim's revenues were derived from Medicare reimbursements. It is not surprising, then, that this segment of Interim's operation was a focal point of the parties' discussion prior to the Sale. Given the intense regulatory environment in which the Medicare program operates, it is also not surprising that the Medicare aspects of Interim's operations has become a focal point of the parties' dispute after the Sale and a key aspect of this litigation. The Medicare program, and Interim's interaction with it, both are quite complicated. The Court will address the background of this aspect of the case in detail in light of its importance to the plaintiffs' summital claim for relief.

Medicare is a federally funded program created in 1966 by the Social Security Act, 42 U.S.C. § 1395 (the "Medicare statute"), to provide healthcare coverage for a designated population, including the elderly and disabled.[12] At the time of the events giving rise to this controversy, the Medicare program was administered by the Health Care Financing Administration of the Department of Health and Human Services ("HCFA").[13] The Medicare program is comprised of two parts: "Part A" provides coverage for in-patient hospital and post-hospital care, home health services and hospice care; "Part B" is a voluntary supplemental health insurance program that provides coverage for services rendered by physicians and other out-patient healthcare providers.[14] Skilled-intermittent nursing, physical therapy and home health aid services rendered by a home health provider to Medicare program beneficiaries are recognized by Medicare in Part A as "covered services."[15] Other services, such as regular "private duty" nursing care, are not covered by Medicare.[16]

Prior to a restructuring of Medicare reimbursement in October, 2000, home healthcare providers were reimbursed for covered services on a per-visit, retroactive cost basis.[17] Under this system, Medicare reimburses providers only for the allowable costs of providing the covered services they render to Medicare beneficiaries.[18] Providers are not entitled to make a profit on billings to Medicare by inflating costs or by improperly shifting non-Medicare costs to the Medicare program.[19] In determining reimbursable costs, Medicare takes into account both the provider's direct and indirect costs to provide services to Medicare beneficiaries.[20] The intent of the reimbursement scheme is to ensure ***520** that the cost of delivering covered services to Medicare beneficiaries is not born by the provider's non-Medicare patients and, likewise, that the cost of providing services to the provider's non-Medicare patients is not born by Medicare beneficiaries.[21]

Under the retroactive cost reimbursement system, the provider bills the Medicare program as it delivers services to program beneficiaries. Medicare, in turn, pays the provider either on a "claim-by-claim" basis or on the basis of estimated lump-sum, bi-weekly payments known as periodic interim payments ("PIP").[22] Such payments are estimates of the costs of delivering services and supplies to program beneficiaries based on past performance. At the end of the program year (usually the provider's fiscal year), the provider prepares and submits to Medicare a year-end "cost report" in which it calculates the costs it incurred to provide services to Medicare beneficiaries during the fiscal year for which the cost report is being submitted.[23] To the extent the actual costs vary from the estimated costs for which the provider already received PIPs, an adjustment occurs and the provider either pays back to Medicare any excess reimbursement or receives from Medicare any reimbursement to which it is owed.[24]

The Medicare statute authorizes HCFA to delegate to insurance companies and other private parties the

responsibility for processing billings from healthcare providers and for verifying that such requests for reimbursement are consistent with the Medicare statute and the rules and regulations interpreting the statute. These entities, known as "Fiscal Intermediaries" ("FI"), are assigned to the healthcare providers by HCFA and are the first point of contact for the providers when interacting with the Medicare program.[25] With respect to home healthcare companies, the FI specifically is charged with responsibility for enforcing the Medicare principles of retroactive costs by, among other measures, scrutinizing requests for PIP and scrutinizing the year-end cost reports submitted by the providers.[26]

C. Cost Reports

The process by which a provider seeks reimbursement from Medicare Part A, at first glance, appears quite simple. First, the provider must identify the costs, both direct and indirect, associated with providing reimbursable services to all of its patients, both Medicare beneficiaries and non-Medicare beneficiaries alike.[27] Once ***521** the provider has identified the costs associated with providing reimbursable services, the provider must then divide that number by the number of covered services provided during the fiscal year. This process yields a "cost per visit" or "cost per service."[28] That number is then multiplied by the number of services rendered to Medicare beneficiaries during the fiscal year. This number yields the total Medicare reimbursement for that year.[29]

The allocation of the provider's direct costs is relatively straightforward. By way of example, if a nurse is providing both reimbursable intermittent nursing care, and non-reimbursable long-term "private duty" care, the direct cost of her salary would be allocated to Medicare by determining the extent to which she provided reimbursable services, and allocating that portion of her salary as a direct cost to be reimbursed by Medicare.[30] Indirect costs in the "chain provider"[31] context, on the other hand, present a range of more complicated issues, from identifying reimbursable indirect costs,[32] to determining in what manner they may be allocated as between healthcare and non-healthcare businesses, and as between Medicare and non-Medicare services.[33] It is this aspect of Interim's cost reports that is primarily at issue here.

1. The Regulation of Cost Reports

The regulation of the home health industry's participation in Medicare and, particularly, the submission of cost reports, is executed through a complex scheme that begins with the Medicare statute itself. From there, the provider looks to regulations promulgated by HCFA, a provider manual published by HCFA (the Provider Reimbursement Manual or "PRM"), regular bulletins from HCFA called "Transmittals" that attempt to clarify or update the regulations or the PRM, and more informal communications or directives from the FI.[34] Unfortunately, these links of authority from which the provider may seek guidance do not always make a perfect chain. In some instances, the links offer vague ***522** guidance,[35] and at other times contradict one another, leaving the provider to make its best guess as to proper procedure.[36]

With respect to cost reports specifically, the Medicare statute offers little, if any, direct guidance. It simply directs that the provider shall be entitled to the payment of the lesser of its reasonable and customary charges, the costs it incurred to provide the service, or established cost limits.[37] The Medicare statute also generally prohibits cost reimbursement methodologies that will result in "cross-subsidization"—any process that would enable the provider improperly to recoup from Medicare its non-Medicare related costs.[38] Beyond this, the provider must turn to secondary authorities for direction.

HCFA's regulations offer slightly more definitive guidance, but are by no means step-by-step instructions.[39] The PRM and, occasionally, HCFA's Transmittals address in some more detail the manner in which a provider should allocate costs for purposes of preparing cost reports and seeking reimbursement.[40] And finally, the FIs themselves frequently offer their own interpretation of the applicable authority, which interpretations may vary from year to year and from FI to FI.[41]

Providers submit their cost reports to their FI on forms supplied by HCFA.[42] The FI reviews the cost reports and notifies the provider if it owes the Medicare program for overpayments it received during the year or if Medicare owes the provider because the provider was not paid enough in the PIPs.[43] If the provider disagrees with the adjustments made by the FI, the provider may appeal the findings to HCFA's Provider Reimbursement Review Board ("PRRB")

and, if appropriate, to an Administrative Law Judge and up the appellate chain from there.[44]

2. Interim's Cost Reports

Like all chain providers, Interim was required to file two types of cost reports with HCFA: (1) separate cost reports on behalf of the providers at each branch location from which it provided services; and (2) a single cost report on behalf of the Spherion home office where the operations of each branch provider were coordinated. With respect to the home office cost reports, Interim was required to allocate corporate overhead first as between the healthcare business and the non-healthcare business of Spherion, and then as among its various providers. HCFA requires the provider equitably to allocate corporate costs between healthcare and non-healthcare ***523** businesses to ensure that the Medicare program does not subsidize the non-healthcare business by providing reimbursement for non-healthcare costs.[45] Once the home office costs were allocated properly to the providers, Interim then could report such costs in the individual provider cost reports and at that level seek reimbursement for all reimbursable costs.[46]

a. The Three Component A & G Methodology

To allocate costs properly at the provider level, Interim, like all chain providers, had to devise an appropriate methodology to allocate operational costs in a manner that reflected those costs that were reimbursable and those that were not. The distinction between reimbursable and non-reimbursable costs at the home office level was made for the chain providers on Interim's home office cost report. All home healthcare providers are required by regulation to undertake this process, known as "cost finding," by employing a "step down cost finding methodology."[47]

In 1991, Interim began to utilize a "step down" cost allocation methodology referred to as "the three component administrative and general ("three component A & G") methodology."[48] Under the three component A & G methodology, Interim first had to identify its "cost centers," i.e., organizational units within Interim that were operated for the benefit of the institution as a whole.[49] Interim then allocated its costs using a three-step process. First, Interim would allocate the costs of its "servicing center"(home office) down to "operating centers" that were located off site from the home office and included Medicare Billing, Medicare Compliance and a Processing Center (payroll, etc.) at one location, Quality Assurance, Commercial Operational Support and Franchise Operational Support at another location, and Regional Field Offices at various locations. The combined servicing center and operational center costs would then be allocated from the operating centers down to the providers using the three component A & G methodology.[50]

In the second step of its cost allocation, Interim identified three "A & G components" to which it could allocate its home office costs: (1) reimbursable or intermittent A & G (A & G related to Medicare-type services); (2) non-reimbursable A & G (A & G related to non-Medicare activities); and (3) shared A & G (A & G that benefited all cost centers).[51] "Shared A & G" included any A & G generated as a result of activities that supported both intermittent and non-intermittent services. Interim interpreted the guidance from HCFA as directing that it allocate A & G ***524** to shared A & G whenever it arose even "slightly" from both intermittent and non-intermittent activities.[52] By regulation, the costs of non-revenue producing centers must be allocated to the cost centers they serve by using an "allocation statistic" designed fairly to reflect the extent to which each cost center uses the services rendered by the cost center being allocated.[53]

In the final step of the process, Interim "closed out" or apportioned its three component A & G cost centers on the cost report.[54] By regulation, all costs of the non-revenue producing centers are allocated to the centers that receive their services, regardless of whether these centers themselves produce revenues.[55] And, by regulation, "[t]he cost of the non-revenue-producing center serving the greatest number of other centers, while receiving benefit from the least number of centers, is apportioned first."[56] Once a center's costs are apportioned, the center is "closed" and no further costs are apportioned to it.[57] When Interim first began to employ the three component A & G methodology, it allocated (or "sequenced") its shared A & G first using a "net accumulated cost" statistic. Under this methodology, Interim allocated shared costs to all relevant cost centers, including the other componentized A & G cost centers.[58] The 100% reimbursable costs were allocated directly to intermittent operational costs for which full reimbursement was sought; the 100% non

reimbursable costs were allocated ***525** to non-intermittent operational costs for which no reimbursement was sought.[59]

The Medicare regulations require a provider to obtain the approval of the FI before implementing a sophisticated allocation methodology (such as the three component A & G methodology), and Interim believed it had obtained such approval for its allocation methodology, including the sequencing and the allocation statistic, beginning in 1992.[60] As discussed below, Interim adjusted its sequencing and allocation statistic in 1996 after its FI expressed concern that Interim's sequencing was leading to inequitable reimbursement results.

b. The Allocation of Capital Costs

Among the indirect costs allocated from the home office to the chain providers are capital costs, e.g., moveable equipment depreciation, building depreciation, etc. Generally, the allowable capital costs of the chain organization's home office are allocated among the chain's facilities, first by allocating all costs directly attributable to particular facilities in the chain to those facilities; then, by allocating costs on a functional basis where possible; and, finally, by allocating all "pooled" or residual costs among healthcare facilities in the chain on the basis of either relative inpatient days or total costs if the chain consists only of healthcare facilities, or among healthcare facilities and the organization's other entities on an approved basis if the chain contains other than healthcare facilities.[61]

Interim elected to allocate its home office capital costs on a "functional basis" utilizing the square footage of its various facilities as its allocation statistic.[62] Although HCFA did not direct providers to utilize a particular statistic for allocating capital costs, it did suggest that a functional allocation statistic (such as square footage) should be utilized only if it was reasonably related to the "services received by the entities in the chain."[63] To the extent a functional statistic could not be identified, the provider was directed to allocate capital costs on the basis of total costs.[64]

It appears from the record that for the time relevant to this inquiry (1994–96), Interim allocated its capital costs as follows: (1) it allocated the costs of the capital equipment physically located within each cost center directly to that cost center; (2) it then reallocated the costs of the home office Medicare operational cost centers back up to the home office administrative departments; (3) it then allocated the capital costs of the administrative departments along with the reallocated Medicare operational indirect costs back down to some, but not all, of the home office departments; ***526** and (5) finally, it allocated these costs to the provider based on a square footage statistic.[65]

c. Regional Vice President and Branch Manager Salaries

Among the "field office" costs allocated to the providers were the salaries and related costs for regional vice presidents (four in number) and regional branch managers (more than 100 in number).[66] In order properly to allocate these costs to the providers so that reimbursement could be sought from Medicare, Interim first had to determine whether the costs were allowable. Medicare will not pay for costs related to marketing or advertising. It will, however, pay for costs associated with "appris[ing] [physicians, hospitals, public health agencies, nurse associations, etc.,] of the availability of the provider's covered services...."[67] Interim sought reimbursement from Medicare for the costs associated with its regional vice presidents and branch managers to the extent it determined they were not engaged in non-allowable marketing activities.[68]

D. Interim's Pre–Sale Discussions With Its Fiscal Intermediaries

Interim's cost allocation methodologies changed as the nature and extent of its Medicare operations changed. In the early part of 1991, Interim sought and received from its FI, Aetna Life Insurance Company ("Aetna"), approval to implement a three component A & G methodology.[69] Interim utilized the three component A & G methodology in its costs reports for fiscal years 1992 and 1993.[70] Interim's 1992 cost reports were fully audited by Aetna and no major issues were detected.[71]

In early 1994, Interim sought to confirm that Aetna continued to approve of Interim's three component A & G methodology.[72] Aetna responded: "You requested a letter authorizing approval of a three component A & G allocation method. We have reviewed this allocation method at the agency level and did not have any problems or exceptions with it."[73]

In early 1995, Aetna expressed concerns regarding the manner in which Interim sequenced its three component A & G components. Representatives from Interim met with Aetna in March, 1995 to discuss the issue.[74] Although it is unclear whether Aetna's concerns arose from its inability to process the sequencing methodology utilized by Interim with Aetna's then current software system, or from some other more substantive problem, it is ***527** clear that concerns were expressed and directions were given to Interim at the March, 1995 meeting.[75] Specifically, Aetna directed Interim to close out "shared A & G" last. Aetna also advised Interim that one A & G could not be allocated to another A & G.[76] Aetna reiterated this direction by letter dated June 7, 1995.[77]

Later in 1995, Aetna advised Interim that the 1994 home office cost report had been selected for a field audit.[78] On November 7, 1995, Interim attended a meeting with Aetna to address Aetna's concerns prior to the commencement of the field audit.[79] Shortly after this meeting, Aetna provided Interim with a memorandum from HCFA which confirmed that providers utilizing a three component A & G cost allocation methodology should close out shared A & G last in the sequence.[80]

The field audit of the 1994 home office cost report ultimately was cancelled by Aetna because it lacked the resources to conduct the audit.[81] Aetna advised Interim that the audit probably would not be rescheduled, but that Interim should expect a field audit of its 1995 home office cost report.[82] A desk review of the 1994 home office cost report resulted in Aetna issuing NPR's to Interim reflecting downward adjustments of reimbursement totaling $821,475.[83] Interim timely appealed the adjustments to the PRRB shortly thereafter.[84]

In August, 1995, in the midst of its discussions with Aetna regarding the sequencing of A & G and other issues, Interim made a formal request to the Regional Administrator of HCFA to remove Aetna as Interim's FI.[85] HCFA rejected Interim's request and supported Aetna's conclusions regarding the impropriety of Interim's cost finding methodologies.[86] Throughout this time frame, Interim continued to receive advice from its outside legal counsel encouraging Interim to stay the course and make its case for its three component A & G methodology.[87]

HCFA formally weighed in on the sequencing question when it issued Transmittal ***528** 2 on May 1, 1996.[88] Transmittal 2 was effective for cost reporting periods ending on or after September 30, 1996, and expressly stated that providers utilizing the three component A & G methodology must allocate shared A & G last in the sequence.[89] Interim complied with Transmittal 2 but changed its allocation statistic to "total accumulated cost." By utilizing this allocation statistic, Interim was able to maintain the same level of reimbursement it was receiving when it allocated its shared A & G first.[90]

Aetna responded in July, 1996 by admonishing Interim for using an improper allocation statistic and warning that if Interim did not comply with "published guidelines," Aetna may not allow Interim to continue to utilize the three component A & G methodology.[91] If Interim's three component A & G methodology was disallowed, then Aetna would "collapse" the A & G—a process that would result in an allocation of operational costs on the basis of Interim's old method, i.e., on the basis of the relationship between the direct costs of Medicare and non-Medicare operations.[92] The practical effect of a collapse of A & G is that all A & G is placed in the "shared bucket."[93] Interim estimated that a collapse of its A & G would decrease its Medicare reimbursement for home office costs by $3.4 million per year.[94] Throughout this time frame, Interim continued its direct communications with HCFA, through counsel, in an effort to convince HCFA to revisit the sequencing issue.[95]

In January, 1997, HCFA issued Transmittal 3 which mandated that providers utilize net cost, rather than net accumulated cost, as the allocation statistic when allocating costs under the three component A & G methodology.[96] Transmittal 3 also provided: "[FI's should] not make adjustments for alternative A & G fragmentation methodologies employed for cost reporting periods beginning prior to January 1, 1997, which may have been allowed for those periods."[97] Interim took some comfort in Transmittal 3. Even though HCFA was now directing providers to utilize a net cost statistic, it appeared to be offering grandfather grace to providers that were utilizing a methodology that had been approved by the FI prior to January, 1997.[98] Interim believed that its three component A & G methodology fell into this category.[99]

Finally, on November 1, 1997, in a tacit admission that it had been sending conflicting messages to providers in Transmittals 2 and 3, HCFA issued Transmittal 4 in which it attempted to offer definitive guidance to providers by reconciling its conflicting instructions with the applicable regulations.[100] In Transmittal 4, HCFA clarified its position on sequencing and specified that shared A & G should be ***529** sequenced first and allocated to the other componentized A & G cost centers, i.e., providers should utilize a net accumulated cost statistic.[101] HCFA declined, however, to give Transmittal 4 retroactive application; according to HCFA, it applied only to cost reports filed in 1997 or thereafter.[102]

In late October 1996, Interim learned that Aetna would no longer serve as its FI.[103] Interim's new FI, Palmetto Government Benefits Administrators ("PGBA"), assumed Aetna's responsibilities sometime between April and June, 1997.[104] PGBA made it clear that it intended to maintain as much of Aetna's audit/reimbursement staff as possible, and that it did not intend to implement many changes in "the way things operate."[105] The change in FI occurred during Interim's 1996 fiscal year. Interim knew, therefore, that it would be submitting its 1996 year-end cost reports to PGBA for review.

E. Catamaran Acquires Interim at Auction

1. The Timing of the Sale

Spherion first considered the possibility of selling its healthcare division in the Fall of 1995.[106] Plaintiffs contend that the decision to sell Interim was motivated by Interim's ongoing difficulties with Aetna.[107] The preponderance of the evidence, however, establishes that Spherion was motivated to sell Interim for reasons separate and apart from the reimbursement issues it was discussing with the FI. Specifically, Spherion determined that its expanded healthcare business was no longer readily compatible with its commercial staffing business and that Interim required more resources than Spherion was willing to dedicate to it, particularly given the intense regulatory environment in which it was required to operate.[108]

Although Spherion first contemplated a sale of Interim in 1995, the Sale was not consummated until two years later. In the meantime, Spherion completed a major acquisition in connection with its commercial staffing business, and completed a second public stock offering in late August of 1996. Spherion decided a month or two later to go forward with the Sale of Interim.[109]

2. The Financial Statements

a. The Audited Historical Financial Statements

After Spherion decided to sell the Interim healthcare division, it began the process of preparing historical financial statements to reflect the operations of Interim as a stand-alone business.[110] While Spherion did maintain "divisional profit and loss ***530** statements" for Interim, these statements were incomplete in that they did not reflect certain home office expenses, interest income or allocated overhead, all of which a potential buyer would expect to see in the mix of information needed properly to evaluate Interim as a stand-alone company.[111] Accordingly, Spherion tasked Paul Haggard, Spherion's Vice President for Financial Affairs and Controller, with the responsibility of preparing a set of historical financial statements for Interim that could be supplied to potential buyers.[112]

Haggard prepared the historical financial statements by taking "the total company, Spherion, and divid[ing] it into the two divisions, the commercial division and the healthcare division, so that the sum of the two divisions equaled the total. It was a bifurcation of the company on a historical basis."[113] The historical financial statements were intended to "reflect the results of operations, financial position, changes in [Spherion] investment and cash flows of the businesses [that will comprise Interim when sold] ... as if [Interim] were [sic] a separate entity for all periods presented."[114]

Once completed, Spherion submitted Interim's historical financial statements to its outside accountants for a complete audit. Deloitte and Touche ("D & T") had been acting as Spherion's auditor since at least 1994.[115] During the audit process, D & T "looked at every account, every balance sheet and profit and loss account and re-analyzed them."[116] It also reviewed Interim's cost reports, including the 1996 cost report.[117] The D & T audit team consisted of as many as nine people, some of whom were intimately familiar with

Interim because they would spend upwards of three quarters of the year resident at Spherion reviewing information relevant to the annual audits and/or meeting with Interim management.[118] As part of its audit team, D & T included an in-house "Medicare specialist" to review the cost reports and cost reporting methodologies.[119] Although the audit was complete, given the nature of the estimates and allocations that were utilized to reflect the newly bifurcated healthcare business, D & T cautioned the consumer of the financial statements that the information contained therein may not provide a valid basis to measure future performance.[120]

b. The *Pro Forma* Financial Statements

In addition to the historical financial statements, Haggard also prepared *pro forma* historical and projected financial statements by taking the historical financial statements and adjusting them to account for expenses that would be created ***531** as a result of the bifurcation of the company.[121] The purpose of the *pro forma* financial statements was to provide an estimate of what Interim would look like going forward as a stand-alone company.[122] While the historical financial statements were audited by D & T, the *pro forma* historical and projected financial statements were not audited.[123] As explained by Spherion's then Chief Financial Officer, Roy Krause:

> Q. And why would they [the *pro forma* financial statements] not be audited by Deloitte and Touche?
>
> A. There was no attempt to estimate every particular revenue or expense account that could be adjusted under the new leadership or the new ownership. We did not know who would buy the company, whether it was a hospital, a home-health agency, or an individual venture capital company. So, we disclosed the items that we believed on an expense-account basis that they [potential acquirers] need to understand and, then, we also disclosed that we didn't affect revenue or any of the other items, because it was impossible to determine the impact of operations. We didn't know who was going to buy it.
>
> So we could audit the historical because that was a bifurcation of the company and the sum of the parts had to equal the total. But to try to adjust it further was—we considered to be impractical, and we disclosed that it was impractical.[124]

Indeed, the *pro forma* financial statements themselves provided the following disclaimer:

> The *pro forma* financial statements show the adjustments to the historical financial statements to reflect the operating expenses of the company as if it was a stand alone organization. This presentation does not reflect the actual performance of the Company as a stand alone organization, since management may have run the company differently if it was not a division of [Spherion]. The basis for this presentation is the audited financial statements inclusive of incremental operating expenses. Therefore, sales, revenues and direct costs remain unchanged from the audited historical statements.[125]

c. The Medicare Reserves

Spherion's financial statements included reserves for Medicare cost report adjustments.[126] Spherion historically maintained reserves for cost report adjustments in the range of $600,000 per year.[127] In 1996, it appeared that Interim would set its reserves in a range consistent with its past practice.[128] In November, 1996, however, Haggard directed that reserves be reduced by $300,000.[129] In December, 1996, Medicare reserves were reduced by another $250,000.[130] These adjustments (or "reversals") and others left Medicare reserves as reflected on Interim's 1996 income statement at $15,000.[131]

***532** The reserves reflected on the balance sheet—the cumulative reserves—showed a different picture by year-end 1996. As of December 27, 1996, Spherion carried $707,795 in Medicare reserves on its balance sheet.[132] As of the time of the Sale in 1997, Interim's Medicare reserves were set at $3,088,129.[133] The significant jump in Medicare reserves from year-end 1996 to September 26, 1997 was the product, *inter alia,* of Interim's determination at the time it filed its 1996 year-end cost report that its interim cost reports had understated Medicare costs by approximately $3,000,000.[134]

d. The Descriptive Memorandum

Spherion engaged Alex.Brown to serve as the investment banker for the Sale.[135] After considering various options, Alex.Brown recommended that Spherion sell Interim at auction.[136] Spherion did not ask Alex.Brown to value Interim; it was content to allow the auction process to set the price.[137]

Spherion and Alex.Brown prepared a Descriptive Memorandum in April, 1997 for circulation to prospective bidders.[138] Alex.Brown had selected a range of potential bidders (approximately 20), including private equity firms (like Cornerstone), home health competitors, hospitals and nursing homes.[139] In the introduction to the Descriptive Memorandum, Alex.Brown explained that the purpose of the document was "to assist [potential bidders] in deciding whether to proceed further in the investigation of a possible acquisition."[140] Alex.Brown made it clear that the Descriptive Memorandum did "not purport to contain all of the information that a potential acquirer may desire."[141] Among the information contained as schedules to the Descriptive Memorandum were Interim's actual historical financial statements for the fiscal years 1994–96, a summary of *pro forma* adjustments, and the *pro forma* historical and projected financial statements for the fiscal years 1994–2001.[142]

3. Cornerstone's Due Diligence

Cornerstone first expressed interest in bidding for Interim in April, 1997.[143] Cornerstone proposed "an aggregate all-cash purchase price to acquire Interim in the range of $120–$150 million."[144] The expression ***533** of interest was conditioned upon "further due diligence and the receipt of additional information," including "meeting with management, ... comprehensive legal due diligence (including regulatory and environmental due diligence to the degree necessary), a thorough review of the Company's historic, current and projected financial performance, ... [and] reference calls with customers *and payers.* "[145]

Cornerstone's due diligence was extensive and continued over a period of several months.[146] While the due diligence covered a number of issues,[147] the primary focus was on Interim's financial performance and its Medicare operations.[148] With respect to Medicare operations, and particularly reimbursement issues, Cornerstone involved one of its partners with healthcare experience, Martha Robinson, in the due diligence process.[149] Cornerstone also engaged outside experts. First, it engaged Ernst & Young ("E & Y") as a consultant to review Interim's financial statements.[150] E & Y was selected because of its particular expertise in the healthcare industry.[151] Cornerstone also engaged Judy Bishop of Bishop Consulting ("Judy Bishop") to review Interim's Medicare reimbursements and cost reporting methodology.[152]

Spherion developed a "data room" in which it maintained extensive documentary information regarding Interim's operations.[153] Included among the information contained in the data room were Interim's last three finalized cost reports, NPRs for 1994 and 1995 (including adjustments made by the FI with explanations), and related material correspondence with the FI.[154] Spherion provided members of the Interim management team to "chaperone" the Cornerstone representatives while in the data room and to answer any questions they might have.[155] Robert Getz, a principal of Cornerstone, explained the process as follows: the Cornerstone representatives would "submit a request for a specific ***534** document or documents and, then, they would be brought to [the Cornerstone representatives] to the extent that they were available."[156]

Cornerstone's expert consultants provided positive feedback on Interim. For its part, E & Y concluded that "there were very few significant audit adjustments made by the FIs [with respect to Interim's cost reports]."[157] Mr. Getz summarized his impression of the E & Y report as follows:

> [O]verall, the report represented a net positive, because, again, it indicated that the company was relatively doing things in a conservative fashion, particularly when it came to Medicare. So while there might have been specific issues raised here in terms of number of visits that seemed a little off kilter, overall the perception was, based on this two-page summary, that we were getting positive feedback from E & Y from their brief review.[158]

Judy Bishop likewise was both "impressed" with the opportunity an Interim acquisition would present for Cornerstone and satisfied that "there should not be any major changes required in Interim's current cost reporting."[159] Significantly, it appears that both E & Y and Judy Bishop

were aware of Interim's ongoing discussions with Aetna regarding the three component A & G methodology and Aetna's challenges to the 1994 cost report.[160]

4. Cornerstone's Final Bid

Cornerstone communicated its offer to acquire Interim by letter dated June 24, 1997. In its letter, Cornerstone stated:

> [Cornerstone] has performed extensive business due diligence on [Interim] during the last 55 days, having met with the management team on five separate occasions and we are comfortable with the information that we have learned. In addition to our own examination, [Cornerstone] has had the benefit of examination of [Interim] by its attorney and consultants. At this point, we have completed substantially all of our due diligence and we are prepared to move swiftly to a definitive agreement. [Cornerstone] has been waiting to review Interim's audited financial statements, which we received yesterday (previous financials were marked "Draft.") Our accountants at E & Y can quickly perform confirmatory due diligence on the audit work papers and year-to-date financials.[161]

Cornerstone's final bid was $134 million,[162] and the auction gavel fell at this price.[163]

5. The Restated Stock Purchase Agreement

The parties negotiated the terms of a definitive agreement for the sale of Interim ***535** from June 24, 1997 through September 26, 1997.[164] The first Stock Purchase Agreement was dated June 29, 1997.[165] Prior to closing, however, Interim discovered a potential Medicare fraud and abuse issue at its El Paso, Texas and Hollywood, Florida branches.[166] The closing was delayed and additional provisions were added to the Stock Purchase Agreement to address the newly discovered potential liability, and also to "firm up" the provisions of the parties' agreement relating to fraud and abuse liability.[167]

The Restated Stock Purchase Agreement By and Among Interim Services, Inc., Catamaran Acquisition Corp., and Cornerstone Equity Investors, IV, L.P. ("the Agreement") comprises 51 pages.[168] As indicated by its title, the parties to the Agreement are Interim Services, Inc. (now known as Spherion) listed as "Seller," Catamaran listed as "Buyer," and Cornerstone.[169] According to its terms, Cornerstone was a party to the Agreement solely for the purpose of allowing Spherion to recover liquidated damages from Cornerstone in the event of a Buyer's default.[170]

As to be expected, the parties exchanged numerous representations and warranties in connection with the transaction. They also provided for indemnification in the event of breach. The parties negotiated five separate "Representations and Warranties of Seller" that address specifically Medicare issues and Medicare-related liabilities.[171] And each of these representations and warranties is tied to an indemnification obligation which, subject to certain limitations, provides the Buyer with indemnity protection in the event it is later required to pay "any [d]amages that are caused by or arise out of ... any breach by Seller of any of its covenants or agreements under [the] Agreement...."[172]

In addition to Medicare issues, plaintiffs sought and obtained representations and warranties that the historical consolidated financial statements for Interim supplied to Cornerstone were prepared in accordance with generally accepted accounting principles ("GAAP"), and that they "present[ed] fairly in all material respects the consolidated financial position and results of operations of [Interim] ... as of and for the periods indicated ... and are consistent with the books and records of [Interim] for such periods."[173] Plaintiffs also obtained representations and warranties that Spherion had disclosed all pending and threatened litigation involving Interim, ***536** [174]] and that Interim did not have any liability ("accrued, absolute, contingent or otherwise") that would have a "material adverse effect" on Interim that was not either disclosed in the Agreement, or the schedules to the Agreement, or adequately reflected and reserved against in the financial statements.[175]

Based on developments that occurred after the Sale, plaintiffs now allege that Spherion has breached numerous representations and warranties regarding Medicare operations and liabilities, the accuracy of the financial statements and pending or threatened litigation and/or liabilities. The specific provisions of the Agreement implicated by plaintiffs' claims are set forth below.

a. The Medicare Provisions

Spherion represented and warranted that it had not received "Notice" of any problems with its cost reports, that it had not intentionally filed cost reports without a reasonable basis and that its cost reports were filed in compliance with applicable laws. The specific provisions of the Agreement governing Medicare filings provide, in pertinent part, as follows:

> **3.16** ***Medicare/Medicaid Notices.***
>
> (a) Except as set forth in Schedule 3.16(a),[176](i) [Interim] is [not] appealing any notices of program reimbursement, and no notices have been issued regarding any disputes related to [Interim] cost reports from
>
> Governmental Entities[177] responsible for administering the Medicare program for Seller's three (3) most recent fiscal years.[178]
>
> (b) Except as set forth on Schedule 3.16(b), with respect to [Interim], no member of the Seller Group, current or former employees of any member of the Seller Group, or entities or individuals (other than Franchisees) with whom a member of the Seller Group has contracted to provide services have intentionally filed a false claim, or filed a claim without a reasonable basis therefore, with HCFA, its fiscal intermediaries or any state agency, or other third-party payer, or violated the so-called "Medicare Fraud and Abuse" Laws contained in Section 1128(B) of the Social Security Act or any similar laws addressing fraud and abuse in government healthcare programs.[179]

Section 3.17 addresses Spherion's compliance with applicable "Laws" in the filing of its cost reports and provides, in pertinent part:

> **3.17** ***Government Filings.***
>
> Except as set forth in Schedule 3.17, [all] cost reports and other filings are complete and in compliance in all material respects with applicable Laws.[180]

***537 b. The Financial Statements Provision**

The Agreement provides with respect to the audited historical financial statements that they are accurate and have been prepared in accordance with GAAP:

> **3.7** ***Financial Statements.***
>
> Schedule 3.7 sets forth: (i) The audited consolidated financial statements for the fiscal years of [Interim] ended on December 30, 1994, December 29, 1995 and December 27, 1996 and (ii) The unaudited consolidated balance sheet, income statement, and statement of cash flows, as of and for the period ended March 28, 1997 (collectively, "the Healthcare Financial Statements"). The Healthcare Financial Statements have been prepared in accordance with GAAP applied on a consistent basis throughout the periods covered thereby and present fairly in all material respects the consolidated financial position and results of operations of [Interim] operated by the Seller Group as of and for the periods indicated (subject, in the case of unaudited statements to normal year-end audit adjustments, matters that would be disclosed in the notes thereto and to any other adjustments described therein) and are consistent with the books and records of [Interim] for such periods. The Healthcare Financial Statements have been prepared from the separate records maintained by [Interim] and may not necessarily be indicative of the conditions that would have existed or the results of operations if [Interim] had been operated as an unaffiliated company. Portions of certain income and expenses represent allocations made from corporate headquarters items applicable to [Interim] as a whole.[181]

c. The Pending or Threatened Litigation or Liabilities Provisions

The Agreement provides that Spherion has disclosed threatened or pending litigation and all pending or contingent liabilities:

> **3.20** ***Litigation***
>
> Except as set forth in Schedule 3.20, there is no claim, action, suit, litigation, proceeding, or arbitration, at Law or in equity (collectively, "Actions"), pending, or to the Knowledge of the Seller Executives, after consultation with the Healthcare Executives, threatened against Seller related to the Healthcare Business, any of the Transferred Entities or arising from any actions by current or former employees of any member of the Seller Group directly related

to the matters described in Section 3.16(b) regarding Medicare and Medicaid fraud or abuse that would have a Material Adverse Effect, and to the Knowledge of the Seller Executives, after consultation with the Healthcare Executives, there are no facts presently existing that would lead to any such Action.[182]

3.29 ***Undisclosed Liabilities.***

The Transferred Entities do not have any liability, whether accrued, absolute, contingent or otherwise, that would have a Material Adverse Effect, other than liabilities (a) reflected or reserved against in [Interim's] financial statements (or in the notes thereto), (b) disclosed in this Agreement, including the ***538** Schedules, (c) that are fully covered by enforceable insurance, indemnification, contribution or comparable arrangements, (d) under this Agreement or any other Transaction Document or (e) liabilities incurred or arising in the ordinary course of business of the Transferred Entities since December 27, 1996.[183]

d. The Indemnification Provisions

The parties addressed the Seller's indemnification obligation by including a general indemnification commitment at Section 10.1 and a more specific indemnification commitment at Section 10.4. The parties also negotiated certain limitations to their respective indemnification obligations including deductibles, caps, notice requirements and time limitations. The general Seller's indemnification provision provides, in pertinent part:

10.1 ***Indemnification by Seller***

(a) Subject to the terms and limitations of this Section 10, Seller shall indemnify Buyer Indemnitees against any Damages that are caused by or arise out of (i) any breach by Seller of any of its covenants or agreements under this Agreement or any of the other Transaction Documents (ii) any inaccuracy in any representation or breach of any warranty of Seller set forth in Section 3, except to the extent provided in Section 10.3(c) or, (iii) any of the Excluded Liabilities.

(b) The representations and warranties of Seller set forth in Section 3 shall survive the Closing. The representations and warranties set forth in Section 3.3, 3.4, 3.5, 3.7 and subsequent Sections of Section 3 shall expire and be of no further force and effect eighteen months after the Closing Date, except ... (ii) claims that Buyer has previously asserted against Seller in writing, setting forth with reasonable specificity the nature of such claims.[184]

The general indemnification obligation set forth in Section 10.1 is subject to the limitations set forth in Section 10.3:

10.3 ***Limitations.***

(a) Buyer Indemnitees may not assert any claim for indemnification under Section 10.1(a)(ii) or 10.1(a)(iii) (a "Buyer's claim") unless and until: (i) such Buyer's Claim (or a series of related Buyer's Claims) gives rise to Damages (excluding Litigation Expenses for purposes of this threshold only) in excess of $10,000 and (ii) the aggregate amount of such Buyer's Claims shall exceed $2,000,000 and then only with respect to the excess of such aggregate Buyer's Claims over $2,000,000. Notwithstanding the foregoing, in no event shall Seller's liability under and with respect to this Agreement, the Other Transaction Documents, the Transactions or any claims associated herewith arising under Section 10.1(a)(ii) or 10.1(a)(iii) (whether in contract, tort or otherwise, but not including any claim for willful misconduct or willful fraud) exceed an aggregate amount equal to $25,000,000. The limitations set forth in this Section 10.3(a) shall not apply to ... any Section 3.16 damages ..., which shall be governed by Section 10.4 below.[185]

***539** The Agreement's special indemnification provision provides as follows:

10.4 ***Special Indemnity.***

The limitations and thresholds set forth in Section 10.3 shall not apply to the following Special Indemnity matters:

(a) Seller shall indemnify Buyer Group with respect to damages resulting from (i) the failure to collect all notes receivable from the Therapy Students,[186] to the extent that such failure to collect exceeds the amount specifically reserved therefore as of the Closing Date on the books and records of the Healthcare Business, as set forth on Schedule 10.4(a); (ii) claims by Therapy Students against the Seller Group with respect to obligations of Seller or the Transferred Entities under those certain contract concerning the education of the Therapy Students ... (collectively, the "Specified Damages"). Seller and Buyer shall each pay 50% of all Specified Damages; provided,

however, (I) Buyer shall pay the first $100,000 of Specified Damages and (II) Seller's liability for Specified Damages shall not exceed $2,000,000. Any payments made by Buyer pursuant to this Section 10.4(a) shall be included for purposes of determining the threshold set forth in Section 10.3(a)(ii). Any payments made by Seller pursuant to this Section 10.4(a) shall be included for purposes of calculating the $25,000,000 maximum set forth in Section 10.3(a).

(b) Notwithstanding any provision contained herein to the contrary, Seller shall indemnify Buyer Group with respect to Section 3.16 Damages ...; provided, however, that Buyer shall pay 50% of any such Section 3.16 Damages ... up to an aggregate maximum of $500,000, and, provided further that Buyer shall not be liable for Section 3.16 Damages ... in excess of $250,000.... Any payments made by Seller pursuant to this Section 10.4(b) shall not be included for purposes of calculating the $25,000,000 maximum set forth in Section 10.3(a) and such $25,000,000 maximum shall not be applicable to any Section 3.16 damages....[187]

F. Interim's Pre–Sale Liabilities

Shortly after the closing, plaintiffs discovered that Interim was exposed to potential or actual liabilities that they believed were covered by the Seller's representations and warranties and the corresponding indemnity obligations in the Agreement. Some of the liabilities were unanticipated; some, plaintiffs argued, should have been anticipated and disclosed in the Agreement; and others were anticipated and specifically addressed in the Agreement.

1. The Medicare Adjustments

Within months after the Sale, HCFA, through PGBA, initiated an audit of Interim's 1996 home office cost report.[188] The ***540** audit was expanded to include certain provider cost reports in the summer of 1998, and expanded even further to include additional provider cost reports in September, 1998.[189] The first adjustments proposed by PGBA disallowed all of the expenses of numerous Interim employees on the ground that their job descriptions included non-allowable marketing activities. PGBA then issued NPRs that proposed to collapse the three A & G components utilized by the providers. PGBA also proposed to reallocate home office capital costs on the basis of "total cost," as opposed to the "square footage" statistic utilized by Interim.[190]

PGBA immediately began to withhold payments to Interim in order to recoup the amounts specified in the NPRs.[191] PGBA also expanded the audit to include Interim's 1997 cost reports and thereafter began to propose adjustments similar to those made to the 1996 cost reports.[192] If all of the adjustments proposed by PGBA for the 1996 and 1997 cost report years were applied to all Interim providers, Interim would have faced a Medicare liability of approximately $38–40 million.[193]

Interim immediately tendered the defense of the claims to Spherion pursuant to the Agreement, but Spherion elected, as it was entitled to do under the Agreement, to allow Interim to defend the claims since Spherion no longer possessed the expertise in Medicare reimbursement to address the adjustments effectively.[194] Interim engaged its long-time healthcare attorneys, Pyles, Powers, Sutter and Verville, P.C., as well as healthcare consultants, Thomas Curtis, CPA, and Eric Yospe, to assist in its audit defense.[195]

Over the course of the next two years, Interim, with the assistance of its attorneys and consultants, submitted several position papers to PGBA,[196] had numerous telephone conferences with PGBA's auditors, and met directly with HCFA representatives.[197] At Interim's request, PGBA conducted field audits at Interim's provider locations in order to review personnel files and interview employees to determine whether certain employees were involved in non-allowable marketing activities.[198] As a result of these meetings, Interim persuaded PGBA to reverse several of the proposed adjustments relating to disallowed salaries and benefits.[199] PGBA held firm, however, with respect to its disallowance of all of the regional vice president's salaries and twenty-five percent of the branch manager's salaries.[200] PGBA also refused to reverse its adjustments regarding the three component A & G methodology for the 1996 and 1997 cost reports or the adjustments relating to the allocation of capital costs.[201]

After receiving PGBA's final position, Interim began to present its case directly to HCFA.[202] Ultimately, HCFA reversed ***541** PGBA's decision to collapse the three component A & G for the 1996 and 1997 cost reports.[203] HCFA did not, however, reverse the adjustments regarding the sequencing of A & G or the capital cost allocation. Nor

did HCFA reverse the adjustments to disallow regional vice president and branch manager salaries.[204]

After receiving HCFA's final position, Interim filed multiple appeals to the PRRB regarding all issues implicated by the NPRs issued by PGBA.[205] The settlement discussions with HCFA continued, however, and on July 27, 2001, Interim entered into a global settlement agreement with HCFA's successor, CMS, pursuant to which Interim paid CMS an additional $4.2 million (over and above the approximately $1 million already withheld by PGBA) in settlement of all outstanding NPR's and/or adjustments to its cost reports for fiscal years 1994 through 1999.[206] Spherion consented to the settlement by letter dated October 9, 2001.[207]

2. The Black and Burns Franchise Loans

Interim maintained a variety of franchise loan programs to provide funding to franchisees either to create or expand their franchises.[208] The franchise loans generally were secured by the franchisee's accounts receivable and other franchise assets, including Interim's ability, in the event of a default, to reassume territorial rights to the market area contractually held by the franchisee.[209] The loans also were collateralized in most instances by a personal guarantee of the franchise owner.[210] Interim monitored the loans and required franchisees periodically to provide their financial statements so that Interim could compare the loan to the franchisee's financial performance.[211] Interim also monitored the value of collateral that it received from franchisees.[212] At the time of the Sale, Interim's financial statements reflected loans receivable due from franchisees of approximately $14,750,000.[213] These loans were transferred by Spherion to Interim (as acquired) as part of the Sale.[214]

Among the loans in Interim's franchise loan portfolio were loans to the franchise owned by Mary Black (the "Black franchise") and loans to the franchise owned by Jean and David Burns (the "Burns franchise"). The Black franchise entered into a revolving loan agreement with Interim in July, 1995 for a total loan amount of $120,000.[215] By August 31, 1997, however, the Black franchise owed Interim $281,650 on its loan. It paid Interim $90,850 on the loan in 1997. Throughout 1997, the attorney for the Black franchise advised Spherion that the Black franchise was having financial difficulties.[216] After the Sale, when the Black franchise continued to default on its loan payments, Interim ***542** sued Mary Black and the Black franchise seeking to recover the principal amount of the loan and all accrued interest.[217] Ultimately, Interim obtained a default judgment for the total uncollectible debt for the Black franchise in the amount of $268,400.[218] The Black franchise filed for bankruptcy protection shortly thereafter.[219]

The Burns franchise had an outstanding loan balance of $230,000 as of December 27, 1996.[220] This amount was the product of two loans extended to the Burns franchise, the first in October, 1994, and the second in October, 1996.[221] In July, 1997, Spherion negotiated a payment plan with the Burns franchise for overdue accounts receivable.[222] This agreement was renegotiated in September, 1997 after the outstanding accounts receivable still had not been paid in full.[223] The renegotiated agreement was prompted by the Burns franchise advising Spherion that it "was having difficulty with a cash flow shortage."[224] On September 22, 1997, the Burns franchise provided further information regarding its financial situation and advised Spherion that it was losing $40,000 each month.[225]

After the Sale, Interim commenced collection actions to recover the outstanding Burns franchise loan balance.[226] In response, the Burns franchise declared bankruptcy in February, 1998.[227] At the time of the bankruptcy, the Burns franchise owed Interim $230,000.[228] Interim then pursued Jean and David Burns personally on their financial guarantees and ultimately settled that claim with Spherion's consent.[229] Interim incurred $28,788.47 in legal expenses and costs in its effort to collect the outstanding Burns franchise loan balances.[230]

3. The Huff Litigation

In June, 1996, Interim was sued by the parents of Joseph Huff, an infant treated by a nurse employed by an Interim franchise in Portsmith, Ohio, who alleged that the nurse's medical negligence caused significant brain damage to their infant son ("*Huff I* ").[231] The defendants in *Huff I* were, *inter alia,* Interim and Interim Home Solutions ("IHS"), an Illinois general partnership in which Interim was a general

partner.[232] Spherion's insurance carrier assumed the defense of the case.[233]

In late 1996, prior to the Sale, the parties in *Huff I* began settlement negotiations that culminated in the settlement and voluntary dismissal of *Huff I* in 1998.[234] A full and final release was not executed ***543** until June, 2000.[235] In exchange for the payment of $50,000 by Spherion's insurance carrier, Mr. and Mrs. Huff released Interim, its franchisee, Appalachian Healthcare, Inc., and their agents and employees (including the nurse who rendered the care to Joseph Huff).[236] They did not, however, release claims against IHS.[237]

In the midst of the discussions regarding the release language in connection with the settlement of *Huff I,* Mr. and Mrs. Huff initiated a second lawsuit in federal court against several defendants, including IHS ("*Huff II* ").[238] In *Huff II,* plaintiffs alleged that pharmacists were negligent in their preparation of intravenous medication for Joseph Huff, thereby causing the neurological deficits that were at issue in *Huff I.*[239] Plaintiffs alleged that IHS was jointly and severally liable with the other named defendants for Joseph Huff's brain injury and claimed more than $15 million in compensatory damages and $25 million in punitive damages.[240] IHS forwarded the complaint in *Huff II* to Spherion which, in turn, referred the matter to its insurance carrier to defend.[241] The carrier, AIG, denied coverage.[242]

As indicated, Interim, along with Home Solutions Systems, Corporation ("HSSC"), were the general partners of IHS.[243] The primary defendant in *Huff II* was Home Solutions Equity Corporation ("HSEC"), an affiliate of HSSC.[244] According to a management agreement between IHS and HSSC, liability insurance related to the preparation of intravenous solutions was to be procured by HSSC.[245] Shortly after *Huff II* was commenced, however, Spherion learned that HSSC had not obtained such coverage.[246]

By letter dated July 21, 2000, Interim requested that Spherion pursue insurance coverage for *Huff II.*[247] Spherion declined on the grounds that no "Interim entity" was a party to the litigation, and that Spherion was not obligated to provide insurance coverage for IHS.[248] Spherion allowed that Interim could undertake an action against AIG for coverage "at [its] own risk and expense."[249] Interim did just that and, after incurring $91,180.26 in legal fees, Interim successfully prevailed upon AIG to provide coverage for *Huff II.*[250] As part of the settlement with AIG, Interim was reimbursed some of its legal fees, but $41,180.26 remained unreimbursed.[251] AIG ultimately funded the settlement of *Huff II.*[252]

Spherion did not disclose *Huff I* to the plaintiffs prior to the Sale because it believed that the lawsuit represented an "Excluded ***544** Liability" under the Agreement (it was a claim against Interim for which it maintained liability insurance).[253] When Interim made a demand for indemnification under the Agreement for the expenses related to securing coverage in *Huff II,* Spherion rejected that claim on the ground that *Huff II* was post-closing litigation that did not involve a "Transferred Entity" under the Agreement against which an indemnification claim could be made.[254]

4. The Williams Litigation

Nancy Williams owned an Interim franchise in a territory immediately adjacent to an Interim company-owned branch office.[255] Spherion's Chief Operating Officer, Robert Livonius, testified that Ms. Williams threatened to sue Spherion "many times" prior to the Sale for alleged "territorial infringement."[256] It is undisputed that Spherion never disclosed these threats to plaintiffs. After the Sale, Interim terminated Williams' franchise for failure to pay royalties.[257] Williams' franchise then sued Interim claiming, *inter alia,* that Interim had interfered with the franchise's prospective economic advantage by engaging in territorial infringement.[258]

Interim prevailed on several of the claims raised by the Williams franchise on summary judgment.[259] The summary judgment was upheld on appeal.[260] Interim then settled the remaining claims with Ms. Williams for $100,000.[261] The parties have stipulated that the fees and costs incurred by Interim (as required) to defend the Williams litigation were $290,717.25.[262]

5. The Therapy Student Claims

Prior to the Sale, Spherion disclosed to plaintiffs that Interim faced potential liability arising from a failed foreign

exchange program it had sponsored on behalf of American students who wished to study physical therapy abroad (the "Therapy Student program").[263] Interim had recruited these students to participate in a joint program it formed with several physical therapy schools in the Netherlands and had agreed to fund a portion of the tuition in exchange for the student's commitment to work a minimum of two years for Interim after graduation.[264] The Therapy Student program ended abruptly when the students learned that the schools in the Netherlands were not properly accredited making it difficult, if not impossible, for the Therapy Students to be licensed in most American jurisdictions.[265] Many of the Therapy Students asserted claims against Interim alleging that Interim had misled them about the accreditation of the Netherlands schools and had breached express ***545** contractual provisions regarding the Therapy Student program.[266]

In addition to tuition assistance, Interim also provided low interest loans to many of the Therapy Students to cover incidental expenses while they participated in the program. When the students realized that the program was a failure, many of them defaulted on the loans.[267] Consequently, in addition to facing potential damages for the legal claims brought by the Therapy Students, Interim also received several requests for forgiveness of the Therapy Student loans.[268]

Interim had begun the process of settling certain Therapy Student claims prior to the Sale. It also had agreed to forgive certain Therapy Student loan obligations in exchange for a release of claims.[269] Because it was clear that Interim would not resolve all of these claims prior to the closing, the parties agreed specifically to address the claims in the Agreement at § 10.4.[270] At the time of closing, Spherion carried reserves of $578,463 to address Therapy Student loans. In addition, Spherion disclosed two separate Therapy Student lawsuits (one of which was a multi-plaintiff lawsuit) on the Schedules to the Agreement.[271]

After the Closing, Interim provided notice to Spherion regarding additional Therapy Student claims and demanded indemnification under the Agreement. Spherion rejected many of these claims on the grounds that certain of the claimants were not "Therapy Students" as defined in the Agreement, Interim had not provided adequate notice of the claims, or the claims were otherwise barred by the limitations set forth in the Agreement.[272]

II.

A. Preliminary Findings of Fact and Conclusions of Law

Before the Court addresses specifically each of the plaintiffs' claims, it is appropriate first to identify certain legal principals and predicate factual determinations that will guide the Court's analysis throughout the balance of this opinion. They will be stated in general terms here and reiterated, when necessary, in the Court's discussion of the specific claims.

1. The Burden of Proof

[1] The Court begins with the fundamental observation that plaintiffs bear the burden of proving their claims by a preponderance of the evidence. In this regard, the Court must be mindful that if the evidence presented by the parties during trial is inconsistent, and the opposing weight of the evidence is evenly balanced, then "the party seeking to present a preponderance of the evidence has failed to meet its burden."[273] When balancing the evidence, the Court has applied "the customary Delaware standard to the trial testimony:"

> I must judge the believability of each witness and determine the weight to be given to all trial testimony. I considered each witness's means of knowledge; strength of memory and opportunity ***546** for observation; the reasonableness or unreasonableness of the testimony; the motives actuating the witness; the fact, if it was a fact, the testimony was contradicted; any bias, prejudice or interest, manner or demeanor upon the witness stand; and all other facts and circumstances shown by the evidence which affect the believability of the testimony. After finding some testimony conflicting by reason of inconsistencies, I have reconciled the testimony, as reasonably as possible, so as to make one harmonious story of it all. To the extent I could not do this, I gave credit to that portion of testimony which, in my judgment, was most worthy of credit and disregarded any portion of the testimony which, in my judgment, was unworthy of credit.[274]

2. The Parol Evidence Rule

[2] The Court next takes this opportunity to restate a legal conclusion it reached prior to trial and reaffirmed during the trial: the Agreement at issue here is clear and unambiguous; the Court will not consider parol evidence when construing it.[275] In this regard, the Court notes that, at various times in this litigation, the parties have concurred with the Court's characterization of the Agreement as "unambiguous."[276] At other times during the litigation, however, when it suited them, the parties have suggested that the Agreement was ambiguous and that parol evidence was needed to interpret it.[277] Suffice it to say, a contract is either ambiguous or it is not ambiguous. The proper interpretation of a contract does not depend upon the parties' perceived need to present parol evidence when the contract, as written, does not support their position.

[3] **[4]** **[5]** **[6]** **[7]** The parol evidence rule provides that "[w]hen two parties have made a contract and have expressed it in a writing to which they have both assented as to the complete and accurate integration of that contract, evidence ... of antecedent understandings and negotiations will not be admitted for the purpose of varying or contradicting the writing."[278] To ensure compliance with the parol evidence rule, the Court first must determine whether the terms of the contract it has been asked to construe clearly state the parties' agreement.[279] In this regard, the Court must be mindful that the contract is not rendered ambiguous simply because the parties disagree as to the meaning of its terms.[280] ***547** "Rather, a contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings."[281] Upon concluding that the contract clearly and unambiguously reflects the parties' intent, the Court's interpretation of the contract must be confined to the document's "four corners."[282] The Court will interpret the contract's terms according to the meaning that would be ascribed to them by a reasonable third party.[283]

[8] Having concluded that the Agreement is clear and unambiguous, the Court will not consider extrinsic evidence to construe it.

3. There is No Evidence of Fraud or Intentional Misrepresentation

The Court feels obliged at this point to state its view of what this case is *not* about. Throughout the pretrial proceedings, at times during the trial, and again in the post-trial briefing, plaintiffs repeatedly have attempted to characterize Spherion's alleged wrongful conduct as either intentional or fraudulent. Here again, plaintiffs' position has evolved as this litigation has progressed. When plaintiffs sought to amend their complaint to include the equitable claims of reformation and rescission, they claimed they were without a legal remedy because the facts did not support a claim for fraud.[284] Plaintiffs now apparently perceive some advantage to characterizing Spherion's conduct as intentional and/or fraudulent. They have suggested that Spherion intentionally withheld information from Cornerstone during due diligence, intentionally misled HCFA in the cost reports submitted on behalf of Interim, and intentionally misled Spherion's own auditor during the preparation of Interim's audited financial statements. They also suggest that Spherion executives intentionally destroyed damaging financial information "in a show of corporate arrogance which recent events have shown to be all too common."[285]

Notwithstanding their hyperbolic declarations, the fact remains that plaintiffs have not pled fraud or intentional misconduct and, instead, have maintained in this litigation when it suited them that they were aware of no facts upon which such a claim could be based.[286] Their strategy apparently changed as the case moved closer to trial. Nevertheless, despite apparent best efforts, plaintiffs failed to present any facts at trial that would support a claim for fraud or intentional misconduct. Consequently, the Court will not consider a claim of fraud, nor will it consider plaintiffs' breach of warranty claims (or any other claim) in the context of, or against the backdrop of, fraud. The evidence simply ***548** does not support the fraud-related "conspiracy theories" peppered throughout plaintiffs' trial presentation and post-trial arguments. This is a breach of warranty case and nothing more or less than that.

4. The Elements of a Breach of Contract Claim

[9] **[10]** Under Delaware law, the elements of a breach of contract claim are: (1) a contractual obligation; (2) a

breach of that obligation; and (3) resulting damages.[287] "Reliance is not an element of [a] claim for indemnification [arising from a breach of contract]."[288] Having concluded that this is a breach of warranty case, the Court will consider the evidence of record to determine whether the plaintiffs have met their burden of proof on each of the foregoing elements. The Court will not, however, require the plaintiffs to prove that they were justified in relying upon Spherion's representations and warranties as set forth in the Agreement. No such reasonable reliance is required to make a *prima facie* claim for breach. It follows, then, that the extent or quality of plaintiffs' due diligence is not relevant to the determination of whether Spherion breached its representations and warranties in the Agreement. To the extent Spherion warranted a fact or circumstance to be true in the Agreement, plaintiffs were entitled to rely upon the accuracy of the representation irregardless of what their due diligence may have or should have revealed. In this regard, Spherion accepted the risk of loss to the full extent of its indemnification commitments in the event its covenants were breached.

5. Catamaran Has Standing to Allege a Breach of the Agreement

Spherion contends that Cornerstone may not seek damages because Cornerstone is a party to the Agreement only for the purpose of allowing Spherion to recover liquidated damages against Cornerstone if the Buyer breaches certain provisions of the Agreement.[289] Spherion points to the fact that Catamaran is the only "Buyer" identified in the Agreement.[290] And, Spherion continues, the Seller's warranties set forth in Section 3 of the Agreement are given only to the "Buyer."[291] Thus, concludes Spherion, "Cornerstone cannot independently recover for any breach based on representations and warranties in a contract to which it is not a party."[292]

The plaintiffs acknowledge that they are not seeking to recover breach damages on behalf of Cornerstone.[293] Their references to "Cornerstone" in the briefing were intended to include both Cornerstone and Catamaran collectively, as explained at the outset of their Opening Brief.[294] Catamaran, as a named party to this lawsuit and a party to the Agreement to whom representations and warranties were made, has standing to plead a breach of warranty claim and any other claims that may properly arise from a breach of the Agreement, including expectancy or benefit-of-the-bargain damages, if appropriate.

***549 6. The Contractual Allocation of Risk and Expectancy Damages**

[11] Plaintiffs' showcase claim is that they were denied the benefit of their bargain with Spherion: they purchased a company that Spherion represented was worth approximately $134 million when, in fact, it was worth only $90 million.[295] Based on these facts, plaintiffs seek to invoke what is perhaps the most basic tenet of contract law: a party that breaches a contract must place the non-breaching party back to the position he would have enjoyed had there been no breach.[296] Thus, according to the plaintiffs, Spherion must fulfill the plaintiffs' expectancy by making up the approximately $26 million shortfall. While the plaintiffs' expectancy argument has curb appeal, it does not withstand closer inspection.

The Court first considers whether the plaintiffs' expectancy damages claim is legally viable in the context of this highly negotiated contract between two sophisticated parties. Clearly, the Agreement does not expressly contemplate expectancy damages; they are nowhere mentioned or even insinuated in the contract. The sole remedy for breach identified in the Agreement is indemnification, both for the Seller (in the event of a Buyer's breach) and the Buyer (in the event of a Seller's breach). The indemnification provisions are quite specific in both their scope and application. According to Spherion, they provide the parties with their exclusive remedy in the event of a breach of the Agreement. The Court disagrees.

[12] **[13]** "Although the parties may, in their contract, specify a remedy for a breach, that specification does not exclude other legally recognized remedies. An agreement to limit remedies must be clearly expressed in the contract."[297] Here, although the Agreement does not specifically provide for expectancy damages, it also does not specifically exclude them. Accordingly, if other remedies (including expectancy damages) are factually viable, then they are legally viable as well.[298]

Turning, then, to the factual *bona fides* of expectancy damages in this case, as a fact finder, the Court must admit to some knee-jerk reluctance to embrace the claim given the generous pre-Sale due diligence afforded to the plaintiffs and

the purity of the auction process leading up to the Sale. The Court's first impression has only been reinforced by further consideration of the claim.

At its essence, plaintiffs' claim appears to rest on the circular proposition that Interim was worth $134 million because that is what the plaintiffs paid for it. While that logic may apply to a commodity the total value of which can be realized ***550** immediately through use or sale—a barrel of oil, for example—it does not hold true in the sale of a going concern. In a free market economy, all businesses operate under the constant risk of declining profits caused by an infinite panoply of market factors. The emergence of a superior competing product, an adverse regulatory ruling, and the unexpected insolvency of a major customer are but a few examples. Market risks also work in the opposite direction; the insolvency of, or a regulatory ruling against a major competitor, for example, may provide windfall profits. The presence of these market factors—more prevalent in some industries (like healthcare) than others—must be taken into consideration when attempting to measure a firm's value. Even then, the process is by no means an "exact science."[299]

In this case, the occurrence of a foreseeable risk factor, an adverse regulatory ruling, soon after the plaintiffs acquired Interim does not necessarily mean that the plaintiffs received less than what they paid for. If Spherion could have in some way entirely eliminated the risk of an adverse audit, the parties' Agreement would reflect this protection and the price for Interim most certainly would have been higher. The representations and warranties in the Agreement, however, reflect that the parties were fully aware that a Medicare audit could occur and that Spherion would bear the risk of that loss only in certain circumstances, e.g., if Spherion failed to file its cost reports in a manner consistent with its Medicare representations and warranties.[300] The expectations of both parties, therefore, were shaped by the risks of which they were aware, and the allocation of those risks as expressed in their Agreement.[301]

Professor Williston exposes the factual weakness in plaintiffs' expectancy argument in his explanation of the theoretical basis of the remedy:

> The theory underlying [expectancy damages] is as simple as it is significant: A promissee enters into a particular outcome and believes that the best possible outcome, under the circumstances, will be achieved by contracting with this particular promisor. When the promisor *fails to perform as promised,* the promissee ***551** becomes entitled to damages designed to compensate him or her for the harm caused by the breach. That harm, in turn, is the loss suffered by the promissee when the promisor *failed to perform his or her promise*—in other words, the value to the promissee of the promise that was broken.[302]

Although plaintiffs purport to link their claim for expectancy damages to alleged breaches of the Agreement,[303] much of their argument suggests that Spherion in all instances must bear the risk of loss in this transaction.[304] All things being equal, if the Agreement did not contain a contractual allocation of risk, the plaintiffs' argument might be received more favorably. But, in the shadow of the parties' highly negotiated Agreement, after thorough due diligence, the plaintiffs sound much like an experienced gambler asking the pit boss to allow him to take his losing bet off the table after the roulette wheel has stopped spinning. Plaintiffs had ample opportunity to negotiate for a specific representation and warranty regarding the value of the company they were acquiring. No such warranty was given, however. To the contrary, Spherion constructed the Sale of Interim as an auction, prepared *pro forma* financial statements peppered with disclaimers, and opened Interim's doors to Cornerstone for due diligence. Under these circumstances, plaintiffs' reasonable expectancy must be tied to and limited by the express promises made to them in the Agreement.[305]

The cases that the parties belabor involve either the pure economic loss doctrine or estimating stock price in an appraisal action and, as such, are off point.[306] More relevant is the long line of cases in which buyers, like the plaintiffs here, seek to escape written warranties and disclaimers in favor of common law remedies that ***552** assume the absence of bargained for allocations of risk. Most common among these are disputes over the sale of goods involving the Uniform Commercial Code. For example, in upholding a contractual allocation of risk in *Employers Ins. Of Wausau v. Suwannee River Spa Lines, Inc.,*[307] the Fifth Circuit noted,

> We will not disturb the agreed upon allocation of risks simply because the worst of those risks has materialized. While this result may seem harsh, it is clear that two sophisticated commercial actors such as [plaintiff] and [defendant] could have allocated the risk of damage stemming from a guarantee deficiency differently… [Defendant] and [plaintiff] are "commercial giants"

> of equal bargaining power. Their lengthy negotiations produced a detailed contract of nearly 100 pages in length. We will not rewrite this contract to substantially alter the allocation of risks to which the parties have consented.

Here, plaintiffs made a business decision to allocate the risk of loss as between Buyer and Seller by including highly negotiated representation and warranty provisions in the Agreement. These representations and warranties were integral to the transaction and were reflected in the purchase price paid for Interim. The contractual allocation of risk was etched in stone when the parties included an integration clause, in which they acknowledged that the Agreement, including the express warranties, represented the sole and complete understanding of the parties.[308] The plaintiffs' calculated risk did not pan out, and now they seek to escape the express language of the Agreement in favor of more liberal common law platitudes. The Court is not persuaded. In the absence of proof by a preponderance of the evidence that Spherion breached a promise expressed in the Agreement in a manner that materially affected the value of Interim at the time of the Sale, the Court will not award expectancy damages. As discussed below, no such breach occurred here.

B. The Medicare Adjustments

1. The Parties' Contentions

The plaintiffs contend that the post-Sale audit of Interim's cost reports uncovered numerous problems which, individually or in total, constitute breaches of Spherion's representations and warranties in the Agreement. Specifically, the plaintiffs have identified two provisions of the Agreement implicated by Spherion's alleged improper cost reporting methodologies: Section 3.16 and Section 3.17. As to Section 3.16(a), plaintiffs point to Spherion's representation that "no *notices* have been issued regarding any disputes related to [Interim] cost reports from Governmental Entities responsible for administering the Medicare program ...," and argue that Spherion's failure to disclose Aetna's frequent pre-Sale communications with Interim regarding the deficiencies in their cost reporting methodologies constitutes a breach of this provision.[309] Plaintiffs contend that these communications were "notices" as contemplated in this provision of the Agreement.

With respect to Section 3.16(b), plaintiffs argue that Spherion breached its representation ***553** that "[Interim has not] intentionally filed a false claim, or filed a claim without a reasonable basis therefore, with HCFA [or] its fiscal intermediaries...."[310] Plaintiffs contend that Interim lacked any reasonable basis to support its implementation of the three component A & G methodology, its allocation for capital costs on the basis of a square footage statistic, its allowance of Regional Vice President and Branch Managers salaries and costs, as well as other allegedly improper claims for reimbursement identified during the course of the PGBA audit.

As to Section 3.17, plaintiffs contend that Interim's cost reports did not comply with "applicable Laws" because the overall reimbursement impact of the cost reports caused "cross-subsidization," a situation where Interim's non-Medicare costs were reimbursed by the Medicare program in violation of the Medicare statute.[311] According to the plaintiffs, Spherion's breach of Section 3.17 is further evidenced by its failure to comply with applicable HCFA regulations, the PRM provisions relating to cost reports, and HCFA's Transmittals 2, 3 and 4.

Spherion denies that it has breached any of the representations and warranties by its Medicare filings. As an initial matter, Spherion disagrees with Interim's interpretation of the relevant provisions of the Agreement. As to 3.16(a), Spherion argues that "notices" in that provision refers specifically to formal "notices of program reimbursement." Spherion alleges that it complied with Section 3.16(a) when it disclosed to plaintiffs all NPRs that it had received from the Medicare program in Schedule 3.16(a) to the Agreement. Spherion also contends that communications from its FI could not form the basis of a claim of breach since its FI is not a "governmental entity" as contemplated by the Agreement. Thus, according to Spherion, it was not required to disclose any communications from the FI regarding the FI's concerns with its cost reporting methodologies because such communications were neither "notices," nor communications from a "government entity."

Spherion also takes issue with plaintiffs' interpretation of Section 3.16(b). Specifically, Spherion contends that to prove a violation of Section 3.16(b), plaintiffs must prove that Spherion "intentionally ... filed a claim without a reasonable basis therefore with HCFA [or] its fiscal intermediaries...."[312] Since the evidence does not support a claim that Spherion intentionally attempted to mislead HCFA or seek reimbursement to which it was not entitled in its cost reports, Spherion contends that plaintiffs cannot prove a violation of Section 3.16(b). Moreover, even if plaintiffs were not required to prove intentional conduct to prove a violation

of Section 3.16(b), Spherion argues that it had a "reasonable basis" for all of its cost reporting methodologies.

Turning to Section 3.17, Spherion contends that its cost reports were filed in compliance with applicable "Laws." According to Spherion, "Laws" includes only Medicare statutes and regulations. It does not include the PRM or HCFA Transmittals. In any event, even if the Court construes "Laws" to mean statutes, regulations, the PRM and Transmittals, Spherion contends that its cost reports complied "in all material respects" with each of these various authorities. Spherion received approval from Aetna of its cost reporting methodologies in 1994 and ***554** continued to believe that its position with respect to its cost allocation methodologies was correct up to the time it filed its 1996 cost reports. Spherion also contends that plaintiffs' lone Medicare reimbursement expert has not made a credible case that any of Interim's cost reporting methodologies "materially" violated any Law. On the other hand, Spherion's expert forcefully and credibly endorsed the propriety of the cost reports. According to Spherion, this view is corroborated by the experts on both sides of the transaction who reviewed the cost reports prior to the Sale. Simply stated, according to Spherion, plaintiffs have failed to carry their burden of proof on this issue.

2. The Interpretation of the Applicable Provisions of the Agreement

a. Section 3.16

As indicated, the parties disagree as to whether the reference to "Governmental Entities" in Section 3.16(a) includes FIs or is limited to HCFA.[313] "Governmental Entity" is defined in the Agreement as "any court, tribunal, administrative agency or commission or other governmental or regulatory authority ... including but not limited to agencies, departments, boards, commissions or *other instrumentalities* of any country or any political subdivision thereof."[314] Spherion contends that a FI is not a "regulatory authority" as that term is used in Section 1.35. According to Spherion, "an FI is merely a private organization with which [HCFA] enters into an agreement to communicate with providers and to conduct audits."[315] Plaintiffs counter that FIs have responsibility (by statute) for administering the Medicare program and, as such, the FI is an "instrumentality" of the government.[316] The Court agrees.

Aetna communicated with Interim on HCFA letterhead.[317] The FI was vested with authority to process bills and approve PIPs. And it was vested with authority to audit cost reports in the first instance.[318] Under these circumstances, the Court is satisfied that Aetna (and later PGBA) were "instrumentalities" of the government/HCFA.

The parties also dispute the appropriate interpretation of "notices" as used in Section 3.16(a). Spherion contends that "notices" refers only to NPRs; plaintiffs contend that "notices" would include any communication from HCFA or the FI in which the provider is notified of a problem. It is a maxim of contract interpretation that, where no contrary intention is apparent, "general words used after specific terms are to be confined to things '*ejusdem generis*'—of the same kind or class as the things previously specified."[319] *Ejusdem generis* captures the general notion that if parties intended a contractual term to be interpreted in accordance with its general definition, they would not have employed the term in the first instance in the context of a specific usage or term of art.[320]

***555** Applying *ejusdem generis* to Section 3.16(a), the Court concludes that "notices" refers to the prior phrase "notices of program reimbursement."[321] The parties first used "notices" in connection with the term of art—"notices of program reimbursement"—and then referred to "notices" generally. This is precisely when *ejusdem generis* applies. Moreover, the language "... and no notices have been *issued ...*" contemplates a formal process whereby a "Governmental Entity" "issues" a formal notice. NPR's are "issued" by the FI after the FI completes its review of the cost report. Interim disclosed all of the NPR's it had received from Aetna in the Schedules to the Agreement.[322] In doing so, it complied with its obligations under Section 3.16(a).[323]

With respect to Section 3.16(b), the Court's task in interpreting this provision is to determine whether the term "intentionally" modifies only "filed a false claim" or also modifies "filed a claim without a reasonable basis therefore."[324] Not surprisingly, plaintiffs endorse the former construction—one that would not require them to prove intentional misconduct to prove a breach. Spherion endorses the latter construction—one that would require proof that Interim intentionally filed improper cost reports. The Court is persuaded that Spherion's interpretation is most consistent

with the Agreement's overall structure and plan, and most reflective of the parties' intent as expressed in the Agreement.

[14] **[15]** The Court begins its analysis by reiterating the general rule that "[t]he standard of interpretation of a written instrument, except where it produces an ambiguous result, or is excluded by a rule of law establishing a definitive meaning, is the meaning that would be attached to such instrument by a reasonably intelligent person acquainted with all operative usages and knowing all the circumstances prior to and contemporaneous with the making of the instrument, other than oral statements by the parties of what they intended it to mean."[325] When construing the meaning of contractual terms, the Court will not allow sloppy "grammatical arrangement of the clauses" or "[m]istakes in punctuation" "to vitiate the manifest intent of the parties as gathered from the language of the contract."[326]

At first glance, one readily could interpret Section 3.16(b) as representing that Interim has neither intentionally filed a false claim, nor filed any claim without a reasonable basis therefore. The placement of the adverb "intentionally" only before the phrase "filed a false claim," and the placement of the comma after "false claim," might be read to support this construction. Certainly this is how plaintiffs have read the provision. Yet the Court ***556** will not allow the imprecise placement of adverbs and commas to alter the otherwise plain meaning of a contractual provision or to frustrate the overall plan or scheme memorialized in the parties' contract. After a careful review of the Agreement, the Court is convinced that Section 3.16(b) was drafted to address conduct that either could give rise to liability arising from fraud and abuse or the intentional submission of improper claims for reimbursement. This conclusion is consistent with the Court's reading of the provision during trial.[327]

[16] When interpreting a contract, the Court must view the document as a whole, giving effect to all of its provisions.[328] "Moreover, the meaning which arises from a particular portion of an agreement cannot control the meaning of the entire agreement where such inference runs counter to the agreement's scheme or plan."[329] Section 3.16(b)'s place in the overall scheme or plan of the Agreement can perhaps best be gleaned from the schedule of liabilities listed in Schedule 3.16(b), specifically incorporated by reference in Section 3.16(b). There, Spherion disclosed only the fraud and abuse investigations in which it might be exposed to Medicare fraud and abuse liability, including the El Paso investigation.[330] Conspicuously absent from this schedule is any reference to the 1994 desk review pursuant to which Aetna alleged, in essence, that Interim had submitted its 1994 cost report without a "reasonable basis" for certain cost allocations.[331] This potential liability was listed in Schedule 3.16(a) and Schedule 3.17.[332]

The structure of the indemnification provisions in Section 10 of the Agreement also support the Court's interpretation of Section 3.16(b). These provisions specifically carve out "Section 3.16 Damages" and exclude them from the limitations that are otherwise in place for indemnification claims arising from improperly filed cost reports.[333] The provisions reflect the parties' recognition after the El Paso and Hollywood, Florida investigations that damages and civil penalties relating to intentional misconduct and fraud and abuse liabilities should not be capped.[334]

Finally, it cannot escape observation that the plaintiffs' interpretation of Section 3.16(b) would allow it to recover unlimited damages based on a lower threshold of proof —"without a reasonable basis"—than the limited damages it would be entitled to ***557** recover upon meeting a higher threshold of proof—"violation of applicable Law"—as established in Section 3.17. This result would also be contrary to the "[A]greement'[s] overall scheme or plan."[335]

Having concluded that Section 3.16(b) relates to intentional misconduct or matters that could give rise to "fraud and abuse" liability, it should come as no surprise that the Court has concluded that plaintiffs have not proven a breach of Section 3.16(b). As the Court already has determined, plaintiffs have not pled or proven that Spherion engaged in fraudulent or intentional misconduct. Moreover, no fraud and abuse investigation was ever initiated against Interim in connection with any of the cost reports at issue in this case.[336] Plaintiffs' remedy for the Medicare adjustments, therefore, if any, must arise from its claim that Spherion breached Section 3.17.

b. Section 3.17

The parties' disagreement with respect to the proper interpretation of Section 3.17 centers on the definition of "Law" as set forth in the Agreement. Spherion represented that it submitted its cost reports in compliance with applicable Laws. The Agreement defines "Laws" at Section 1.62:

" 'Laws' means any federal, state, local or foreign law, statute, ordinance, rule, regulation, permit, order, judgment or decree."[337] Plaintiffs argue that "Laws" includes provisions in the PRM and HCFA Transmittals. Spherion contends that "Laws" includes only statutes and regulations.

Spherion correctly notes that there is ample authority for the proposition that the PRM and Transmittals interpret, but do not supercede, the HCFA regulations.[338] "The PRM has been described as 'not binding like law or regulation. Rather, it guides the application of the laws and regulations.' "[339] The FI' s duty is to "consult and assist providers in interpreting and applying the principles of Medicare reimbursement to generate claims for reimbursable costs."[340] The PRM and Transmittals assist the FI to this end.

Thus, there is a recognized distinction between the Medicare statute and regulations on the one hand, and the PRM and Transmittals on the other. Clearly, the statute and regulations have the force of law and the manual and transmittals do not. It is equally clear, however, that the PRM and Transmittals are considered "interpretive ***558** rules" in Medicare parlance.[341] And "rules" are encompassed within the Agreement's definition of "Laws."[342]

Spherion contends that the distinction between interpretive and substantive rules is important because interpretive rules cannot supercede the Medicare regulations and are not perceived among the courts or the providers of Medicare services as "laws." Substantive rules, such as regulations, on the other hand, are controlling. While this distinction may have meaning in other contexts, it has no meaning in the operative language chosen by the parties to define their obligations. The Agreement expressly provides that "Laws" includes both "regulations" *and* "rules;" the Agreement is silent as to whether those "rules" must be interpretive or substantive.

[17] Clearly, the parties were sophisticated scribners and knowledgeable of the healthcare field. They were familiar with the range of written authorities that regulate the healthcare industry. If they had intended to exclude the PRM or Transmittals from "Laws," they could have drafted the Agreement in a manner that it clearly did so. The Agreement as drafted, however, encompasses the PRM and Transmittals. Thus, when determining whether Spherion breached Section 3.17, the Court must consider whether Interim's cost reports as submitted complied "in all material respects" with applicable Medicare statutes, Medicare regulations, provisions of the PRM, and HCFA Transmittals.[343]

3. The Medicare Experts

Apparently recognizing the remarkable complexity of the Medicare-related issues, both parties engaged Medicare "reimbursement" experts to address the propriety of Interim's cost reporting methodologies. Not surprisingly, there was little upon which the experts could agree. Given that the plaintiffs' claims regarding the Medicare adjustments, in large part, rise or fall on the testimony of the experts, it is appropriate for the Court to share its observations regarding the credibility of the experts' testimony before addressing the substance of the Medicare-related claims.

Plaintiffs presented the testimony of Thomas Curtis, a certified public accountant with extensive experience as an auditor with Medicare FIs. Mr. Curtis eventually rose to the position of "Audit Manager," in which capacity he supervised approximately thirty field auditors.[344] In 1987, Mr. Curtis started his own consulting company where he continues to provide services to healthcare providers regarding Medicare compliance issues, particularly reimbursement issues.[345] In this capacity, Mr. Curtis has represented several Medicare providers before the PRRB in connection with appeals of cost report adjustments.[346]

In late 1998, Interim's outside legal counsel retained Mr. Curtis on Interim's behalf to assist Interim in its efforts to reverse PGBA's audit adjustments of Interim's ***559** 1996 and 1997 cost reports.[347] Mr. Curtis served as Interim's principal "outside expert" in all of its subsequent dealings with PBGA and later with HCFA.[348] As Mr. Curtis himself described his role: "My job was to help [Interim] fight through [the audit] adjustments."[349]

Mr. Curtis' first impression upon reviewing the PGBA audit findings was that the audit was "not properly performed...."[350] He characterized PGBA's approach to the three component A & G methodology as "troubling," its collapse of the three component A & G as "flawed," and the audit adjustments as "incorrect on several grounds."[351] During the audit process, Mr. Curtis assisted Interim in preparing for meetings with the FI, the purpose of which was either to obtain a reversal of audit adjustments or, at

the very least, a new audit.[352] Position papers were prepared in advance of the meetings setting forth points that Interim or its consultants intended to communicate to the FI during the course of the meeting.[353] The position papers included such statements as: "we acted in good faith with reasonable assurances from Aetna that how we handled Interim Health Care cost reports was appropriate and permissible;"[354] and "our goal today is to show you that we have filed our cost reports based on supportable approved methods."[355] Later, when asked at his deposition in this litigation whether he believed in the positions Interim was taking with the FI and later with HCFA during the audit adjustment meetings, Mr. Curtis acknowledged that he "[couldn't] imagine ... advocat[ing] a position that [he] didn't think was correct."[356]

At trial, however, Mr. Curtis' views regarding the propriety of Interim's cost reports appeared to change dramatically. Of course, Mr. Curtis' role had changed too. During the audit process, Mr. Curtis was engaged to support Interim in its efforts to secure reversals of the audit adjustments. At trial, Mr. Curtis was engaged by the plaintiffs to be critical of Interim's methodologies in support of the plaintiffs' claims of breach of the Agreement. Thus, when asked at trial, Mr. Curtis opined that Interim's 1996 and 1997 cost reports did not comply with Law and were not otherwise proper.[357] He concluded that Interim had improperly attempted to shift its costs to Medicare in an inequitable manner.[358]

While Mr. Curtis' clients may be comforted by his willingness to advance their positions in accordance with their circumstance, the Court takes little comfort in this approach to forensic analysis as it searches for the truth. Mr. Curtis' conflicting roles, and the disconcerting evolution of his opinions, has limited his usefulness to the fact finder.[359]

***560** For its part, Spherion engaged William J. Simione, Jr., as its Medicare reimbursement expert. Mr. Simione is a certified public accountant who has been working in the healthcare industry for more than thirty-eight years.[360] His work as a healthcare consultant included work on several national committees that participated in the promulgation of national healthcare legislation.[361] Indeed, Mr. Simione was instrumental in working with HCFA to introduce the step-down cost allocation methodology to the home healthcare industry.[362] Mr. Simione spent between thirteen hundred and fourteen hundred hours reviewing the information relating to Interim's cost report submissions before reaching his opinions.[363] Although there were instances where Mr. Simione appeared to contradict himself,[364] his approach generally was measured, and his ultimate conclusions were not overreaching. In short, Mr. Simione made a credible expert presentation on behalf of Spherion and, in the Court's view, was the most persuasive witness on Medicare reimbursement issues.

The Court's determination that Mr. Simione was the more credible Medicare reimbursement expert does not end the inquiry. As the Court considers each individual claim upon which the experts have opined, the Court must evaluate the experts' conclusions in the context of the entire evidentiary record. Accordingly, the Court will make reference to the competing expert opinions as appropriate when considering each of the individual claims.

4. The Audit Conclusions of HCFA and the FI are Not Dispositive

Finally, before addressing the specific Medicare claims, the Court must address a fundamental analytical flaw that flows throughout plaintiffs' arguments regarding the legality of Interim's cost reports. Plaintiffs appear to assume that the cost reports were prepared illegally because PGBA and, to a lesser extent, HCFA said they were prepared illegally during the audit and post-audit meetings. The statements and conclusions of the regulators, however, are not dispositive of the issue. They are, of course, evidence to be considered in the total mix of evidence regarding the propriety of Interim's cost reporting methodologies. At the end of the day, however, the Court must consider the legality of the cost reports as the issue has been presented in this case: the Agreement requires that Interim submit its cost reports "in all material respects in compliance with applicable Laws." This does not mean that Interim must submit its cost reports in a manner that is satisfactory to its FI and HCFA. PGBA's and HCFA's interpretation of the applicable Laws is but one piece of evidence that must be considered along with the other evidence, including the opinions of the experts who have weighed in on the Medicare issues.

5. Cross–Subsidization

Plaintiffs allege that Interim's allocation of operational costs resulted in "cross-subsidization" in violation of the Medicare

statute.[365] Plaintiffs offer the following example to illustrate the point with respect ***561** to the allocation of capital costs: even though the President of the company would spend only 7% of his time running the Medicare operations from his desk, Interim would allocate its capital costs in a manner that would indicate that 40% of the President's desk, computer, etc., were used in connection with the Medicare operations.[366]

Plaintiffs' cross-subsidization analysis appears persuasive as far as it goes. The apparent imbalance in the allocation of capital versus other costs certainly merits a closer look. But the criticism ultimately fails because it does not contemplate the fact that the Medicare component of Spherion's business, by its nature, drained more of Spherion's resources than the other two components of the business (non-intermittent healthcare and commercial staffing). As Mr. Simione explained, the skilled intermittent services Interim provided had to be billed on a per visit basis. The manner in which a Medicare bill must be generated is much more highly regulated than the billings related to Spherion's other business segments. A skilled intermittent care provider likely will have several patient encounters and make several Medicare visits during an eight hour shift. The resources needed to generate separate bills for these encounters and visits will far exceed the resources needed to administer the other components of Spherion's business.

In the commercial staffing realm, for instance, an individual likely would be assigned to one client for a full shift and, therefore, only one bill would be required.[367] In the non-intermittent nursing realm, fewer patient encounters and fewer visits generally will occur in a nurse's shift.[368] Under these circumstances, the fact that the allocation of capital costs did not match the allocation of related costs (such as salaries), or did not match the percentage of Medicare revenues to Spherion's total revenue, is not surprising and not necessarily indicative of improper cost reporting. Moreover, given the Court's conclusion that plaintiffs have not proven that Interim's methodologies violated any Law, as discussed below, it follows that they have not proven that Interim failed to allocate the "reasonable cost ... of services ... in accordance with regulations...."[369]

6. The Three Component A & G Methodology

Plaintiffs allege that Interim's three component A & G cost allocation methodology ***562** violated "applicable Laws" because the methodology allowed Interim to pass on more of its operational costs to Medicare than was appropriate in violation of Medicare Law, including HCFA Transmittal 2, Transmittal 3 and, to a lesser extent, Transmittal 4. Having concluded that HCFA Transmittals are "Laws" as that term is used in the Agreement, the Court must consider whether any HCFA Transmittal or other law was violated by Interim's use of its three component A & G methodology.

According to the plaintiffs, Interim violated Transmittals 2 and 3 by sequencing the allocation of its A & G components improperly and by utilizing an improper allocation statistic. In this regard, the parties do not dispute that Transmittal 2 required providers to allocate shared A & G last.[370] Nor do they dispute that Interim complied with this directive in its 1996 cost report.[371] Interim negated the reimbursement impact of Transmittal 2, however, by utilizing a "total accumulated cost" statistic to allocate the A & G cost centers which, in essence, allowed it to readjust the allocation percentage each time it closed out an A & G cost center.[372] The parties appear to agree that the use of this allocation statistic was not contemplated by Transmittal 2.

Transmittal 3 made it clear that HCFA expected that a net cost, rather than a total accumulated cost statistic, would be used when allocating the three A & G components.[373] Transmittal 3, however, also stated:

> [FIs] are **not** to make adjustments for alternative A & G fragmentation methodologies employed for cost reporting periods beginning prior to January 1, 1997, **which may have been allowed** for those periods. [Providers] opting to fragment A & G costs for cost reporting periods beginning on or after January 1, 1997, must seek [FI] approval or re-approval for previously approved alternative A & G fragmentation methodologies ... that do not comport with this Transmittal.[374]

Next in the line of HCFA pronouncements on step down cost allocation was Transmittal 4 which expressly superceded Transmittals 2 and 3 and directed providers once again to close out shared A & G first in the allocation sequence.[375] HCFA explained that the allocation sequence prescribed in Transmittal 4 reflected the need "[f]or greater accuracy when allocating componetized or fragmented A & G service costs," and was consistent with long-standing Medicare regulations.[376]

Not surprisingly, Mr. Simione testified that HCFA's issuance of Transmittals 2, 3 and 4 caused great confusion in the home healthcare industry.[377] Even Aetna acknowledged ***563** that HCFA had been sending conflicting signals regarding the appropriate means by which to allocate costs under three component A & G methodology.[378]

While plaintiffs appear to acknowledge that Transmittal 4 superceded Transmittals 2 and 3, they contend that HCFA declined to give Transmittal 4 retroactive effect. Consequently, according to plaintiffs, Interim's 1995 and 1996 cost reports were subject to Transmittals 2 and 3. In addition, plaintiffs contend that Interim did not comply specifically with Transmittal 4 in any event. The Court rejects both arguments.

First, it is not at all clear that Interim was in violation of Transmittals 2 and 3. Transmittal 3 stated that providers could employ cost allocation methodologies for which they had approval prior to January 1, 1997. Interim had received approval for its three component A & G methodology from Aetna in 1994.[379] Plaintiffs concede that Aetna approved of the three component A & G methodology in concept, but dispute whether Aetna was actually aware of either the sequencing of the three component A & G, or the allocation statistic utilized by Interim, at the time it gave its approval in early 1994. Under these circumstances, plaintiffs contend that Transmittal 3's savings provision does not apply to Interim.

In support of their contention that the allocation sequencing was not incorporated in Aetna's January, 1994 approval, plaintiffs cite to the testimony of one of Interim's Medicare managers who indicated that the first time the sequencing was clearly reflected on an Interim cost report was in the fourth quarter of 1994 (several months after Aetna confirmed its approval of the three component A & G methodology).[380] Spherion counters by noting that changes in Interim's computer system in 1994 caused the cost reports to be presented in a slightly different format, but the sequence for allocating A & G remained the same throughout 1991–94. According to Spherion, Aetna's field audit, or even a desk review of Interim's cost reports, would have revealed the details of its methodology.[381] The Court agrees.

***564** The preponderance of the evidence demonstrates that Aetna was aware of, or should have been aware of, the allocation sequence and statistic utilized by Interim in its 1992 and 1993 cost reports. While the information was more readily discernible in the last interim (periodic) cost report filed by Interim in 1994, it was clearly available to Aetna if it had reviewed the schedules to the cost reports in the course of the desk review (or audit) process in 1992 or 1993. There is absolutely no evidence to support the suggestion that Interim was attempting to hide its sequencing or allocation statistic from Aetna prior to 1994, or the contention that Aetna was not aware of these practices prior to re-affirming its approval of Interim's three component A & G methodology in January, 1994.[382]

In any event, even if Aetna's prior approval does not save Interim from a violation of Transmittals 2 and 3, HCFA's promulgation of Transmittal 4 provided Interim with ample ammunition with which to defend its cost reports. In this regard, the Court notes that HCFA's refusal to apply Transmittal 4 retroactively has been held by the PRRB to be improper.[383] Moreover, the fact that HCFA acknowledged that Transmittal 4 simply reiterated long-standing HCFA policy as reflected in HCFA's regulations suggests quite clearly that Transmittals 2 and 3 are not, in fact, (and never were) "Laws" as that term is used in the Agreement.

That HCFA's flawed perception of its own regulations happened to be prevailing at the time Interim submitted its 1995 and 1996 cost reports is of no moment when determining whether Interim properly represented and warranted that it had submitted its cost reports in compliance with applicable "Laws." The representation and warranty was accurate in so far as Interim, in fact, submitted its cost reports in a manner consistent with "long-standing HCFA policy."[384]

In reaching the conclusion that Interim's three component A & G methodology did not violate applicable Laws, the Court has taken notice of the overwhelming weight of the expert evidence on this issue. Interim's outside healthcare attorneys, the Pyle law firm, and the healthcare experts who reviewed Interim's cost reports during the due diligence leading up to the Sale, all were satisfied that the three component A & G methodology was appropriate.[385] Mr. Simione, Spherion's healthcare consultant in this litigation, and one of the architects of the step-down methodology for reimbursement of home healthcare providers, was unequivocal in his opinion that Interim's three component A & G methodology complied with applicable Laws.[386] Even Mr. Curtis, when he was paid to advocate Interim's position before the FI and HCFA, expressed his view that the FI was employing an unreasonable

interpretation of HCFA's requirements relating to step-down methodologies.[387]

Finally, the Court is satisfied that the concerns that caused PGBA to "collapse" the A & G into one cost center were ***565** unfounded. Indeed, HCFA agreed to reverse this adjustment prior to the settlement of all outstanding audit issues.[388] Moreover, no expert has opined that the collapse of the A & G was warranted and, given the Court's conclusion that the three component A & G methodology was proper, the Court can find no reason to disagree with the experts.

In sum, the Court concludes that the plaintiffs have failed to prove by a preponderance of the evidence that Interim's three component A & G cost allocation methodology constituted a material violation of applicable Law.

7. The Allocation of Capital Costs

According to plaintiffs, the PRM requires that chain providers allocate home office costs in "a manner reasonably related to the services received by the entities in the chain...."[389] With respect to capital costs, plaintiffs contend that such costs may be allocated on a functional basis only "if there is a correlation of a statistic and a specific function," i.e., a reasonable relationship between the allocation statistic and a department's use of the services provided by the cost center whose costs are being allocated.[390]

Spherion counters that the Medicare regulations are silent as to the use of "square outage" or any other specific statistic when allocating capital costs on a functional basis.[391] Spherion contends that the use of a square footage statistic in its case yielded a substantially more "equitable" allocation of costs than the "total costs" statistic proffered by the plaintiffs (and endorsed by PBGA after the audit).[392] As "equitable" cost allocation is at the heart of Medicare's cost-based reimbursement scheme, Spherion contends that an allocation of capital costs that is "equitable" is, per se, lawful.[393]

The parties appear to agree that neither the Medicare regulations nor the PRM prescribe the use of a particular functional statistic for purposes of allocating home office capital costs. Rather, the theme that surfaces throughout the PRM is that capital costs must be allocated on an "equitable" basis.[394] To establish that Interim ***566** allocated its capital costs in a manner that was not "in compliance in all material respects with applicable Laws," plaintiffs must demonstrate that the use of a square footage statistic yielded an inequitable allocation of capital costs from the home office servicing center to the other components of the Interim chain. Plaintiffs have not carried their burden of proof on this issue.

Plaintiffs contend that square footage was not reasonably related to the costs Interim was attempting to allocate. They contend, therefore, that Interim was obliged to allocate costs on the basis of "total cost." Yet plaintiffs offered absolutely no evidence to suggest that this simplistic method of cost allocation would have yielded a more "equitable" result. In this regard, the Court notes that the PRM does not qualify its use of the term "equitable"—it does not, for instance, state that the cost allocation methodology must be "equitable" only in the eyes of HCFA and/or its FIs. Equity runs both ways; the allocation of costs must be equitable to both parties involved, the provider and the Medicare program.

On this notion of "equitable" cost allocation, the Court found Mr. Simione's testimony particularly persuasive. Mr. Simione opined that allocating capital costs on the basis of square footage was a more "equitable" allocation methodology than allocating on the basis of total costs as suggested by PGBA.[395] Specifically, Mr. Simione testified:

> What they're doing is ... trying to mandate that you go from a more sophisticated approach to the least sophisticated approach, which is pooled cost and using the least sophisticated statistic for pooled cost being total cost.
>
> > Really what they are saying here is that, and that is the least, what pooled costs say when you have to allocate it on total costs is that because a component or a cost center costs more, it should take down more A & G costs to it, and there's no relationship between those ... they force them into using a statistic that was really unequitable, extremely unequitable.
> >
> > * * *
> >
> > I'm not saying its [square footage] the most equitable way, but its a lot more equitable than throwing it into total costs.[396]

While it may be true that there is no direct correlation between square footage and the capital costs of the servicing centers, there is likewise no correlation between the amount of time

people spent at the home office (servicing center) to support the second-tier cost centers and the total cost statistic used to allocate home office salaries.[397] Nevertheless, Medicare requires salaries to be allocated on the basis of total costs.[398] Thus, Medicare in its own instructions, appears to recognize that there may not always be a correlation between the costs to be allocated and the statistic used for the allocation.

Moreover, the Court notes that other FIs have recommended the use of square footage as an appropriate statistic to allocate capital costs. For instance, Mr. Simione persuasively relied upon a 1992 Case Study prepared by Blue Cross and Blue Shield Association, a HCFA FI, in which Blue Cross provides examples where square footage has been utilized as ***567** a statistic to allocate capital costs.[399] Square footage is also recognized in the PRM as a legitimate basis to allocate capital-related costs in certain instances.[400] Given that square footage is a statistic that has been endorsed by HCFA and its FI as a means to allocate capital costs, the Court is hard-pressed to conclude that Interim's utilization of this statistic (even if ultimately determined by the FI and HCFA to be improper) violated "applicable Laws" in breach of the Agreement.

Finally, unlike Interim's three component A & G methodology, which plaintiffs contend was not clearly reflected in the Interim costs reports, the use of square footage as a statistic to allocate capital costs without question was reflected in Interim's cost reports going back to at least 1994.[401] The 1994 cost report was the subject of a "desk review" performed by Aetna which resulted in substantial adverse adjustments. Yet the use of square footage as a statistic to allocate capital costs—clearly reflected in Schedule F of the cost report—was not challenged.[402] These same cost reports were reviewed by plaintiffs own healthcare experts during due diligence, and the use of the square footage statistic again was not identified as an issue for concern.[403] Indeed, E & Y concluded that Interim's cost reports, in general, were "conservative" and that "there may be opportunity *to increase* reimbursement by refining the cost allocation methodologies used."[404] Thus, when the Court weighs the experts' respective views regarding the propriety of Interim's cost reporting methodologies, including the use of the square footage statistic, the Court cannot ignore the fact that three healthcare experts—E & Y, Judy Bishop, and Mr. Simione—have not taken issue with the square footage statistic.[405]

8. The Allowance of Regional Vice–President and Branch Manager Costs

Plaintiffs contend that Interim's allowance for regional vice-president and branch manager costs violated applicable Laws because these positions involved a certain level of non-allowable marketing activity.[406] HCFA distinguished between allowable education activities—activities intended to advise providers regarding the availability of services—and non-allowable marketing activities—activities designed to ***568** increase utilization of services.[407] In addition to these PRM references, plaintiffs rely upon the testimony of Mr. Curtis who opined that FIs required providers to support their allocation of salary costs with documentation that demonstrated that the employee was engaged in allowable activities, and that the failure to maintain such documentation violates Medicare Law.[408]

To succeed on their claim that seeking reimbursement for branch manager and regional vice president salaries violated the Law, plaintiffs bore the burden of proving that these Interim employees engaged in improper, non reimbursable marketing activity. To sustain this burden, plaintiffs produced expense reports that indicated that a branch manager may have taken a dozen donuts along to a meeting at a medical provider's office.[409] Plaintiffs also introduced job descriptions for the regional vice-president and branch manager positions, both of which indicate that the positions involved some level of "marketing" and/or sales.[410] On the other hand, the Interim executives who testified at trial indicated that, in fact, neither the regional vice-presidents nor the branch managers actually engaged in significant marketing or sales activities. They simply did not have time to do so given their other responsibilities.[411]

Plaintiffs correctly observe that certain branch managers acknowledged during field interviews that they were engaged in some "small amount of marketing."[412] But Interim also "[self]-disallowed some regional sales managers" and did not seek reimbursement for these costs.[413] That is as far as the evidence will take the plaintiffs on this claim. The fact that a branch manager or regional vice-president may have brought donuts to a meeting is not competent proof that these employees were involved in disallowed marketing activity, and is certainly not proof that Interim violated the Law when it allocated a portion of these costs to Medicare.

Finally, the Court cannot help but take notice once again that the Interim cost reports for 1992 and 1994 were reviewed by the FI and the allowance for regional vice-president and branch manager salaries was never questioned. Indeed, Aetna discouraged Interim from utilizing the very time studies that both PGBA and Aetna (and now Mr. Curtis) maintain ***569** should have been prepared in order to support the allocation of these executive-level costs.[414] The absence of these time studies was cited as a primary basis for the audit adjustments.[415] But, according to Mr. Simione, HCFA traditionally has not required time studies for senior executive positions within healthcare entities.[416]

One can readily glean from the PRM's less than definitive guidance that providers walked a fine line between "education" and "marketing." Given this fine line, and the paucity of record evidence demonstrating that the Interim executives in question were engaged in significant non-allowable activities, the Court concludes that plaintiffs have not carried their burden of proving a material breach of Section 3.17 with respect to this issue.

9. The Failure to Adjust Visits to the Provider's Statistical and Reimbursement Report

Interim's FI would process its requests for PIP throughout the course of a year and, from time to time, would reject requests that were improperly submitted for various reasons.[417] The FI would prepare a running tally of disallowed requests for reimbursement called the Provider Statistical and Reimbursement Report ("PS & R"). Needless to say, the provider is not entitled to be reimbursed for costs associated with rejected visits.[418] Plaintiffs allege that Interim failed to reconcile its year-end cost reports with the PS & R to ensure that it was not seeking reimbursement for costs associated with disallowed visits. According to the plaintiffs, this constituted a violation of Law.[419]

Interim's own billing records reflected disallowed visits.[420] Yet plaintiffs have failed to identify any Law that would require Interim to compare its own records to a PS & R to ensure that its own records captured all disallowed visits. Nor have plaintiffs demonstrated that Interim's records were somehow deficient in capturing disallowed visits, or that Interim did not review its own records prior to submitting its year-end cost reports. In any event, HCFA's own instructions to providers suggest that cost reports can be submitted without reconciling them to the PS & R.[421] ***570** Moreover, the fact that the detailed PS & R is available from the FI only "on request" belies the suggestion that HCFA, as a matter of law, requires the provider to reconcile its cost report with the PS & R.[422]

In sum, while it may have been prudent for Interim to attempt some reconciliation of its cost report with a PS & R, plaintiffs have failed in their burden of proving that the failure to do so constituted a material violation of Law.

10. The Miscellaneous Violations of Law

Plaintiffs contend that Spherion did not contest plaintiffs' allegation that Interim's 1996 and 1997 cost reports violated applicable Law in several additional respects, including the failure to allocate costs associated with routine medical supplies between reimbursable skilled intermittent services and non-reimbursable services, and the attempt to classify Interim's special billing department as "benefitting both the skilled intermittent and private duty nursing."[423] After reviewing these claims, the Court cannot conclude that plaintiffs have carried their burden of proving that the adjustments for medical equipment and billing department allowances constitute material violations of any Laws. As Mr. Curtis acknowledged, ninety percent of cost reports are adjusted by the FI in some manner or another.[424] When adjustments are made, the FI has determined that the cost report is "incorrect" in some respect.[425] The fact that a cost report contains "incorrect" information does not, however, equate to a violation of Law.[426]

11. Causation and Damages

[18] The Court has concluded that plaintiffs have not proven that any of Interim's cost reports were submitted to HCFA in violation of the Agreement's Medicare representations and warranties. Yet even if plaintiffs had proven a breach, they still could not recover under the indemnification provisions of the Agreement because they have not proven their damages with the requisite specificity. As Professor Williston has observed:

> [D]amages which are considered too remote and speculative are not recoverable. Where actual pecuniary

> damages are sought, there must be evidence of their existence and extent, and some data from which they may be computed: The amount of damages must be established with reasonable, not absolute, certainty.... It is sufficient if a reasonable basis for computation of damages is afforded, even though the result will only be approximate.[427]

In this case, Interim (as acquired) seeks indemnification for amounts paid to CMS in global settlement of all adjustments made to Interim cost reports from 1994 ***571** through 1999. The total settlement was approximately $5.2 million, and plaintiffs seek the entirety of this amount.[428]

The claim for indemnification damages is flawed for two reasons. First, the representations and warranties to which the right to indemnification attaches are expressly limited to pre-Sale cost reports, and to liabilities not disclosed in the Schedules to the Agreement.[429] Yet the global settlement included post-Sale cost reports and the 1994 cost reports, the potential liability for which was disclosed in the Schedules. Plaintiffs made no effort to secure a breakdown or itemization of the specific claims that were part of the global settlement or the specific dollar amounts attributed to each claim.

Plaintiffs were well aware of the limitations of Spherion's express warranties and should have been aware, therefore, of the need to specify those damages attributable to conduct that was not warranted. Plaintiffs elected not to do that, however, and have declined in this litigation to explain or justify the manner in which the Medicare claims were settled. Instead, they have proffered various reasons why the Court should award the entire settlement amount as Damages, or suggested various formulas the Court might employ to extract from the global settlement the parties' intent with respect to the settlement of claims subject to warranty.[430] As fact-finder, the Court declines to attempt the extraction. The damages are too speculative and are not subject to "a reasonable basis for computation." The Medicare indemnification claim fails for this reason as well.

C. The Interim Financial Statements

1. The Parties' Contentions

[19] Plaintiffs contend that Interim maintained its financial records in a manner that violated Sections 3.7 and 3.29 of the Agreement. In Section 3.7, Spherion represents and warrants that Interim's financial statements were "prepared in accordance in GAAP" and that they "present[ed] fairly in all materials respects the consolidated financial position and results of operations of [Interim]—as of and for the periods indicated—and are consistent with the books and records of [Interim] for such periods."[431] In Section 3.29, Spherion represented and warranted "that the Transferred Entities do not have any accrued, absolute, contingent or other liability except as disclosed."[432] According to the plaintiffs, these representations were inaccurate because Spherion did not maintain adequate reserves for Medicare liability, did not account for the impact of "segment reporting," and did not adequately disclose the liability to Medicare created by Interim's improper cost shifting methodologies.[433] Spherion denies that Interim's financial statements were prepared improperly, were inaccurate, or otherwise breached any provision of the Agreement.

Neither party disputes that a healthcare provider participating in the Medicare program must set reserves to account for cost ***572** report adjustments.[434] Beyond acknowledging this basic notion of corporate responsibility, the parties take very different views regarding the adequacy of the reserves Interim carried on its books for cost report adjustments. Indeed, the parties cannot even agree on the actual amount of reserves that Interim carried at any given point in time or where in Interim's financial statements the Court should look to find the actual reserves. Plaintiffs contend that as a result of inexplicable "reversals" in the reserve for cost report settlements made near the end of 1996 at the direction of Mr. Haggard, Interim closed 1996 with only $15,000 booked as reserves for Medicare losses as reflected in Interim's income statement.[435] According to the plaintiffs, this amount was as little as $585,000, and as much as $3.6 million short of the amount required to address probable Medicare losses identified (or identifiable) by Interim as of the end of 1996.[436]

Spherion's argument regarding the adequacy of the Medicare reserves focuses on Interim's balance sheet. According to Spherion, Interim's balance sheet reflects a 1996 year-end reserve for cost report settlements of $707,795.[437] This balance incorporates the $300,000 reversal authorized by Mr. Haggard in November, 1996, and the $250,000 reversal authorized by Mr. Haggard in December, 1996.[438] As of the time of the Sale in September, 1997, Spherion's balance sheet reflects that reserves for cost report settlements rose to $3,088,129.[439] Spherion contends that these reserves were

more than adequate, were set in compliance with GAAP, and were accurately reflected in Interim's financial statements.

2. The Adequacy of Interim's Reserves

The balance sheet reflects a "snapshot" of a firm's financial state at a given time, and reveals a cumulative picture.[440] In this case, the Court finds that the cumulative picture depicted in Interim's balance sheet offers the most accurate and appropriate measure of the adequacy of Interim's reserves to address contingent liabilities. The income statement simply does not provide a complete and accurate image of the reserve picture.[441] The cumulative reserve on the balance sheet reflected Interim's ongoing assessment of its exposure to Medicare adjustments, not only for the current year but also for past years for which Interim may still be liable.[442] This was an appropriate means by which to account for reserves on receivables and contingent liabilities.[443]

Having determined that the balance sheet is the appropriate source from which to determine whether Interim carried adequate reserves, the Court must determine whether Interim's reserves were sufficient to address Medicare adjustments that Interim management knew its FI and/or HCFA probably would make to the as-filed cost report. Plaintiffs advance two arguments ***573** in support of their contention that the balance sheet reserves were inadequate. First, they challenge the *bona fides* of the reserve number reflected in the balance sheet. Second, they contend that Interim's own "Medicare group" advised Spherion senior management that Interim's likely liability to Medicare far exceeded its established cost report reserves. The Court will address these arguments in turn.

Plaintiffs contend that the increase in the amount of reimbursable costs reflected in the 1996 year-end cost report resulted from Spherion's allocation to Medicare of additional home office costs that were generated after Spherion acquired a commercial staffing business in 1996.[444] Plaintiffs note that this newly acquired business was not involved in providing covered services to Medicare beneficiaries. Nevertheless, Interim allocated some of these costs to Medicare in its 1996 year-end cost report.[445] Without any citation to the record, plaintiffs then summarily conclude that the allocation of such costs was improper because they were not reimbursable.[446] The Court has searched for testimony in the record, either from fact witnesses or expert witnesses, specifically addressing the impropriety of this allocation. The Court has found no such testimony. Moreover, contrary to plaintiffs' suggestion, Mr. Krause did not acknowledge that all of the increase in costs reflected in the 1996 year-end cost report arose from the newly acquired business. Instead, he testified: "Those were parts of it. I don't know if that was all or the primary cost, but the whole headquarters cost had increased in '96 as the company got substantially bigger."[447]

The Court cannot conclude that the increase in Interim's Medicare reimbursable costs, as reflected in the 1996 year-end costs report, and the resulting increase in reserves booked by Interim as a result of the increased reimbursable costs, amounted to the recognition of "baseless revenues," as plaintiffs contend.[448] The evidence simply does not support this conclusion.

As to the contention that Interim's "Medicare Group" told Spherion management to increase the cost report reserves, plaintiffs rely principally upon three documents in the record. The first document, prepared by the Medicare group, considered potential issues that could lead to cost report adjustments, but did so in a format that was not preferred by Interim senior management. According to Ms. Watson and Ms. Snead, they were directed to discard that document and to prepare new documents that separated the issues in one document on the basis of adjustments likely to occur, and in another document on ***574** the basis of adjustments not likely to occur.[449] All of the information presented in the first document was included in the two later-prepared separate documents.[450] As Ms. Watson testified:

> I think I went in with here's all the issues, and some of them I felt really were ridiculous and should not need to be reserved for. But given the fact that the intermediary can do what they want to do, we put them all on.
>
> * * *
>
> Then they [senior management] would have made the determination of how much the reserve would be. Then we would go back and kind of fit it in to the two saying, well, these we're going to reserve for, and these weren't reserved for, but we didn't want to disregard the fact they were still an issue.[451]

The two documents that were prepared to reflect potential issues for adjustment, although not expressly phrased in

terms of "probability," presented the issues of concern in a manner that would allow senior management to assess the need for reserves.[452] The document entitled "Issues Most Likely to Occur Requiring Reserve," in essence, reflects the Medicare group's assessment that adjustments were "probable" (hence, the conclusion that reserves were appropriate.)[453] The corresponding document, "Issues Not Likely to Occur, therefore, Not Reserved," reflects the Medicare group's assessment that adjustments related to the issues identified therein were not "probable."[454] These documents were prepared in April, 1997. At that time, Interim carried a total reserve on its balance sheet of approximately $4,574,281.[455] The Medicare group recommended that reserves be set at $4,612,497.[456] According to the Medicare group, then, Interim was under-reserved by $38,216 as of April, 1997.[457] The difference is not significant in the context of the ongoing assessment of reserves and certainly not, in and of itself, evidence of a breach of Section 3.7.[458]

The Court's factual consideration of this claim recognizes that the process of setting reserves requires management to perform a series of ongoing estimates using its best judgment.[459] Indeed, as Mr. Krause testified:

> Q. Now, with respect to the reserve, whether on the profit and loss statement ***575** or on the balance sheet, to what extent does management's judgment or estimates come into play with regard to any of these reserve items?
>
> A. Well, they're all estimates because, when you establish a reserve account, you're looking at the probability of something happening differently than what you have recorded on the general ledger. So, you are making an estimate and a judgment, and you need to consider it probable and accruable at that point in time, and you make an adjustment for that.[460]

At times, Interim senior management would rely upon the information received from the Medicare group in evaluating the adequacy of Interim's reserves. At other times, however, senior management made the determination that the Medicare group was not being reasonable and would ask them to consider other factors in reassessing their conclusions.[461] This is precisely the process contemplated by GAAP, and there is no compelling evidence in the record that Interim management varied from this accepted practice.[462] The fact that Interim made significant year-end adjustments to its reserve account is not unusual given the fact that management had acquired more information upon which to base its estimates.[463]

Finally, the Court addresses plaintiffs' argument that the financial statements violated the Agreement because they did not account for the impact of "segment reporting"—a process whereby the financial statements would reflect the impact on Interim's revenue of separating the healthcare business from Spherion's other business segments. The Court must reject this argument for the simple reason that it ignores the very documents upon which it purports to be based. First, the audited historical financial statements themselves warn:

> Principally due to the use of estimates in allocations, the financial information included herein may not reflect the financial position and results of operations [of Interim] in the future or what the financial position and results of operation [of Interim] would have been had it been a separate, stand-alone entity during the periods presented. Management does not consider it practical to estimate what the results of operation would have been had the Company operated as a separate stand-alone entity.[464]

***576** Then, in the Agreement's provision relating specifically to financial statements, the parties agreed:

> The Healthcare Financial statements have been prepared from the separate records maintained by [Interim] and may not necessarily be indicative of the conditions that would have existed or the results of operations if [Interim] had been operated as an unaffiliated company. Portions of certain income and expenses represent allegations from corporate headquarters items applicable to [Interim] as a whole.[465]

In view of these multiple disclaimers, which appear throughout the relevant documents, it is difficult to conceive how plaintiffs can suggest that Spherion violated the Agreement by failing to account for "segment reporting." Spherion did not account for the impact of "segment reporting" because it determined that it was not practical to do so under the circumstances.[466] It then advised all potential purchasers of the limitations of the financial statements in the documents themselves and in Alex.Brown's Descriptive Memorandum, and then reiterated this disclaimer specifically to the plaintiffs in Section 3.7 of the Agreement. If plaintiffs had wanted to analyze the impact of "segment reporting,"

they could have attempted to do so with the information supplied by Spherion during due diligence.[467] The fact that this analysis apparently was not undertaken by either party cannot now be manufactured into a claim of breach.

D. The Remaining Section 10.1 Indemnification Claims

The Agreement contains two indemnification provisions relevant to this dispute, a general Seller's indemnification provision and a "Special Indemnity" provision.[468] The general provision is subject to the "Limitations" provision; the Special Indemnity contains its own limitations.[469] The "Limitations" provision sets a $2 million aggregate deductible and a $25 million aggregate cap on recoverable indemnification damages. The Court will address the remaining claims that are subject to the indemnification Limitations first, and then will address the one remaining special indemnity claim. After addressing each of the remaining claims of breach, the Court will give its final word on the plaintiffs' expectancy damages claim.

1. The Burns and Black Franchise Loans

[20] Plaintiffs allege that at the time of the Sale, the franchise loans extended to the Black Franchise and the Burns Franchise were impaired and should have been written down or reserved against in the amount of $230,000 for the Burns loan and $130,00 for the Black loan.[470] Spherion disagrees, ***577** noting that the Black loan, while delinquent, was adequately collateralized, and the Burns loan was only two months in arrears at the time of the Sale, with no portion of the principal being due.[471] Once again, the Court is called upon to determine whether Interim's management exercised appropriate judgment in setting reserves and accounting for potential losses. And, once again, the parties' experts are diametrically opposed in their view on this issue.

To prove a breach of the Agreement, the plaintiffs must establish that Interim's accounting treatment of the Burns and Black franchise loans did not comply with GAAP,[472] or that the impaired loans represented a "liability" that should have been disclosed in the schedules to the Agreement.[473] They have not met their burden of proof on either front.

The Burns and Black franchise loans both were backed by the personal guarantees of the franchise owners and were collateralized by accounts receivable, tangible property and the franchise territories.[474] And, although both franchises were struggling in their start-up phases, this quite common phenomenon does not, in and of itself, indicate a probability of ultimate failure.[475] The financial condition of both franchises appear to have been improving in the months leading up to the sale.[476] The indications that the franchises were facing financial difficulties were not such that Interim should have concluded that it would not eventually collect all amounts due, including any interest accrued during the periods when payments were interrupted.[477] Indeed, Interim's success with franchise loans was quite impressive; it had not written off a franchise note in any of the five years preceding the Sale.[478]

Interim's decision not to write-off or reserve for the Black and Burns franchise loans was supported by its auditor, D & T, who concluded:

> The Franchise notes are collateralized by the Franchise's receivables. Further, the amount to be borrowed cannot exceed 90% of the outstanding receivable balance. There are other covenants that must be met by the Franchisees, such as certain debt to equity ratios, timely financial statements, timely Medicare reimbursement cost reports, etc.... Based on the above, there does not appear to be a need for an allowance regarding the Franchise Notes Receivable.[479]

E & Y likewise raised no concerns regarding the viability of franchise loans in its review of Interim's operations.[480] Aside from the opinion of their accounting expert—an opinion the Court has found to be ***578** less persuasive than Spherion's accounting expert's opinion—plaintiffs have failed to offer any evidence to advance their claim that GAAP required Interim (pre-Sale) either to write-off or reserve against the Burns and/or Black franchise loans or that the loans qualified as liabilities that should have been disclosed under the Agreement. Consequently, the claim fails.

2. The Huff Litigation

[21] Spherion contends that it is not required to indemnify plaintiffs for the costs associated with the litigation initiated by Interim (post-Sale) to obtain insurance coverage for *Huff II* on three grounds: (1) because the liability in *Huff I* was covered by insurance, it was an "Excluded Liability" under

the Agreement not subject to disclosure;[481] (2) Spherion reasonably determined that Interim was not liable for the claims made in *Huff II;*[482] and (3) the named defendant in *Huff II,* IHS, was not a "Transferred Entity" as defined in the Agreement.[483] The Court rejects each of these contentions, and finds in favor of the plaintiffs on this claim.

In Section 3.20 of the Agreement, Spherion warranted: "except as set forth in Schedule 3.20, there is no claim, action, suit, litigation, proceeding, or arbitration ... ("Actions") pending or .... threatened against Seller related to [Interim] [or] any of the Transferred Entities...."[484] Unlike Section 3.29, which provides that any liability covered by liability insurance need not be disclosed, Section 3.20 makes no reference to the presence of insurance at all, and certainly does not excuse disclosure when the claims alleged in the "Actions" are covered by insurance.[485] *Huff I,* therefore, should have been disclosed to the plaintiffs in Schedule 3.20.

Although negotiations to settle *Huff I* began prior to the Sale, the actual settlement agreement was not consummated until June 2, 2000.[486] The litigation was voluntarily dismissed without prejudice in February, 1998.[487] Six months later, Mr. and Mrs. Huff initiated *Huff II* in which they made claims nearly identical to those raised in *Huff I,* and sought in excess of $15 million dollars compensatory and $25 million dollars in punitive damages.[488] Mr. and Mrs. Huff named IHS, a general partnership in which Interim was a general partner, as a defendant in *Huff II* and claimed that IHS was jointly and severally liable for all damages along with the other defendants.[489] IHS forwarded the complaint in *Huff II* to Spherion so that Spherion could seek coverage from its liability carrier.[490] The carrier denied coverage.[491] Spherion then rejected Interim's claim for indemnification, and further advised that it would not seek to compel coverage from its insurance carrier.[492]

The settlement agreement reached in *Huff I* left Interim, as a general partner in IHS, exposed to further liability in *Huff II.* Spherion knew that the plaintiffs had ***579** not released IHS,[493] knew that its insurance coverage, if any, for further claims was limited to $5.5 million,[494] and knew that the $50,000 settlement proceeds paid to Mr. and Mrs. Huff in *Huff I* was hardly satisfactory compensation for the catastrophic brain injuries suffered by their son.[495] Under these circumstances, the Court is satisfied that plaintiffs have carried their burden of proving a breach of Section 3.20 of the Agreement, and have further carried their burden of establishing a right to indemnification under Section 10.1 of the Agreement. The Damages incurred by plaintiffs to coerce Spherion's carrier to provide coverage for *Huff II* "arose out of" Spherion's failure properly to disclose *Huff I* in the schedules to the Agreement.[496] The Court also is satisfied that Spherion received timely notice of the claim.[497]

Interim incurred $91,180.26 in legal fees and expenses in its prosecution of the coverage action.[498] AIG paid $50,000 of these legal expenses as part of the settlement with Interim, leaving $41,180.26 to be indemnified by Spherion.[499] This claim is below the $2 million deductible, however, and is not compensable on its own. It will count towards plaintiffs' aggregate recoverable claim for indemnification under Sections 10.1 and 10.3.[500]

3. The Williams Litigation

[22] The Court already has determined on summary judgment that Spherion breached Section 3.20 of the Agreement by failing to disclose the persistent pre-Sale threats of litigation against Interim made by the Williams franchise.[501] Specifically, the Court determined that Section 3.20 required Spherion to identify all threats of litigation, whether or not the litigation would result in a "material" loss as defined in the Agreement.[502] The Court concluded that the undisputed evidence of record demonstrated that the Williams franchise had threatened to sue Spherion on several occasions for territorial infringement and other claims. These claims ultimately formed the bases of the litigation initiated by the Williams franchise against Interim after the Sale.[503] Nevertheless, the Court declined to grant summary judgment to plaintiffs on their claim for indemnification upon concluding that the plaintiffs had not established causation as a matter of law. The causation issue, therefore, was the only remaining issue to be litigated at trial with respect to the Williams franchise litigation.

The Court finds that the plaintiffs carried their burden of proving causation at trial. A review of the schedules attached to the Agreement demonstrates that the parties were quite thorough in identifying potential liabilities and incorporating such liabilities within the detailed representations and warranties in the Agreement.[504] Had Spherion disclosed Ms.

Williams' persistent threats of litigation to the plaintiffs, as well as the Williams' franchise regular defaults on its franchise responsibilities, it ***580** is probable that the plaintiffs would either have sought specific indemnification protection from the Williams franchise claims or, at least, demanded that appropriate reserves be set for the contingent liability. Moreover, there can be no reasonable question that Interim's (as acquired) exposure to the Williams litigation Damages "arose out of" the inaccuracy of Spherion's representation that it had disclosed all threatened litigation.[505]

Contrary to Spherion's suggestion, the plaintiffs did not improperly prompt the Williams franchise to initiate litigation. Rather, to the extent Ms. Williams' motivation for filing suit can be gleaned from the record at all, it appears most likely that it was the plaintiffs' insistence that she comply with her franchise responsibilities (not routinely enforced by Spherion pre-Sale) that caused Ms. Williams to pull the litigation trigger. The litigation gun, however, had been pointed at Interim many times starting long before the Sale was even contemplated.

Based on the foregoing, the Court concludes that the Damages incurred by the plaintiffs in connection with the Williams litigation are indemnifiable.[506] The parties have stipulated that the fees and costs incurred by Interim to defend the Williams litigation were $290,717.25, and that these fees and costs were reasonable and necessary.[507] Interim paid the Williams franchise $100,000 to settle the claims that remained after dispositive motion practice.[508] Both the settlement proceeds and attorney's fees and costs are "Damages" as defined under Sections 1.19 and 1.65 of the Agreement.[509] Accordingly, the total Damages recoverable for the breach of Section 3.20 with respect to the Williams' litigation is $390,717.25, subject to the limitations provisions of Section 10.3 of the Agreement.[510]

4. Plaintiffs Are Not Entitled To Indemnification For Any Damages Indemnifiable Under Section 10.1

The aggregate of plaintiffs' Damages from Spherion's breaches of its Seller's representations and warranties that are indemnifiable under Section 10.1 is less than $2 million. Consequently, pursuant to Section 10.3, plaintiffs are not entitled to indemnification for these Damages.

E. The Therapy Student Claims

[23] The claim for indemnification arising from the Therapy Student liabilities is not subject to the limitation provisions of Section 10.3. The parties anticipated that Interim would face claims from Therapy Students and other liabilities arising from the failed Therapy Student program so they negotiated special indemnification provisions to address these liabilities. These provisions, and the plaintiffs' entitlement to indemnification Damages thereunder, will be discussed below.

At the time of the Agreement, several matters relating to the Therapy Student program were either already in litigation, or soon to be in litigation.[511] Spherion was in the process of addressing these various claims prior to the Sale and, accordingly, the claims became a subject of certain indemnification provisions in the Agreement. ***581** [512] The parties have stipulated regarding the universe of Therapy Student claims for which plaintiffs seek indemnification.[513] They have also stipulated regarding the amounts of claims paid by Interim in settlement of Therapy Student claims, and the amount of outstanding Therapy Student loans written off by Interim.[514] Finally, the parties have stipulated that plaintiffs are entitled to indemnification as to settlements paid to, or loans written off on behalf of, certain Therapy Students.[515]

As to the remaining Therapy Student claims or Therapy Student loan write-offs, Spherion contends that plaintiffs are not entitled to indemnification because: (1) the claims or loan write-offs identified by the plaintiffs do not relate to "Therapy Students" as that term is defined in the Agreement; and/or (2) any claims or loan write-offs for which plaintiffs seek indemnification are subject to a "bad debt reserve" provided for in the Agreement and, therefore, are not recoverable in this litigation; and/or (3) plaintiffs failed to provide timely notice of the claim(s) as required by the Agreement. The Court will address these arguments *seriatim.*

1. The Definition of Therapy Student In the Agreement

At Section 1.96, the Agreement defines "Therapy Students" as follows:

> 'Therapy Students' means those individuals who have signed an agreement with any of the Transferred Entities

> whereby they receive loans and partial advances of tuition from such Transferred Entity for their education in physical therapy in exchange for their agreement to remain employed by such Transferred Entity for a specified period following licensure in the United States.[516]

Spherion contends that to qualify as a Therapy Student under the Agreement, one actually must have received a loan pursuant to a signed agreement. Under plaintiffs likely view of the Agreement, a participant in the Therapy Student program qualifies as a "Therapy Student" if the individual signed an agreement that provided for the individual to receive a loan, *vel non* the individual actually received it.

The parties have identified in their stipulation those individuals who did, and those who did not actually receive a Therapy Student loan.[517] As to those students who received loans from Interim or its affiliates, the parties appear to agree that these individuals are Therapy Students as that term is defined in the Agreement. The parties also have stipulated that, as to those students who did not actually receive a loan, each of them signed an employment agreement which required them to work for Interim, or its predecessor, TSS, "for a specified period following licensure in the United States."[518] Pursuant to the TSS Employment Agreement, students received a commitment that TSS would contribute $7,500 toward the student's "tuition" and would make a loan available to ***582** the student for incidental expenses.[519] Whether the student accepted the loan was up to the student.

After a careful review of the operative language, the Court concludes that the only reasonable interpretation of the Agreement's definition of Therapy Student must focus on whether the individual signed an agreement that *provided for* loans and tuition assistance from either Interim or its predecessor, not whether the student actually received both a loan and tuition assistance. The definition of Therapy Student describes the requisite provisions of the employment agreement but does not specify whether the student must elect all of the benefits of the employment agreement to fall within the definition. Moreover, Spherion has failed to offer any meaningful justification—either in the tenets of contract construction or in the practical consequences of the competing constructions—for an interpretation of the definition that would allow Interim (as acquired) to seek indemnification for claims made by students who received loans, but would prohibit indemnification for claims made by those students who elected not to accept a loan. Like blue on black, the distinction makes no difference when considered in the context of the liability exposure to Interim that the parties intended Section 10.4 to address.[520]

2. The Therapy Student Reserve

Section 10.4(a) of Agreement provides, in pertinent part:

> Seller shall indemnify Buyer Group with respect to Damages resulting from (i) the failure to collect on notes receivable from the Therapy Students, to the extent that such failure to collect exceeds the amount specifically reserved therefore ["the Therapy Student Reserve"] as of the Closing Date on the books and records [of Interim], as set forth on Schedule 10.4(a), (ii) claims by Therapy Students against the Seller Group with respect to obligations to Seller or the transferred Entities under those certain contracts concerning the education of the Therapy Students, ("Specified Damages").[521]

Spherion contends that the Therapy Student Reserve must be applied to reduce its obligation to indemnify plaintiffs with respect to all Therapy Student loans that were written-off, even those that were subject to "claims by Therapy Students against the Seller Group" as referenced in Section 10.4(a)(ii). Plaintiffs counter that the Therapy Student Reserve is referenced only in Section 10.4(a)(i) and, therefore, it is not applicable to the claims that are the subject of Section 10.4(a)(ii), even if such claims include Therapy Student loans written-off by Interim. Stated differently, plaintiffs contend that the Therapy Student Reserve does not apply to settlements of litigation or threatened litigation, even if the consideration for the settlement includes, in whole or in part, a write-off of a Therapy Student loan.

The Court will follow the interpretation of the Agreement proffered by the plaintiffs. ***583** Section 10.4(a) contemplates separate bases for indemnification. First, in those instances where Interim has determined to write-off Therapy Student loans without the threat of litigation because the loans are uncollectible, the parties agreed to a designated reserve amount to address those situations and to reduce the Seller's indemnity liability. On the other hand, where Therapy Students have made claims, either in threatened or actual litigation, against Interim or its predecessors based on allegations, *inter alia,* of breach of contract, misrepresentation or fraud, the consideration offered by Interim to resolve those claims—including, if

appropriate, the forgiveness of outstanding loan obligations—is not subject to the Therapy Student Reserve. The write-off of the loan, under these circumstances, is tantamount to, and an integral part of, a payment of "Damages resulting from [a] claim by [a] Therapy Student."[522] There is simply no canon of contract construction reasonably applied to the text of the Agreement that would justify applying the Therapy Student Reserve to payments made under such circumstances.

3. Notice of Therapy Student Claims

Spherion next contends that plaintiffs may not seek indemnification for any of the Therapy Student claims because plaintiffs did not submit their demand for indemnification in accordance with the notice provisions of the Agreement. In addition to the adequacy of plaintiffs' notice of the claims, the parties dispute whether loan write-offs constitute "Third Party Claims" as defined in the Agreement.

The first applicable provision of the Agreement is Section 10.1(b), which provides, in pertinent part:

> The representations and warranties of Seller set forth in Section 3 shall survive the Closing. The representations and warranties set forth in Sections 3.3, 3.4, 3.5, 3.7 and subsequent sections of Section 3 shall expire and be of no further force and effect eighteen months after the initial closing date, except with respect to—(ii) claims that Buyer has previously asserted against Seller in writing, setting forth with reasonable specificity the nature of such claims.[523]

The second provision, at Section 10.4(f), specifies that the eighteen-month survival period set forth in Section 10.1 applies to Therapy Student claims.[524] At Section 10.5, the Agreement requires "prompt" and "reasonably detailed notice of Third Party Claims."[525] The Agreement defines "Third Party Claim" as "any and all claims, demands, suits, actions or proceedings by any person or entity, other than members of the Buyer Group or the Seller Group, that could give rise to a right of indemnification under Section 10."[526]

Spherion contends that plaintiffs failed to comply with the notice provisions because they either failed to deliver timely notice, failed to deliver the notice in writing, or failed to deliver notice that set forth the claim for indemnification with the requisite specificity contemplated by the Agreement. Plaintiffs challenge Spherion's interpretation of Section 10.1 and argue that their written notice of the Therapy Student claims complied with a ***584** reasonable interpretation of the Agreement's notice provisions.

The Agreement does not define "reasonable specificity," yet this appears to be the focus of the parties' dispute with respect to this issue. The parties agree that plaintiffs did provide written notice to Spherion regarding several of the Therapy Student claims within the prescribed time period.[527] They also appear to agree that the written notices to Spherion did not identify by name all of the Therapy Students for which plaintiffs demanded indemnification.[528]

Given that Spherion was well aware of the complete fiasco its Therapy Student program had become prior to the Sale, and knew well that most if not all of the Therapy Students had not received what they were promised (an ability to seek an education abroad and then licensure and employment in the United States), the Court is disinclined to follow Spherion's narrow construction of the Agreement's notice provision with respect to the Therapy Student claims.[529] Spherion knew specifically the universe of students who participated in the Therapy Student program. Each of the students, in one form or another, signed an agreement with Interim (pre-Sale) or its predecessor.[530] And each of these Therapy Students possessed a potential claim against Interim from the moment the Therapy Student program failed to deliver what Interim or its predecessor had promised. Under these circumstances, the Court finds that plaintiffs' written notification regarding the future Therapy Student claims was sufficient to satisfy the "reasonable specificity" requirement of Section 10.1(b)(ii), and the "reasonably detailed" requirement of Section 10.5.[531] Spherion knew full well who these potential claimants were and what its likely exposure to such claims would be.

The Court also shares plaintiffs' view that loan write-offs are not "Third Party Claims" as defined in the Agreement, at least to the extent that the write-off did not occur in consideration for the release of a Third Party Claim. Because the Therapy Student program was a total failure, Interim was forced to write-off several loans deemed uncollectible. The assessment of the viability of the loans, and the decision to write them off, had nothing to do with a "claim, demand, suit, action or proceeding."[532] The loan write-offs, therefore, were not subject to the notice requirements of Section 10.5.[533]

4. Indemnification for the Therapy Student Claims

The Agreement provides that the parties are to share the losses associated with the Therapy Student program. Specifically, the Agreement provides that Interim would pay the first $100,000 without any contribution from Spherion. Thereafter, the parties agreed to pay 50% of "Specified ***585** Damages."[534] As to the loan write-offs, Spherion was obliged to pay 50% of the amount written off over and above the Therapy Student Reserve ($578,463.00), plus the fees associated with collection.[535] Based on the parties' stipulations, and the Court's factual and legal conclusions regarding the proper construction of the Agreement, the Court is satisfied that the plaintiffs are entitled to the full amount of indemnification they seek for losses associated with the Therapy Student program. Specifically, plaintiffs are entitled to:

F. Plaintiffs Are Not Entitled to Expectancy Damages

The Court already has concluded that plaintiffs' recovery of expectancy damages must be tied to their ability to prove a breach of the express promises made to them in the Agreement. Thus, for instance, had plaintiffs proven a breach of the Medicare representations and warranties, or the financial statement representations and warranties, plaintiffs could reasonably argue that their valuation of Interim was skewed as a result of these breaches and that expectancy damages, therefore, are appropriate. Plaintiffs failed to meet their burden of proof on these breach claims, however, and the breaches that they have proven are not such that the Court can conclude that plaintiffs' reasonable expectations for this transaction have been frustrated. Indemnification, under the circumstances, is the appropriate (and exclusive) remedy.

III.

For the foregoing reasons, the Court has found in favor of the plaintiffs on Counts I and II of their Amended Complaint. The Court has found in favor of Spherion on Count III of the Superior Court Complaint and Count I of the Court of Chancery Complaint, which claim was transferred to this Court prior to trial. The Court also has found in favor of Spherion on plaintiffs' claim for expectancy damages.

Plaintiffs are awarded $1,070.719.47 with respect to Count II of the Superior Court Amended Complaint, plus pre and post judgment interest at the statutory rate, and reasonable attorney's fees and costs in accordance with Sections 1.19, 1.65 and 10.1 of the Agreement. Because the plaintiffs' Damages with respect to Count I of the Superior Court Amended Complaint, in the aggregate, do not meet the $2 million deductible set forth in Section 10.3 of the Agreement, plaintiffs are not awarded their otherwise recoverable Damages as to these claims.

***586** The parties shall present a stipulation to the Court within fourteen days of this Order setting forth the means and timing by which they propose to address the attorney's fees issues under Sections 1.9, 1.65 and 10.1 of the Agreement. Upon resolution of this issue, the Court will enter its final judgment and verdict on the docket.

IT IS SO ORDERED.

All Citations

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Footnotes

* The following table of contents is included solely for the purpose of aiding the reader and is not part of the Court's official opinion. Therefore, all publishers should feel comfortable repaginating this table for any subsequent publication.

1 References to "Interim" prior to the Sale shall be to the division of Spherion that provided healthcare services; references to "Interim" after the sale shall be to the entity acquired by Catamaran. Where necessary, the Court will indicate parenthetically to which Interim entity it is referring. The Court's reference to "plaintiffs" shall be to all plaintiffs unless otherwise indicated.

2 D.I. 109, at 3–5; D.I. 100, at ¶¶ 33–36. ("D.I. ——" shall refer to the applicable docket item in the Superior Court docket; "PX ——" shall refer to the applicable plaintiffs' exhibit; and "DX ——" shall refer to the applicable defense exhibit. All references to the parties' Pretrial Stipulation, D.I. 100, shall be to the paragraphs of the stipulated statement of facts contained therein unless otherwise indicated.)

3 D.I. 109, at 3–5; D.I. 100, at ¶¶ 33–36.

4 PX 123, at Sph 012139.

5 *Id.*

6 D.I. 100, at ¶ 37.

7 DX 29.

8 D.I. 114, at 30.

9 *Id.* at 36.

10 *Id.* at 37.

11 D.I. 100, at ¶ 91.

12 *Id.* at ¶ 1.

13 *Id.* at ¶ ¶ 2–3. HCFA is now known as the Centers for Medicare and Medicaid Services ("CMS"). *Id.* at ¶ 3.

14 *Id.* at ¶ 4. *See also* 42 U.S.C. §§ 1395c, 1395j.

15 *Id.* at ¶ ¶ 6–7; DX 87, at 6.

16 D.I. 100, at ¶¶ 6–7.

17 DX 87, at 6. On October 1, 2000, Medicare began to reimburse Part A providers through a "prospective payment system" which reimburses provider costs "based on a predetermined rate" rather than a "retrospective" calculation "based on [previously-filed] cost reports." Farrow, et al., *Health Law* § 13–10 (West 1995). *See also* D.I. 119, at 35–37.

18 D.I. 100, at ¶ 7. *See* 42 U.S.C. § 1395f(b)(1)(A).

19 D.I. 100, at ¶¶ 6–7.

20 42 U.S.C. § 1395x(v)(1)(A)(i); 42 C.F.R. § 413.9(b).

21 D.I. 100, at ¶ 8. *See also* 42 U.S.C. § 1395x(v)(1)(A)(defining "reasonable cost" of services as the "cost actually incurred" and stating that the cost "shall be determined in accordance with regulations establishing the method or methods to be used....").

22 DX 87, at 7.

23 *See* 42 C.F.R. § 413.24(f). The provider also submits interim cost reports during the course of the year in order to receive its PIP. The year-end cost reports are reconciled with the interim cost reports and a determination is made as to whether the provider requested too much or too little reimbursement during the course of the year. D.I. 100, at ¶ 23.

24 *Id.* at ¶¶ 23–27. Upon review of the cost report, the FI furnishes to the provider a Notice of Program Reimbursement ("NPR") in which the FI gives notice to the provider of the total amount of reimbursement due, including any adjustments that have been made (with explanations and citations to applicable authority). *See* 42 C.F.R. § 405.1983(a)(1)(b).

25 42 U.S.C. § 1395h.

26 *Id.*

27 A "direct cost" would include such items as the salary of the care provider and the cost of medical equipment used in the provision of care. "Indirect costs" would include such items as office overhead and other administrative expenses that are supportive of, but not directly related to, patient care. D.I. 100, at ¶¶ 16–17.

28 As indicated, not all medical services are reimbursed by Medicare. For instance, Medicare will not reimburse for home nursing services provided on a sustained, "private duty" basis. For reimbursement purposes, then, such services must be segregated from the reimbursable intermittent nursing services in order to reach an "average cost per visit." *Id.*

29 *Id.* at ¶ 22.

30 *See generally Id.* at ¶ 18.

31 A "chain provider" is a provider with multiple facilities in multiple locations. *Id.* at ¶ 16.

32 Certain "indirect" costs may not be submitted to Medicare for reimbursement. For instance, Medicare will not reimburse providers for costs associated with "marketing," defined generally as activities intended to increase utilization of the provider's Medicare services. *Id.* at ¶¶ 17–18.

33 Interim's cost allocation was made more complex by the nature of its operations. Not only did Interim operate multiple locations, it also offered a wide spectrum of services, some of which were reimbursable by Medicare and others of which were not. Moreover, Interim treated both private-pay patients as well as Medicare beneficiaries. Finally, Interim was a division of a company that offered both healthcare services and non-healthcare temporary staffing services. This dynamic created a particularly complicated regulatory environment in which Spherion was expected to allocate its costs for purposes of seeking Medicare reimbursement.

34 D.I. 106, at 207–08; DX 119, at 48–49.

35 *See e.g.* PX 334 at § 2150.2A ("Home office costs directly related to those services performed for individual providers which relate to patient care, plus *an appropriate* share of indirect costs ... are allowable *to the extent they are reasonable.*") (emphasis supplied).

36 *Compare* PX 69 (Transmittal 2), PX 70 (Transmittal 3) with DX 263 (Transmittal 4). *See also* DX 65 (FI acknowledges "inconsistencies in written and verbal direction from HCFA."); D.I. 118, at 68–69, 72 ("We were getting conflicting information from the [FI] ...; "... talking directly to HCFA [we were] hearing one thing, but then in writing it says another. So we just felt it was—we were getting conflicting information. So we were sticking with what we felt was right.").

37 *See* 42 U.S.C. § 1395f(b)(1)(A).

38 *Id.*

39 *See e.g.,* 42 C.F.R. § 413.24(d)(1) (generally describing the "step-down method" of cost allocation).

40 *See* D.I. 100, at ¶ 20.

41 D.I. 119, at 31–34.

42 PX 739, at 3; DX 87, at 9.

43 D.I. 119, at 50–53; D.I. 100, at ¶¶ 26–28.

44 *See generally* DX 87, at 7, 12–14.

45 D.I. 100, at ¶ 19.

46 *Id.* at ¶ 16. Stated differently, in order to pass operational costs on to Medicare, Interim would move its home office costs down to each provider. The provider, in turn, would add the home office costs to its own costs to reach its total reimbursable costs. *See* D.I. 121, at 6.

47 *See* 42 C.F.R. § 413.24(d). "Under the cost finding process, data from the accounts ordinarily maintained by a provider is recast in order to ascertain the costs of the type of services rendered. This is done by allocating direct costs and prorating indirect costs." DX 117, at 7 (citing 42 C.F.R. § 413.24(b)(1)).

48 D.I. 100, at ¶¶ 20–21, 44. "A & G" stands for administrative and general costs incurred at both the home office and provider levels.

49 D.I. 100, at ¶ 20. "Cost centers" would include such "organizational units" as the accounting, legal, billing and human resource departments within Spherion. *See* PX 733.

50 D.I. 110, at 91–108. *See also* PX 733.

51 D.I. 100, at ¶¶ 44–46.

52 *See* PX 689, at 8; D.I. 101, at 26–28.

53 42 C.F.R. § 413.24. Prior to adopting the three component A & G methodology, Spherion utilized an allocation statistic for indirect costs that was the product of the ratio between the direct costs incurred by the departments providing "Medicare-like services" and those providing "non-Medicare-like services." For example, if each division generated fifty percent of the total direct costs the provider incurred, fifty percent of the apportioned home office and provider indirect costs would be allocated to each department. In essence, then, all costs were allocated to a "shared bucket" from which only some of the costs were reimbursable. D.I. 101, at 16–17. Under the three component A & G methodology, however, the allocated home office costs would be segregated into three components (or "buckets"), as outlined above, including a 100% reimbursable "bucket." There appears to be no dispute that the three component A & G methodology, given Spherion's particular circumstances, yielded a greater level of reimbursement from Medicare than its prior methodology.

54 D.I. 101, at 16–17.

55 42 C.F.R. § 413.24(d)(1).

56 *Id.*

57 *Id.*

58 PX 733; DX 177, at 4. The following example illustrates the use of the "net cost" statistic in the three component A & G methodology: if 50% of the Medicare certified provider's total direct costs were intermittent (reimbursable) operational costs and 50% were non-intermittent (non-reimbursable) operational costs, then shared A & G would be split 50/50 between reimbursable and non-reimbursable operational costs, i.e., 50% of shared A & G would be included in the amount sought from HCFA for reimbursement. D.I. 101, at 20. The "net cost" statistic is typically distinguished from the "total accumulated costs" statistic, which is a percentage of reimbursable operational costs including 100% reimbursable A & G. *Id.* at 21. As a general rule, shared A & G would allocate at a higher rate to reimbursable costs using a "total accumulated costs" statistic because Medicare-like services tended to consume more resources (including indirect costs) than non-Medicare like services, a phenomenon not adequately captured by a comparison of direct costs for intermittent and non-intermittent services. *Id.* at 22. By using a "net cost" statistic, and allocating shared A & G first, Interim could allocate a portion of the shared A & G to the 100% reimbursable A & G before allocating it separately to the provider, along with direct costs, for reimbursement. *Id.* at 23–24.

59 *See* PX 733.

60 *See* D.I. 101, at 70; D.I. 100, at ¶ 47; PX 675. The FI and the provider typically negotiate the use of a particular methodology of cost allocation because each chain provider presents its own unique corporate or operational structure

that must be taken into consideration when devising an appropriate reimbursement scheme. *See* DX 87, at 18; DX 264; DX 265; D.I. 110, at 115.

61 *See* PX 334—PRM, Part I, at § 2150.3; 42 C.F.R. § 413.53(a)(3).

62 Specifically, Interim created a square footage allocation statistic for the following "operating centers": the Medicare operations (maintained in a separate building across the street from the home office), the Quality Assurance Operations, and the Commercial and Franchise Support Operations. It did not create a square footage allocation statistic for the Processing Center or the Regional Field Offices. D.I. 101, at 30–31.

63 PX 334, at § 2150.3 C.

64 *See* PX 334, at § 2150.3C, D.

65 D.I. 101, at 29–42. Interim allocated capital costs from the home office servicing center down to the five operating centers identified above based on the percentage the square footage of each operating center occupied in relation to the total square footage of all five operating centers. *Id.* at 31. The net result of its capital cost allocation was that approximately 4% of Medicare 1 servicing center salaries were allocated to the medicare operating center while 40% of the capital costs were allocated to the same operating center. *Id.* at 38. *See also Id.* at 43–51 & PX 677 (According to Interim's FI, 7% of pooled costs allocated to Medicare/reimbursable versus 42% of capital costs.).

66 D.I. 119, at 117, 128.

67 DX 87, at 42–43.

68 D.I. 123, at 56–62.

69 DX 264; DX 265.

70 DX 110.

71 *Id.*

72 *Id.*

73 DX 31.

74 DX 19; PX 20; D.I. 101, at 72–73; DX 169, Ex. G.

75 PX 20.

76 *Id.* at 4.

77 PX 21.

78 PX 47; D.I. 100, at ¶ 56.

79 *Id.* at ¶ 57.

80 *Id.* at ¶ 58.

81 PX 62.

82 *Id.* Curiously, Interim's 1995 cost report, utilizing a slightly different methodology with the same net result, was never formally challenged by the FI. *See* DX 87, at 37 (Interim sequenced its shared A & G last but utilized a "total accumulated cost" statistic).

83 D.I. 100, ¶ 61. A "field audit" is an intensive audit conducted by the FI at the provider's offices and in the field. D.I. 100, at ¶ 29. A "desk review" is a less intensive review of the provider's cost report conducted by the FI at its own office. D.I. 119, at 50–51.

84 D.I. 100, at ¶ 62.

85 PX 41. While Spherion acknowledges that the request to change FI was made as Interim was contesting Aetna's position regarding Interim's three component A & G methodology, Spherion contends that the request also was motivated by Aetna's lack of experience in dealing with chain providers. D.I. 141, at 12; DX 69 ("Our method of cost reporting appears to be the same as ... other chains. By moving to [another FI] we would be measured against what is 'normal and customary' with other chains rather than the random stream of consciousness from our current FI."). It seems likely that both factors motivated Spherion to seek a change in FI.

86 PX 51.

87 *See, e.g.,* DX 9, Attach. A, at 2; DX 215.

88 PX 69.

89 *Id.*

90 D.I. 101, at 21–24.

91 PX 81.

92 *See* D.I. 106, at 47.

93 D.I. 101, at 80.

94 *See* PX 22.

95 *See e.g.* DX 210.

96 PX 70.

97 *Id.* at 2.

98 DX 117, at 5.

99 DX 31.

100 DX 87, Ex. 5 (stating that Transmittal 4 was intended to clarify "longstanding HCFA policy contained in 42 C.F.R. § 413.24(d)(1)...."). *See also* D.I. 119, at 63–64, 73–74.

101 DX 87, at Ex. 5.

102 D.I. 101, at 92–95.

103 D.I. 100, at ¶ 69.

104 PX 91.

105 *Id.*

106 D.I. 109, at 19–20.

107 D.I. 136, at 13–14.

108 *See* D.I. 109, at 19–21. *See also* D.I. 137, Evans Dep., at 51–52 (“the [Spherion] board [decided] to divest itself of healthcare so it could focus, the company could focus, on what we felt were its core competencies which was the commercial staffing business.”). The Court has found no direct evidence to support plaintiffs' contention that Spherion decided to sell Interim as a way out of its regulatory battle with Aetna (and later PGBA).

109 *See* D.I. 109, at 20–21, 226–27; D.I. 137, Evans Dep., at 54.

110 D.I. 116, at 92–94.

111 *Id.* at 90–91.

112 D.I. 109, at 228–29.

113 *Id.*

114 DX 9, at 7.

115 D.I. 137, Gordon Dep. at 26.

116 *Id.* at 34.

117 *Id.* at 37.

118 *Id.* at 138–39.

119 *Id.* at 39, 43, 136–37.

120 *See* D.I. 109, at 229–31. *See also* DX 9, at 5 (“Principally due to the use of estimates and allocations, the financial information included herein may not necessarily reflect the financial position and results of operations of the Company [Interim] in the future or what the financial position and results of operation of the Company would have been had it been a separate stand-alone entity during the periods presented. Management does not consider it practicable to estimate what the results of operation would have been had the Company operated as a separate, stand-alone entity.”).

121 D.I. 109, at 229.

122 *Id.* at 229–31.

123 *Id.*

124 *Id.* at 231.

125 PX 123, at 51.

126 *See e.g.* PX 740, at 17.

127 *Id.*

128 PX 102.

129 PX 98; D.I. 137, Haggard Dep., at 156.

130 PX 98; D.I. 137, Haggard Dep., at 160.

131 PX 101; PX 102; DX 39; D.I. 109, at 192–193; D.I. 118, at 10.

132 DX 39; DX 56. Interim's balance sheet reflects the cumulative financial condition of all of the company's operations, while the income statement reflects adjustments made on a monthly basis and, for Spherion, only certain expenses were booked on the Medicare reserve “expense account.” D.I. 109, at 191–92. Stated differently, on the income statement,

Interim treated Medicare reserves as "an expense item that [Interim] hadn't paid yet." *Id.* The "expense" item would be reflected as an increase in the cumulative Medicare reserve carried on the balance sheet. *See e.g.* DX39; DX 56.

133 DX 57; DX 122, at 40; D.I. 109, at 202–08.

134 D.I. 118, at 26–27, 32–33.

135 D.I. 109, at 22.

136 *Id.* at 24.

137 D.I. 116, at 4.

138 DX 72; D.I. 109, at 25–26.

139 D.I. 109, at 26.

140 DX 72, at SPH 012134.

141 *Id.*

142 *Id.* at SPH 012136.

143 DX 71.

144 *Id.* The parties dispute the means or methodology by which Cornerstone calculated its bid for Interim. Plaintiffs maintain that Cornerstone employed a straight-forward valuation based upon a fixed multiple of income before interest, taxes, depreciation and amortization ("EBITDA"). PX 613; D.I. 114, at 72–75, 144–47. Spherion will not admit that Cornerstone employed this methodology and, in any event, Spherion maintains that it certainly was never advised by Cornerstone of what methodology, if any, it was utilizing to set its bids for Interim. D.I. 116, at 4–5. According to Spherion, this was a pure auction; there was no floor or ceiling set by the seller. It was up to the marketplace to set the final price for Interim. *Id.* To the extent a final resolution of this dispute is required to resolve any of plaintiffs' claims—unlikely given the Court's other factual conclusions—the Court concludes that both parties' contentions can be reconciled quite easily with the facts. It is likely that Cornerstone did utilize a multiple of EBITDA to determine what it was willing to pay for Interim. It is also likely that Spherion did not know or even care by what means the bidders set their bids, particularly given the wide range of potential bidders that might surface for Interim. D.I. 109, at 231.

145 *Id.* (emphasis supplied). It does not appear from the record that Cornerstone ever placed a "reference call" to Aetna, HCFA or any other "payer" affiliated with the Medicare program.

146 D.I. 114, at 51; D.I. 120, at 76; PX 136, at SPH032501.

147 *See e.g.* DX 71.

148 D.I. 117, at 34–38.

149 D.I. 114, at 92–93, 112; D.I. 120, at 83–84, 94–95.

150 D.I. 120, at 49–50.

151 *Id.*

152 PX 134; D.I. 114, at 111; D.I. 123, at 24–25.

153 *See* PX 125; D.I. 114, at 92.

154 D.I. 118, at 42–44. *See also* D.I. 109, at 33; PX 125 (cost reports, NPRs and correspondence in the data room).

155 D.I. 114, at 93–94.

156 *Id.* at 93.

157 DX 75.

158 D.I. 114, at 137.

159 DX 76. *See also* DX 75 (the E & Y report also suggested that Interim was a good deal: "In general, the cost reports appear conservative, given that the percentage of reimbursed Medicare costs to total expenses is typically lower than Medicare utilization based on visits. This indicates there may be opportunity *to increase* reimbursement by refining the cost allocation methodologies used.")(emphasis supplied).

160 PX 125, at SPH 011901–02.

161 PX 136.

162 PX 136. The initial "final bid" was $128 million, but Cornerstone increased the bid to $134 million to secure the right to negotiate exclusively with Spherion. D.I. 100, at ¶¶ 86–88.

163 D.I. 109, at 41–42.

164 *See* PX 136; PX 172. Plaintiffs assert that "Spherion insisted ... that [the] negotiations be completed on an expedited basis." D.I. 136, at 15. *See also* D.I. 114, at 162–63 (Mr. Getz suggests that negotiations were hurried). To the extent plaintiffs are attempting to suggest that they were rushed into the deal, the suggestion is at odds with Cornerstone's offer letter in which it states: "we are prepared to move swiftly to a definitive agreement." PX 136, at SPH 032501.

165 D.I. 100, at ¶ 90.

166 *Id.* at ¶ 92.

167 PX 172, at § 3.16 (added after the El Paso investigation); D.I. 109, at 50–56, 73; D.I. 114, at 204–05; D.I. 117, at 94–96.

168 PX 172.

169 *Id.* As will become apparent below, the identity of the parties to the Agreement is particularly important given Spherion's argument that Cornerstone lacks contractual standing to raise claims for damages under the Agreement.

170 *Id.* at § 11.5.

171 *Id.* at §§ 3.14–3.18.

172 *Id.* at § 10.1(a).

173 *Id.* at § 3.7.

174 *Id.* at § 3.20.

175 *Id.* at § 3.29.

176 Schedule 3.16(a) disclosed the appeal of the NPR's issued after the desk review of the 1994 cost report. PX 174, at SPH 030337.

177 "Governmental Entity" is defined in the Agreement to include "instrumentalities of any country or political subdivision thereof." PX 172, § 1.35. The parties do not appear to contest that HCFA would fall within the definition of "Governmental Entities." *See* D.I. 136, at 31; D.I. 141, at 51–53. They do, however, dispute whether a FI is a "Governmental Entity" for purposes of this provision of the Agreement.

178 PX 172, at § 3.16(a)(i).

179 *Id.* at § 3.16(b).

180 *Id.* at § 3.17. “Laws” is defined at Section 1.62 to mean “any federal, state, local or foreign law, statute, ordinance, rule, regulation, permit, order, judgment or decree.”

181 *Id.* at § 3.7. The “Seller Group” is defined at Section 1.85 to mean “seller, its wholly-owned subsidiaries other than the transferred entities and, prior to the respective Closings, the Transferred Entities.” The “Transferred Entities” include Interim, an affiliate of Interim, and all subsidiaries of Interim. *Id.* at §§ 1.100, 1.101 and 1.103.

182 *Id.* at § 3.20.

183 *Id.* at § 3.29. “Material Adverse Change” or “Material Adverse Effect” is defined in the Agreement to mean “any change or effect that, individually or in aggregate, is materially adverse to the financial condition, business or results of operations of [Interim] taken as a whole.” *Id.* at § 1.67.

184 *Id.* at § 10.1.

185 *Id.* at § 10.3.

186 As explained in detail below, the reference to “Therapy Students” is to a failed foreign exchange program for physical therapy students sponsored by Interim before the Sale that resulted in substantial losses to Interim.

187 *Id.* at § 10.4.

188 D.I. 100, at ¶ 99. It appears that the PGBA audit may have been initiated at the direction of HCFA as part of a nationwide effort “to conduct comprehensive audits of the cost reports submitted by a sample number of home health agencies whose cost reporting periods ended on or after October 1, 1996 through September 30, 1997 (the federal government's fiscal year) ... to serve as the primary data source in developing the cost basis for a new prospective pay system for home health agencies.” DX 87, at 22. *See also* F.N. 17, *infra.* HCFA did not provide any advance notice to the home health industry that it intended to initiate this nationwide audit. *Id.*

189 D.I. 100, at ¶¶ 100–01.

190 *Id.* at ¶¶ 102–06.

191 *Id.* at ¶ 118.

192 *Id.* at ¶ 114.

193 D.I. 115, at 23.

194 *See* PX 172, at § 1.97.

195 D.I. 100, at ¶¶ 109, 110.

196 *See e.g.* DX 260.

197 D.I. 100, at ¶ 111.

198 *Id.* at ¶ 113.

199 *Id.* at ¶ 115.

200 *Id.* at ¶ 116.

201 *Id.*

202 *Id.* at ¶ 117.

203 *Id.*

204 *Id.* at ¶ 116.

205 *Id.* at ¶ 119.

206 *Id.* at ¶¶ 120–21.

207 *Id.* at ¶ 122.

208 *Id.* at ¶ 157.

209 *Id.* at ¶ 158.

210 D.I. 137, Livonius Dep., at 125.

211 D.I. 100, at ¶ 159.

212 *Id.* at ¶ 160.

213 *Id.* at ¶ 161.

214 PX 174, at Sch. 1.38.

215 PX 34; PX 35; PX 36; PX 37; PX 38. *See also* D.I. 100, at ¶ 163.

216 *Id.* at ¶ ¶ 164–67.

217 *Id.* at ¶ 168.

218 *Id.* at ¶¶ 169–71.

219 *Id.* at ¶ 170.

220 *Id.* at ¶ 173.

221 PX 84; D.I. 100, at ¶¶ 173–74.

222 PX 152.

223 PX 166.

224 PX 731.

225 PX 171; D.I. 100, at ¶ 175.

226 *Id.* at ¶ 176.

227 *Id.* at ¶ 177.

228 *Id.* at ¶ 178.

229 PX 719; PX 721.

230 D.I. 100, at ¶ 176.

231 *Id.* at ¶¶ 122, 136–37.

232 PX 77; D.I. 100, at ¶ 138.

233 *Id.* at ¶ 139.

234 DX 297; D.I. 100, at ¶ 141.

235 DX 295; D.I. 100, at ¶ 141.

236 DX 295.

237 D.I. 100, at ¶¶ 141–44.

238 PX 219.

239 *Id.*

240 *Id.;* D.I. 100, at ¶ 145.

241 D.I. 100, at ¶ 147.

242 PX 276.

243 D.I. 100, at ¶ 138.

244 *Id.* at ¶ 143; PX 219.

245 D.I. 109, at 92–93.

246 *Id.*

247 D.I. 115, at 80; DX 99.

248 DX 99.

249 *Id.*

250 D.I. 100, at ¶¶ 150–51; D.I. 115, at 79–81.

251 D.I. 115, at 78–80; PX 330.

252 D.I. 115, at 78; D.I. 100, at ¶ 151.

253 D.I. 109, at 90–91; PX 172, at § 1.30.

254 D.I. 109, at 91–93; PX 172, at § 1.101.

255 D.I. 100, at ¶ 152.

256 D.I. 137, Livonius Dep., at 115. *See also* PX 142; PX 144.

257 D.I. 100, at ¶ 153; PX 220; D.I. 115, at 74.

258 PX 223; D.I. 115, at 74–75, 76.

259 PX 690.

260 PX 691; D.I. 115, at 76.

261 PX 312; D.I. 115, at 77.

262 PX 335.

263 In 1994, Interim acquired certain assets known as Therapy Staff Services ("TSS"). PX 735; D.I. 115, at 38, 40. Among the assets purchased was the Therapy Student program initiated by TSS to train American physical therapy students abroad. *Id.* at 39–40.

264 D.I. 100, at ¶¶ 123–124; PX 704; PX 705.

265 D.I. 100, at ¶ 125.

266 *Id.* at ¶¶ 126–128.

267 *Id.* at ¶ 129.

268 *Id.* at ¶ 130.

269 *Id* at ¶ 131.

270 *Id.* at ¶ 132; PX 172, at § 10.4.

271 D.I. 100, at ¶¶ 133–34; PX 174, at Sch. 3.20.

272 D.I. 115, at 55–58.

273 *Eskridge v. Voshell,* 593 A.2d 589 (Del.1991) (ORDER), *citing* *Guthridge v. Pen–Mod, Inc.,* 239 A.2d 709, 713 (Del.Super.1967).

274 *Dionisi v. DeCampli,* 1995 WL 398536, at *1, 1995 Del. Ch. Lexis 88, at *2–3.

275 *See Interim Healthcare, Inc. v. Spherion, Corp.,* C.A. No. 00C–09–180, Slights, J. (Del.Super.Nov. 21, 2003)(Mem. Op. at 20–21); D.I. 101, at 2–7.

276 *See e.g.* D.I. 75, at 24 (Plaintiffs' Opening Brief in Support of Their Motion for Partial Summary Judgment: "the proper construction of an unambiguous contract is 'purely a question of law' and may be resolved on summary judgment."); D.I. 85, at 28 (Spherion's Opening Brief in Support of Its Motion for Partial Summary Judgment: "notwithstanding the clear language of the parties' Agreement....").

277 *See e.g.* D.I. 120, at 13 (plaintiffs' counsel argues that portions of the Agreement are ambiguous and acknowledges that plaintiffs have changed their position on this issue); D.I. 109, at 51–52 (defense counsel asks witness to interpret the Agreement).

278 26 Corbin on Contracts § 573 (1960).

279 *Comrie v. Enterasys Networks, Inc.,* 837 A.2d 1, 13 (Del.Ch.2003) (*citing* *In re Explorer Pipeline Co.,* 781 A.2d 705, 713 (Del.Ch.2001)).

280 *See* *Rhone–Poulenc Basic Chem. Co. v. American Motorists Ins. Co.,* 616 A.2d 1192, 1196 (Del.1992)("A contract is not rendered ambiguous simply because the parties do not agree upon its proper construction.").

281 *Id.* (citation omitted).

282 *See* *O'Brien v. Progressive Northern, Ins. Co.,* 785 A.2d 281, 288–89 (Del.2001).

283 *Comrie,* 837 A.2d at 13 (citations omitted).

284 *See* D.I. 13, at 15–16; D.I. 14, at 3, n. 5. Indeed, plaintiffs withdrew their fraud claim in this Court as a predicate to their argument that the entire case should be transferred to the Court of Chancery. *Accord E.I. duPont De Nemours & Co. v. HEM Research, Inc.*, 1989 WL 122053, at *4 n. 12, 1989 Del. Ch. Lexis 132, at *14 n. 12 ("It should be noted that in cases involving a prayer for rescission based upon a claim of innocent misrepresentation, the equity court has exclusive jurisdiction.").

285 D.I. 136, at 2.

286 *See Interim Healthcare Inc. v. Spherion,* 2003 Del. Ch. Lexis 130, at * 30–31 (discussing the procedural history of the case as it relates to plaintiffs' position regarding Spherion's alleged fraud and explaining why the Court would not consider the claim).

287 *H–M Wexford, LLC v. Encorp, Inc.,* 832 A.2d 129, 144 (Del.Ch.2003).

288 *Gloucester Holding Corp. v. U.S. Tape & Sticky Products, LLC,* 832 A.2d 116, 127 (Del.Ch.2003).

289 PX 172, at § 11.5.

290 *Id.* at § 1.6.

291 D.I. 141, at 94.

292 *Id.*

293 D.I. 145, at 27.

294 D.I. 136, at 1.

295 Plaintiffs presented a more "conservative" claim for expectancy damages at trial based on an analysis of Interim's *pro forma* financial statements with adjustments to account for proper cost reporting methodologies. *See* D.I. 121, at 55–60; PX 739. According to this damages model, plaintiffs were denied the benefit-of-their-bargain in the amount of $25,485,600. *See* D.I. 136, at 79.

296 *Duncan v. Theratx, Inc.,* 775 A.2d 1019, 1022 (Del.2001).

297 17A Am.Jur. 2d *Contracts* § 709 (2004). *See also Oliver B. Cannon & Son, Inc. v. Dorr–Oliver, Inc.,* 336 A.2d 211, 214 (Del.1975)("[T]he contractual remedy cannot be read as exclusive of all other remedies since it lacks the requisite expression of exclusivity.") (citations omitted).

298 This does not necessarily hold true for the equitable remedies plaintiffs have sought in the companion Court of Chancery litigation. *See Elysian Fed. Savings Bank v. Sullivan,* 1990 Del. Ch. Lexis 30 (holding that plaintiffs must elect between breach damages and rescission).

299 *See Cooper v. Pabst Brewing Co.*, 1993 WL 208763 at *9, 1993 Del. Ch. Lexis 9, at *23 ("Ordinarily, the value of any commodity in a competitive market is what a willing buyer would pay a willing seller for that commodity...."); *Northern Trust Co. v. C.I.R.,* 87 T.C. 349, 380, 1986 WL 22171 (1986) ("[A] sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgments and reasonableness must enter into the process of weighing those facts and determining their aggregate significance. Indeed, we have repeatedly recognized that stock valuation is not an exact science, but rather is inherently imprecise and capable of resolution only by a Solomon-like pronouncement."); *Messing v. Commissioner,* 48 T.C. 502, 512, 1967 WL 960 (1967) ("Too often in valuation disputes the parties have convinced themselves of the unalterable correctness of their positions and have consequently failed successfully to conclude settlement negotiations—a process clearly more conducive to the proper disposition of disputes such as this. The result is an overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement.").

300 PX 172, at § 3.17.

301 Although not relevant to the breach of warranty claim, plaintiffs' due diligence, including their discovery of information regarding past audits of Interim cost reports, Interim's current cost reporting methodologies, and the FI's expressed concerns regarding those methodologies, all are relevant in determining the scope of plaintiffs' reasonable expectations.

302 24 Williston on Contracts, § 64:2, at 23–34 (2002) (emphasis supplied). *See also* Holmes, *The Common Law & Other Writings,* at 297–303 (Legal Classics Library 1982) (Justice Holmes discusses the nature of contractual promises generally, and notes that he views the contract "as the taking of a risk" tied to the specific nature and extent of the promises contained in the agreement).

303 D.I. 136, at 59 (referring to alleged breaches of Sections 3.7, 3.16 and 3.17 of the Agreement).

304 *See Id.* at 60–61.

305 Even assuming *arguendo* that the plaintiffs miscalculated and improperly discounted the regulatory risks when formulating their $134 million offer, absent some type of fraud not present here, the miscalculation is their own fault. This was not a cloak-and-dagger transaction presented in a rushed take-it-or-leave-it fashion; it was a multi-party auction that incorporated a substantial due diligence process. Delaware courts do not rescue disappointed buyers from circumstances that could have been guarded against through normal due diligence and negotiated contractual protections. *See VGS, Inc. v. Castiel,* 2004 WL 876032 at *6 (Del.Ch. Apr. 22, 2004) (finding that a sophisticated investor's failure to recognize the importance of a contract that was made available during due diligence diminished the plaintiffs' fraud and breach of contract claim); *Debakey Corp. v. Raytheon Service Co.,* 2000 WL 1273317 at *26–*28 (Del.Ch. Aug. 25, 2000) (finding that a sophisticated party's failure to conduct adequate due diligence or to procure express warranties for facts that it supposedly relied upon in entering a transaction made it impossible to prove justifiable reliance. Instead, this behavior indicated that the sophisticated party made a business decision it was willing to accept in order to complete the deal quickly and cheaply, a decision the Court would not second-guess.). Put another way, if plaintiffs failed properly to account for risks ascertainable through due diligence, and to protect against them in the Agreement, then their $134 expectation was not reasonable and, therefore, it is not compensable.

306 *See e.g. Danforth v. Acorn Structures, Inc.,* 608 A.2d 1194 (Del.1992); *Duncan v. Theratx, Inc.,* 775 A.2d 1019 (Del.2001).

307 866 F.2d 752, 780 (5th Cir.1989). *See also Progressive International Corp. V. E.I. DuPont De Nemours & Co.,* 2002 WL 1558382 at *8 (Del.Ch. Jul. 9, 2002)(finding that even strict confidentiality requirements that considerably impede due diligence do not make a deal between sophisticated parties unconscionable because they are fully capable of making the business decision to continue the deal or walk away).

308 PX 172, at § 15.4.

309 *Id.* at § 3.16(a)(emphasis supplied).

310 *Id.* at § 3.16(b).

311 *Id.* at § 3.17.

312 *Id.* at § 3.16(b).

313 Again, Section 3.16(a) provides, in pertinent part: "no notices have been issued ... from Governmental Entities...."

314 PX 172, at § 1.35 (emphasis supplied).

315 D.I. 141, at 53, *citing* 42 U.S.C. § 1395(h); 42 C.F.R. § 421 *et. seq.* (establishing FIs and defining their roles).

316 *See* 42 U.S.C. § 1395(h).

317 *See e.g.* PX 282; PX 283.

318 42 U.S.C. § 1395(h); 42 C.F.R. § 421.

319 17A Am.Jur. 2d *Contracts* § 364 (2d Ed. 2004).

320 *See New Castle County v. National Union Fire Ins. Co. of Pittsburgh,* 243 F.3d 744, 751 (3d Cir.2001) (quoting *Donaghy v. State,* 100 A. 696, 707 (Del.1917)).

321 Again, Section 3.16(a) provides in pertinent part: "[Interim is not] appealing any notices of program reimbursement and no notices have been issued regarding any disputes related to [Interim's] cost reports...."

322 PX 174, at Sch. 3.16(a).

323 The Court also notes that it appears that Interim disclosed at least some of its correspondences with Aetna regarding the NPRs by supplying these documents to plaintiffs in the data room during due diligence. *See* PX 125.

324 Again, Section 3.16(b) provides in pertinent part: "[Interim has not] intentionally filed a false claim, or filed a claim without a reasonable basis therefore, with HCFA [or] its fiscal intermediaries...."

325 17A Am.Jur. 2d, *Contracts* § 337 (2d. Ed. 2004).

326 *Id.* at §§ 365, 366.

327 *See* D.I. 114, at 192 (the Court observed during trial: "I believe that 3.16 is really meant to address issues that could give rise to a fraud and abuse liability and, therefore, there were particular indemnity provisions that were required because of the nature of that liability to address specifically those sorts of claims that might arise down the road, as opposed to 3.17, which was a more general government filing provision that could apply to any number of submissions that would be made on behalf of Interim.").

328 *See E.I. duPont de Nemours & Co. v. Shell Oil Co.,* 498 A.2d 1108, 1113 (Del.1985) ("[I]n upholding the intentions of the parties, a court must construe the agreement as a whole giving effect to all provisions therein.") (citations omitted).

329 *Id.* (citations omitted).

330 PX 174, at SPH 030339.

331 *Id.*

332 *Id.* at Sch. 3.16(a) and Sch. 3.17.

333 *See* PX 172, at §§ 10.1, 10.3(a), 10.4(b).

334 As indicated previously, the parties renegotiated the initial purchase agreement after the El Paso and Hollywood, Florida fraud and abuse investigations and agreed to add Section 3.16(b) and the corresponding indemnification provisions. D.I. 100, at ¶¶ 92–93. *See also* D.I. 109, at 73; D.I. 117, at 94–96.

335 *E.I. duPont de Nemours,* 498 A.2d at 1113.

336 D.I. 121, at 69.

337 PX 172, at § 1.62.

338 *See Shalala v. Guernsey Mem'l Hosp.,* 514 U.S. 87, 99, 115 S.Ct. 1232, 131 L.Ed.2d 106 (1995)(characterizing the provisions of the PRM as "interpretive rules" and stating that "interpretive rules do not require notice and comment, although ... they also do not have the force and effect of law and are not accorded that weight in the adjudicatory process."); *Ashtabula County Medical Center v. Thompson,* 352 F.3d 1090, 1093 n. 1 (6th Cir.2003) ("[T]he PRM contains the interpretive rules regarding Medicare reimbursement."); *St. Mary's Hosp. of Troy v. Blue Cross & Blue Shield Assoc.,* 788 F.2d 888, 890 (2d.Cir.1986) ("We recognize that we deal here, not with either a statute or with formally promulgated

regulations, but with a Manual explicating those regulations. While such interpretive guides are without the force of law, they are entitled to be given weight.") (citations omitted).

339 *GCI Health Centers, Inc. v. Thompson,* 209 F.Supp.2d 63, 69 (D.D.C.2002)(quoting *Wilmot Psychiatric v. Shalala,* 11 F.3d 1505, 1507 (9th Cir.1993)).

340 *Shalala,* 514 U.S. at 94, 115 S.Ct. 1232 (citing 42 C.F.R. § 413.20(b)).

341 *See In re Cardiac Devices Qui Tam Litigation,* 221 F.R.D. 318, 352 (D.Conn.2004).

342 PX 172, at § 1.62.

343 Of course, when reviewing an agency's decision regarding a provider's compliance with the applicable law, the courts first look to the applicable statute. *See Chevron, U.S.A., Inc. v. Natural Resources Defense Council,* 467 U.S. 837, 842, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). Only if the intent of Congress is not clearly expressed in the statute will the Court consider the agency's construction of the statute. *Id.*

344 D.I. 106, at 188–91.

345 *Id.* at 191–92.

346 *Id.* at 194–95.

347 *Id.* at 213–15.

348 *Id.*

349 *Id.* at 216.

350 DX 5.

351 *Id.*

352 D.I. 121, at 85–86.

353 *Id.* at 82.

354 DX 169, at 9.

355 DX 171, at 4.

356 D.I. 111, at 16.

357 D.I. 121, at 13.

358 *Id.* at 14.

359 The Court also considered the opinions of plaintiffs' other expert, John K. Dugan, as they related to the Medicare issues. *See* DX 8. While not affected by the same credibility issues, the Court found the opinions to be less persuasive than those offered by Spherion's expert.

360 D.I. 119, at 23–24.

361 *Id.*

362 *Id.* at 26.

363 D.I. 130, at 77.

364 *See e.g.* D.I. 130, at 6 (Interim probably should have filed 1996 cost report under protest); *Id.* at 73 (suggesting that Interim did not have to file its cost report under protest).

365 *See* 42 U.S.C. § 1395X (v)(1)(A)("[T]he reasonable cost of any services shall be the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services, and shall be determined in accordance with regulations establishing the methods or methods to be used, and the items to be included, in determining such costs for various types or classes of institutions, agencies and services....").

366 D.I. 136, at 23; D.I. 130, at 46–48. Plaintiffs also allege that "of the $19.4 million in A & G allocated to Interim in 1996, $19 million, or over 99%, was deemed reimbursable even though Medicare only accounted for about 25% of Interim's healthcare revenues." D.I. 136, at 20. As to this example, Spherion disputes plaintiffs' characterization of the costs allocated to Medicare, and with good reason. A review of the evidence reveals that Medicare was actually asked to pay only 34% of Interim's allowable Medicare costs of $19.4 million. *See* DX 270, at Sch. G.

367 D.I. 130, at 102–05.

368 *Id.* In addition to the added resources required to generate a bill, the Medicare program also demands additional resources to support and/or justify the bill if later challenged, in the form of document retention and management protocols, regulatory experts and, as evidenced by the events in this case, outside experts and legal assistance. (D.I. 101, at 109–11, discussing documentation issues).

369 *See* 42 U.S.C. § 1395X(v)(1)(A) (the "cross-subsidization" statute).

370 D.I. 100, at ¶ 63.

371 *Id.* at ¶ 64.

372 *Id.* at ¶ 65.

373 PX 70.

374 *Id.* (emphasis supplied).

375 D.I. 100, at ¶ 71; DX 87, at Ex. 5.

376 *See* DX 87, at Ex. 5 (In Transmittal 4, HCFA states that it "clarifies long standing HCFA policy contained in 42 CFR 413.24(d)(1) which states, in part, that 'the cost of non revenue-producing cost centers serving the greatest number of other centers, while receiving benefits from the least number of centers, is apportioned first.' "). Needless to say, statutory and regulatory provisions trump manual provisions to the extent there is a conflict between the two. *See Shalala v. St. Paul–Ramsey Medical Center,* 50 F.3d 522, 528 (8th Cir.1995); *Daviess County Hosp. v. Bowen,* 811 F.2d 338 (7th Cir.1987).

377 D.I. 119, at 63–64 ("HCFA issued this Transmittal Letter [Transmittal 2] and put it as part of the manual instructions and stipulated that the sequence would no longer be the sequence that most of the agencies were using and had approval for and, that is, with A & G share [sic] first, reimbursable second and non-reimbursable third. They were reversing their opinion and saying that 100% reimbursable should come first, 100% non-reimbursable should come second, and shared A & G should come last.... I mean we, in the industry, when this came out, and this was effective for cost reports ... ending on or after September 30, 1996, I mean—in the financial managers work group, we went kind of nuts over this whole situation, because here was HCFA coming into a middle of a fiscal year, and agencies had approval to file under a certain methodology from the fiscal intermediary, and HCFA comes in with this Transmittal saying, well we don't care if you're right in the middle of your fiscal year, this is in May, you have to now if you are a December year-end, you have to now change your methodology within the middle of the year. We took this up with HCFA and we said, you know, you just can't do this. And what happened was they recognized that they made an error.").

378 *See* DX 65.

379 DX 31.

380 D.I. 136, at 11, *citing* D.I. 101, at 28 ("Q: When was the first time, if at all, the actual sequence that you utilized appeared on the cost report? A: I believe it was the December #94 cost report.").

381 DX 9, Attach. H, at 2; DX 218 ("FY 94 ... was the first year that we [Interim] were able to update our year-end cost report software to actually show the three lines of A & G as separate items.... Having been unable to have the software updated, we did an off-line allocation of our intermittent A & G to the disciplines.").

382 *See* DX 9, Attach. H, at 2; DX 62; DX 218.

383 *In Home Health,* PRRB Case No. 95–2210 GE.

384 The Court also refuses to find a breach of Section 3.17 simply because Interim did not comply with the letter of Transmittal 4. The Court is satisfied that Interim complied "in all material respects" with Transmittal 4 as required by the Agreement. *See* D.I. 101, at 93–95; D.I. 106, at 141–42; DX 87, at 37–38.

385 DX 210; PX 134; DX 75.

386 D.I. 119, at 26; D.I. 130, at 4, 17–19.

387 DX 5.

388 Plaintiffs' argument that Interim's allocation methodology produced an inequitable result irregardless of whether it complied with Transmittal 4 is, in essence, a restatement of the "collapse" adjustment that was ultimately reversed by HCFA. *See* PX 313. The Court cannot conclude on this record that plaintiffs have proven that "inequitable" reimbursement occurred as a result of Interim's cost allocation methodology.

389 PX 334, at PRM § 2150.3.

390 D.I. 121, at 20–21. HCFA's instruction to home offices is first to allocate those expenses that can be allocated directly and then, as a next step, allocate those costs that cannot be allocated directly on the basis of a functional statistic.

391 D.I. 119, at 98.

392 *Id.* at 102–03.

393 *Id. See generally* 42 C.F.R. § 413.130.

394 *See e.g.* PRM, § 3104C ("Cost of home office operations—allocate among the providers the allowable costs not directly allocable on a basis designed to equitably allocate the costs over the chain components or activities receiving the benefits of the costs and in a manner reasonably related to the services received by the entities in the chain."); PRM, § 2150.3 C ("Costs Allocable on a Functional Basis—The allowable home office costs that have not been directly assigned to specific chained components must be allocated among the providers ... on a basis designed to equitably allocate the costs over the chain components or the activities receiving the benefits of the costs."); PRM § 2150.3 D ("Pooled Costs in Home Office—[Pooled] costs may be allocated to the components in the chain on the basis of beds, bed days or other basis, provided the basis used equitably allocates such costs.").

395 D.I. 119, at 102–03, 109.

396 *Id.* at 102–03, 109.

397 D.I. 130, at 80–82.

398 *Id.*

399 DX 87, at Ex. 1.

400 PRM § 1709; DX 87, at Ex. 10; D.I. 119, at 109–10 (“Capital-related costs, movable equipment, all expenses, i.e., interest, personal property taxes for movable equipment should be allocated to the appropriate cost centers on the basis of square feet of area occupied or dollar value.”)

401 D.I. 130, at 32–33.

402 *Id.*

403 DX 75; DX 76.

404 DX 75 (emphasis supplied).

405 The Court notes that it did not hear from any representatives of PGBA or HCFA during trial. In any event, the fact that PGBA took issue with Interim's cost reporting methodologies, at the end of the day, carries little weight with the Court given that its initial adjustments, totaling nearly $40 million, were drastically reduced in the final global settlement (to approximately $5 million). To reiterate, the fact that PGBA was prosecuting *alleged* improprieties in the cost reporting methodology through the civil administrative process by no means indicates that such improprieties actually occurred or that they rose to the level of a violation of Law.

406 D.I. 100, at ¶ 13. After determining that regional vice presidents and branch managers were engaged in non allowable marketing activities, PGBA disallowed 25% of branch manager and 100% of regional vice president salaries. D.I. 106, at 168.

407 The PRM, at Section 2136.1, provides:

> Costs of activities involving professional contacts with physicians, hospitals, public health agencies, nurses associations, state and county medical societies, and similar groups and institutions, to apprise them of the availability of the provider's covered services are allowable. Such contacts make known what facilities are available to persons who require such information and providing for patient care, and serve other purposes related to patient care, e.g., exchange of medical information on patients and the provider's facility, administrative and medical policy, utilization review, etc.
>
> Section 2136.2, on the other hand, provides:
>
> Costs of advertising to the general public which seeks to increase patient utilization of the provider's facilities are not allowable. Situations may occur where advertising which appears to be in the nature of the provider's public relations activity is, in fact, an effort to attract more patients.

408 D.I. 106, at 220 (incorrectly referenced in the plaintiffs' opening brief (at p. 26–27) as an admission from Interim's Mary B. Sneed; actually testimony from plaintiffs' expert, Thomas Curtis). *See also* D.I. 136, at 26–27.

409 PX 604.

410 PX 602; PX 603.

411 *See* D.I. 123, at 59–60; D.I. 101, at 105–10.

412 D.I. 118, at 53–54; D.I. 101, at 105–06.

413 D.I. 101, at 105–06.

414 “Time studies” are employee surveys that breakdown how the employee spends his/her time during the workday. *See* DX 87, Ex. 14 (Interim writes to Aetna: “You cautioned us on the use of time studies to allocate common salaries.”). *See also* DX 4 (Agenda for 12/18/98 meeting indicating that “time study requirements is new”); DX 119 (Agenda for August 14, 2000 meeting noting “PGBA & Aetna have different opinions of time studies/time records”); DX 17 (notes from September 30, 1998 meeting: “... we were told by Aetna that time studies would not be accepted as documentation for the cost

report. Now it's hard to be told that a time study is the only thing that would save us when Aetna originally told us that time studies would not be accepted.").

415 PX 739, at 11.

416 D.I. 119, at 122 (no manual instruction and he has never seen a FI require time studies to support salaries of senior executives).

417 *See* D.I. 101, at 109–11 (Ms. Watson testified that reasons a bill might be rejected include "if they ask for documentation and we did not have it—there was not documentation of a visit or if orders were not signed or if it wasn't reasonable and necessary."); PX 739, at 12.

418 *Id.*

419 D.I. 121, at 43 (According to Mr. Curtis, "[Interim wasn't] in compliance with law because they made a claim for visits that they knew were not paid or going to be paid by Medicare.").

420 D.I. 109, at 212–13.

421 *See* PRM Pub. 15–2 § 1102–3 N; PRM Pub. 15–1 § 2408.2.

422 *See* Medicare Intermediary Manual CMS Pub. 13–2 §§ 2242, 2243. To the extent that Medicare Law required the provider to reconcile to the PS & R, one would think that HCFA would regularly supply the required information to the provider to ensure compliance. As stated, under current practice, if the provider wants a PS & R, they have to ask for it.

423 D.I. 136, at 28.

424 D.I. 121, at 106.

425 *Id.*

426 *Id.* at 106–07. Having found that Interim's cost reporting methodologies did not breach the Agreement, the Court need not address plaintiffs' argument that Interim improperly certified the accuracy of its cost reports or improperly failed to submit its cost reports under protest. *See* D.I. 136, at 33.

427 24 Williston on Contracts, § 64:8 (4th Ed. 2002).

428 D.I. 100, at ¶ 121; D.I. 125, at 29–31; DX 276.

429 PX 172, at §§ 3.16(a) & (b), 3.17.

430 *See* D.I. 136, at 65–68.

431 PX 172, at § 3.7.

432 *Id.* at § 3.29.

433 The plaintiffs' criticism focuses on the adequacy of the reserves carried by Interim for Medicare accounts receivable. They contend that Interim's Medicare reserves were too low and that, consequently, the earnings attributed to Medicare receivables were too high. This, of course, skewed plaintiffs' valuation of Interim which was the product of a multiple of Interim's EBITDA.

434 D.I. 111, at 36–37; D.I. 130, at 125–28.

435 PX 102; D.I. 111, at 51–52.

436 D.I. 111, at 51.

437 DX 56.

438 *Id.*

439 DX 57; DX 122, at 40.

440 D.I. 111, at 42; D.I. 130, at 125.

441 Even plaintiffs' own accounting expert acknowledged that "the balance sheet reserve is going to be reflective of reserves throughout ownership of an organization, whereas the income statement is strictly looking at a reserve for a given point in time—for that current year." D.I. 111, at 42.

442 D.I. 109, at 197–200.

443 D.I. 130, at 125–30.

444 D.I. 136, at 36. The sharp increase in Interim's year-end reserves is explained, in substantial part, by the difference between the Medicare revenues Interim projected it would receive as a result of its PIPs and the final amount of Medicare reimbursement sought in the as-filed year-end cost reports. Rather than record the approximately $3 million difference as additional revenue, Interim chose not to make a journal entry for the additional revenue and to carry the amount as a Medicare cost report reserve. DX 57; D.I. 118, at 26–27, 33. This practice was consistent with GAAP, which requires that adjustments to the financial records occur at the time the new information justifying the adjustment is discovered (as opposed to going back to adjust previously prepared financial statements). *See* D.I. 131, at 17; D.I. 137, Ex. 3, Haggard Dep. at 327.

445 D.I. 119, at 108–10.

446 D.I. 136, at 36.

447 D.I. 119, at 108.

448 *See* D.I. 147, at 145–46 (Plaintiffs' counsel's characterization during oral argument).

449 *See* PX 21; PX 122; D.I. 106, at 55–57, 59.

450 D.I. 106, at 56–57.

451 D.I. 101, at 61, 67.

452 Management must determine, on the basis of "probability," the "net realizable value" of the accounts receivable. D.I. 130, at 126, 129. In other words, the firm bills for an amount it believes that it is entitled to receive, but then assesses the amount it will probably receive. The difference represents the amount reserved against accounts receivable. *Id.* at 125–29.

453 PX 121; D.I. 130, at 125 (Reserves against receivables reflect what will probably be realized in the judgment of management).

454 PX 122.

455 PX 121.

456 *Id.*

457 *Id.*

458 *See* DX 122, at 44 (concluding that reserves were set in accordance with GAAP and were adequate to address potential cost report adjustments). Obviously, the Court's finding that Interim did not breach any of the Medicare

representations and warranties has influenced its analysis of whether Interim management properly assessed the likelihood of adjustments to Interim's requests for reimbursement from Medicare.

459 D.I. 111, at 83 (Dugan); D.I. 130, at 125 (Wright); D.I. 109, at 193–94 (Krause).

460 D.I. 109, at 194.

461 D.I. 137, Ex. 3, Haggard Dep. at 42.

462 D.I. 131, at 15, 17. It should be noted that D & T raised no concerns regarding the adequacy of Interim's reserves, an opinion implicitly echoed by E & Y when it later concluded that D & T's audit reflected "adequate" procedures and "consistent" application of "accounting principles." DX 147. *See also* DX 9 (D & T audit report).

463 D.I. 131, at 11–12. *See also,* D.I. 130, at 127–28 ("The setting of reserves is—is a process of estimate—of making estimates. Information that a company ... has access to constantly changes. And as such, it is—it is imperative upon management to make the appropriate estimates as one passes through the course of the year" to reevaluate what is expected to be collected as information becomes—new information becomes available.). In this regard, it is important to note that Interim's audited historical financial statements are dated December 23, 1996. DX 9, Attach. A, at 5. To the extent additional information was developed after these documents were prepared, the adjustments would be recorded in the cumulative balance sheet, not by making retroactive adjustments to the income statements. D.I. 131, at 17.

464 DX 9, Attach. A, at 7. Alex.Brown also made it clear in the Offering Memorandum that "[e]ach recipient is responsible for conducting its own independent analysis of [Interim] in connection with any proposed acquisition and for independently verifying the information contained herein." DX 72 at SPH012134.

465 PX 172, § 3.7.

466 DX 9, Attach. 5. Moreover, neither the audited historical financial statements nor the *pro forma* financial statements purport to analyze the effect or impact upon Interim's revenues of Interim's separation from Spherion. D.I. 109, at 229–30, 231. While certain adjustments were made in the *pro forma* financial statements, any adjustments to revenues appeared in the midst of multiple prominent disclaimers. *Id.* at 236.

467 *See* D.I. 121, at 102–04.

468 PX 172, at §§ 10.1, 10.4.

469 *Id.* at § 10.3.

470 D.I. 111, at 62–64, 72–73. The franchise loan portfolio was transferred from Spherion to Interim as part of the Sale. PX 174, at § 1.38.

471 DX 122; DX 288.

472 PX 172, at § 3.7.

473 *Id.* at § 3.29.

474 PX 8–12; PX 87–89, PX 93–94.

475 D.I. 131, at 27–29.

476 DX 122; D.I. 100, at ¶ 165.

477 *See* DX 122, at 52 (citing paragraph 8 of FASB Statement 114; "A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period

of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding.").

478 D.I. 131 at 31; DX 122, at 51.

479 DX 134.

480 DX 75.

481 PX 172, at § 1.30; PX 174, at Sch. 1.44.

482 D.I. 109, at 91–92.

483 *Id.* at 93.

484 PX 172, at § 3.20.

485 *Id.*

486 DX 295.

487 D.I. 100, at ¶ 141.

488 *Id.* at ¶¶ 142–45.

489 *Id.*

490 *Id.* at ¶ 146.

491 *Id.* at ¶ 147.

492 *Id.* at ¶¶ 147–48.

493 DX 295.

494 PX 276.

495 DX 295.

496 PX 172, at § 10.1.

497 *See* PX 692.

498 D.I. 100, at ¶ 151.

499 *Id.*

500 PX 172, at §§ 10.1, 10.3.

501 D.I. 94, at 34.

502 *Id.*

503 D.I. 100, at ¶ 153.

504 PX 174.

505 PX 172, at § 10.1(ii).

506 PX 172, at §§ 3.20, 10.1(a).

507 PX 335.

508 PX 312; D.I. 155.

509 PX 172, at §§ 1.9, 1.65.

510 *Id.* at § 10.3.

511 *See* DX 112; PX 225; PX 223; PX 225; PX 239; PX 253. *See also* DX 174, at § 3.20.

512 PX 172 at §§ 1.96, 10.4.

513 D.I. 96; D.I. 132.

514 *Id.;* PX 336.

515 D.I. 96, at ¶¶ 11–15; D.I. 100, at ¶¶ 130–35; DX 74; PX 705.

516 PX 172, at § 1.96.

517 D.I. 132, at ¶¶ 1–2.

518 D.I. 96, at ¶ 10 ("Each student entered into an Employment Agreement in connection with his or her physical therapy education in the Netherlands identical to the Employment Agreements marked as plaintiffs' exhibits 704 and/or 705"); PX 704; PX 705.

519 *See e.g.* PX 354; PX 355; PX 388; PX 392; PX 412; PX 451; PX 466; PX 474; PX 491; and PX 501.

520 The parties' course of conduct prior to this litigation supports the Court's interpretation of the clear language of the Agreement. D.I. 115, at 68–69 ("—at no time [prior to the litigation] did Spherion—ever take the position that a Therapy Student without a loan was not a Therapy Student under the definition in the Stock Purchase Agreement.").

521 PX 172, § 10.4(a). "Seller Group" includes Interim (pre-sale) and Spherion. *Id.* at § 1.85. "Transferred Entities" includes Interim and its subsidiaries. *Id.* at §§ 1.100, 1.101, 1.103.

522 *Id.* at § 10.4(a)(ii). *See also Id.* at § 1.19 (" 'Damages' means claims, *losses,* penalties, fines, damages, *liabilities* and *expenses* ....") (emphasis supplied).

523 *Id.* at § 10.1.

524 *Id.* at § 10.4(f).

525 *Id.* at § 10.5.

526 *Id.* at § 1.97.

527 D.I. 109, at 134–36; PX 225; PX 229; PX 235; PX 239.

528 *See e.g.* PX 239 ("[Interim] and Buyer take the position that other Therapy Students making allegations in the future, similar to the allegations previously disclosed to you, would be covered by the Special Indemnity provision of Section 10.4(a) of the Agreement.").

529 *See* PX 112; PX 233; PX 234; PX 253; PX 174, SCH. 3.20.

530 D.I. 96, at ¶ 10.

531 PX 172, at §§ 10.1(b)(ii), 10.5.

532 *See Id.* at § 1.97.

533 *Id.* at § 10.5 ("any Indemnified Party that seeks indemnification with respect to *a third party claim* from the other party ... must provide written notice to the Indemnifying Party ....") (emphasis supplied).

534 *Id.* at § 10.4(a)(iii).

535 *Id.* at § 10.4(a)(i).

Alford Action:	$	467,722.88
Abrajano Action:	$	420,086.12
Stecker Action:	$	255,443.89
Other asserted claims:	$	444,700.54
Loan write-offs in access		
Therapy Student reserve:	$	322,051.31
Probable additional loan write-offs:	$	331,434.21
Total:	$	2,241,438.95
Less:	$	100,000.00
Interim share:	$	1,070,719.48
Spherion share:	$	1,070,719.47 536

536 The following evidence relates to each element of the Therapy Student indemnification Damages: (1) Alford action—PX 112; PX 329; PX 336; D.I. 132, ¶ 9.(2) Abrajano action—PX 233; PX 329; PX 336; PX 716; D.I. 96, ¶ 1; D.I. 132, at ¶ 9.(3) Stecker action—PX 253; PX 254; PX 336; D.I. 132, ¶ 9.(4) Other asserted claims—PX 239; PX 329; PX 336; D.I. 132, at ¶ 9.(5) Loan write-offs—PX 329; PX 336; D.I. 132, at ¶ 11; D.I. 96, at ¶ ¶ 6, 7, 8.

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441 B.R. 437
United States Bankruptcy Court, D. Delaware.

In re INTERLAKE MATERIAL HANDLING, INC., et al., Debtors.
Tiare International Inc., Plaintiff
v.
United Fixtures Co., Inc., National City Business Credit, Inc., Defendants.

Bankruptcy No. 09–10019 (KJC).
|
Adversary No. 09–50895 (KJC).
|
Jan. 11, 2011.

Synopsis
Background: Retailer for which Chapter 11 debtor had agreed to engage in direct customers sales of certain products that it supplied filed complaint for imposition of constructive trust and order directing turnover of excess customer payments that debtor should have turned over to retailer. Defendants moved to dismiss.

The Bankruptcy Court, Kevin J. Carey, J., held that allegations in complaint filed by retailer on whose behalf the Chapter 11 debtor, a supplier of products for resale, had agreed to engage in direct customer sales, while remitting to retailer any customer payments in excess of what debtor had billed to retailer, that as result of cash collateral order entered by bankruptcy court, pursuant to which postpetition lender was authorized to sweep debtor's accounts, excess customer payments that debtor should have remitted to retailer were instead acquired by postpetition lender, did not sufficiently aver kind of misconduct needed under Illinois law to support imposition of constructive trust.

Motion granted.

Attorneys and Law Firms

***438** Edward J. Kosmowski, Epiq Systems Bankruptcy Solutions, Jaime Luton, Kenneth J. Enos, M. Blake Cleary, Young Conaway Stargatt & Taylor, LLP, Maria Aprile Sawczuk, Stevens & Lee, P.C., Wilmington, DE, Jason Jay Scott, Kurtzman Carson Consultants, LLC, El Segundo, CA, Jeremy T. Stillings, Proskauer Rose LLP, Chicago, IL, for Debtors.

***439 MEMORANDUM**[1]

KEVIN J. CAREY, Bankruptcy Judge.

BACKGROUND

On January 5, 2009 (the "Petition Date"), Interlake Material Handling, Inc. and its related entities (the "Debtors") filed petitions for relief under chapter 11 of the United States Bankruptcy Code with the United States Bankruptcy Court for the District of Delaware (the "Court"). Defendant, United Fixtures Company, Inc. ("UFC"), was one of the Debtors that filed chapter 11. Defendant National City Business Credit ("NCBC") provided debtor in possession financing under the Secured Super–Priority Debtor in Possession Credit and Security Agreement (the "Credit Agreement"), pursuant to a February 11, 2009 Order of the Court.[2]

In accordance with a prepetition distributorship agreement (the "Distributorship Agreement"), UFC, operating through its division, National Store Fixtures ("National Store"), sold shelving product to the plaintiff, Tiare International, Inc., ("Tiare"), which then resold the shelving product to third parties. Tiare commenced this adversary proceeding on April 14, 2009 by filing a Complaint asserting three counts against the Defendants, alleging that certain funds were wrongfully taken and held by the Defendants, instead of being paid over to Tiare. Specifically, Tiare requests (1) a declaratory judgment establishing that the funds are not property of the bankruptcy estate, (2) "turnover" of those same funds to Tiare, and (3) the imposition of a constructive trust.

Before the Court are the Defendants' nearly identical Motions to Dismiss the Complaint.[3] For the reasons set forth below, the Defendants' motions will be granted.

LEGAL STANDARD FOR A MOTION TO DISMISS

Fed.R.Civ.P. 12(b)(6), made applicable by Fed.R.Bankr.P. 7012(b) governs a motion to dismiss for failing to state a claim upon which relief can be granted. "The purpose of a motion to

dismiss is to test the sufficiency of a complaint, not to resolve disputed facts or decide the merits of the case." *Paul v. Intel Corp. (In re Intel Corp. Microprocessor Antitrust Litig.),* 496 F.Supp.2d 404, 407 (D.Del.2007) citing *Kost v. Kozakiewicz,* 1 F.3d 176, 183 (3d Cir.1993).

In considering a motion to dismiss under Fed.R.Civ.P. 12(b)(6), the court must accept as true all factual allegations in the complaint and draw all inferences from the facts alleged in the light most favorable to the plaintiff. *Worldcom, Inc. v. Graphnet, Inc.,* 343 F.3d 651, 653 (3d Cir.2003). Fed.R.Civ.P. 8(a)(2), made applicable by Fed.R.Bankr.P. 7008, requires the complaint to contain "a short and plain statement of the claim showing that the pleader is entitled to relief," in order to "give the defendant fair notice of what the ... claim is and the grounds upon which it rests." *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 555, 127 S.Ct. 1955, 1964, 167 L.Ed.2d 929 (2007) quoting *Conley v. Gibson,* 355 U.S. 41, 47, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957).

***440** In *Twombly,* the Supreme Court decided that "[w]hile a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, a plaintiff's obligation to provide the 'grounds' of his 'entitle [ment] to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do." *Twombly,* 550 U.S. at 555, 127 S.Ct. at 1964–65. See also *Fowler v. UPMC Shadyside,* 578 F.3d 203, 210 (3d Cir.2009) quoting *Ashcroft v. Iqbal,* 556 U.S. 662, 129 S.Ct. 1937, 1948–49, 173 L.Ed.2d 868 (2009)("[I]t is clear that conclusory or 'bare-bones' allegations will no longer survive a motion to dismiss; 'threadbare recitals of elements of a cause of action, supported by mere conclusory statements do not suffice.' To prevent dismissal, all civil complaints must now set out 'sufficient factual matter' to show that the claim is facially plausible. This then 'allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.' ")

The relevant record under consideration consists of the complaint and any "document integral or explicitly relied on in the complaint." *U.S. Express Lines, Ltd. v. Higgins,* 281 F.3d 383, 388 (3d Cir.2002), citing *In re Burlington Coat Factory Sec. Litig.,* 114 F.3d 1410, 1426 (3d Cir.1997). The movant carries the burden of demonstrating that dismissal is appropriate. *Intel Corp.,* 496 F.Supp.2d at 408.

ALLEGED FACTS

For the purpose of considering the Motions to Dismiss, the facts set forth in the Complaint are accepted as true.[4] Under the terms of the Distributorship Agreement, Tiare bought shelving product from National Store, which it then marked-up and resold to its own customers. (Complaint ¶ 7–8.) Because Tiare had limited resources, National Store and Tiare agreed that National Store would issue the invoices for any large orders directly to Tiare's customers. (Complaint ¶ 8.) The total amount invoiced to Tiare's customers consisted of the price Tiare agreed to pay to National Store for the product, plus Tiare's mark-up. (*Id*). After the customers paid the invoice, National Store turned over the mark-up amount to Tiare. (*Id.*) To keep track of what monies belonged to Tiare, National Store prepared a spreadsheet, setting forth the customer's price, Tiare's cost, and the difference, *i.e.,* Tiare's mark-up or revenue. (Complaint ¶ 10.)

Prior to the Petition Date, in November, 2008, Tiare placed an order with National Store for two of its customers. (Complaint ¶ 11.) After the Petition Date, those customers sent checks to National Store in payment for the shelving product the customers had received, which National Store deposited between March 2 and 4, 2009. (Complaint ¶ 12.) The portion of the price paid to National Store that represented Tiare's mark-up was $207,711.13 (the "Mark-up Amount"). (Complaint ¶ 11.)

The Credit Agreement provided that NCBC would sweep UFC's deposit accounts nightly to pay down outstanding amounts owed under the prepetition revolving loan facility. (Complaint ¶ 5.) ***441** Therefore, under the terms of the court-approved Credit Agreement, NCBC swept the funds that Tiare's customers paid to National Store the night they were deposited, including the Mark-up Amount. *Id.*

DISCUSSION

Both Defendants contend that the viability of Tiare's entire Complaint hinges on whether the circumstances warrant imposition of a constructive trust on the Mark-up Amount, as requested in Count III of the Complaint. The Defendants' argue that, absent imposition of a constructive trust, there is no basis for either a declaratory judgment excluding the Mark-up Amount from the estate (Count I), or an order to "turn over" the Mark-up Amount to Tiare (Count II). For the reasons set forth below, I conclude that Tiare has not alleged any plausible basis for imposing a constructive trust on the Mark-

up Amount under state law. Consequently, the Complaint will be dismissed.

Section 541 of the Bankruptcy Code provides that the commencement of a bankruptcy case creates an estate comprised of "all legal and equitable interests of the debtor in property." 11 U.S.C. § 541. "Where the debtor's 'conduct gives rise to the imposition of a constructive trust, so that the debtor holds only bare legal title to the property, subject to a duty to reconvey it to the rightful owner, the estate will generally hold the property subject to the same restrictions.' " *In re Howard's Appliance Corp.,* 874 F.2d 88, 93 (2d Cir.1989) quoting *In re Flight Transp. Corp. Securities Litigation,* 730 F.2d 1128, 1136 (8th Cir.1984).

Property interests are creatures of state law and "the happenstance of bankruptcy" should not inform the way courts analyze them. *Butner v. United States,* 440 U.S. 48, 55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979); *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.,* 549 U.S. 443, 450–51, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007). Accordingly, the determination of whether a constructive trust should be imposed is a question of state law. *Howard's Appliance,* 874 F.2d at 93. Under the terms of the parties' contract, Illinois law applies here.

The Illinois Supreme Court described a constructive trust as follows:

> A constructive trust is one raised by operation of law as distinguished from a trust created by express agreement between the settlor and the trustee. A constructive trust is created when a court declares the party in possession of wrongfully acquired property as the constructive trustee of that property, because it would be inequitable for that party to retain possession of the property. The sole duty of the constructive trustee is to transfer title and possession of the wrongfully acquired property to the beneficiary

Suttles v. Vogel, 126 Ill.2d 186, 127 Ill.Dec. 819, 533 N.E.2d 901, 904 (1988) (citations omitted). The Illinois Supreme Court set forth the circumstances under which a constructive trust should be imposed:

> A constructive trust will not be imposed unless the complaint makes specific allegations of wrongdoing, such as fraud, breach of a fiduciary duty, duress, coercion or mistake. Furthermore, the grounds for imposing a constructive trust must be so clear, convincing, strong and unequivocal as to lead to but one conclusion.

Id., 127 Ill.Dec. 819, 533 N.E.2d at 905. Mere nonpayment of a money debt is not "wrongdoing" sufficient to justify imposition of a constructive trust. *Midwest Decks, Inc. v. Butler & Baretz Acquisitions, Inc.,* 272 Ill.App.3d 370, 381, 208 Ill.Dec. 455, 649 N.E.2d 511 (1995). Nor ***442** will a breach of contract give rise to a constructive trust. *In re Stotler and Co.,* 144 B.R. 385, 390 (N.D.Ill.1992); *Bear Kaufman Realty, Inc. v. Spec Development, Inc.,* 268 Ill.App.3d 898, 906, 206 Ill.Dec. 239, 645 N.E.2d 244 (1994).

Tiare argues that the alleged facts support a finding of wrongdoing against the Defendants because the Defendants' claimed ownership of the Mark-up Amount is based on mistake or theft, since "a debtor cannot improve its position and create rights to property that do not exist outside of bankruptcy." Tiare Brief in Opposition, D.I. 16 at p. 10, citing 5 Collier On Bankruptcy § 541.04 (15th ed. 2006). Tiare relies on *In re Bake–Line Group, LLC,* 359 B.R. 566 (Bankr.D.Del.2007), in which the Court imposed a constructive trust. In *Bake–Line,* the debtor received a check in the mail that was made payable to the defendant, with whom the debtor had no business or other relationship. *Id.* at 568. The debtor deposited the check into its own bank account and then, realizing its mistake (or acknowledging its wrongdoing—it was unclear which was the case), the debtor returned the funds to the defendant. *Id.* The trustee in bankruptcy argued that the debtor's transfer, returning the funds to the defendant, was an avoidable preference. *Id.* at 569. The *Bake–Line* Court held that the debtor never had an interest in the property and merely held the funds in constructive trust for the defendant. *Id.*

The *Bake–Line* case is inapposite to the matter before me. In contrast to the facts in *Bake–Line,* the checks at issue in this case were made payable to National Store. Tiare had a long-standing, arms-length business relationship with National Store. The Mark-up Amount was deposited according to normal business practice and swept from the account pursuant to an Order of this Court. (D.I. 222). The facts alleged in the Complaint, viewed in the light most favorable to Tiare, do not provide a plausible basis for determining that there was any mistake or wrongdoing by the Defendants.

Another pertinent decision is *In re Stotler and Co.,* 144 B.R. 385, 390 (N.D.Ill.1992), which considered whether to impose a constructive trust on funds held by a trustee in bankruptcy. There, the plaintiff, an introducing broker ("IB"), referred one of its customers to the debtor, a futures commodities merchant ("FCM"). *Id.* Pursuant to a detailed contract, the

IB was to be paid part of the commission that the FCM charged its customer. *Id.* In *Stotler,* the plaintiff (along with many other IBs) did not receive the commission for its referral and argued, under a theory of breach of fiduciary duty, that a constructive trust should be imposed on funds in the defendant trustee's possession. *Id.* at 386. The *Stotler* court held that the plaintiff failed to establish the requisite fiduciary relationship and declined to impose a constructive trust. *Id.* at 389. Rather, the court observed that the plaintiff's only claim was one for breach of contract. *Id.* at 390.

There are no facts alleged to support the existence of a fiduciary relationship between National Store and Tiare. "Generally, where parties capable of handling their business affairs deal with each other at arm's length, and there is no evidence that the alleged fiduciary agreed to exercise its judgment on behalf of the alleged servient party, no fiduciary relationship will be deemed to exist." *Midwest Decks,* 272 Ill.App.3d at 380, 208 Ill.Dec. 455, 649 N.E.2d 511.

CONCLUSION

Tiare has not alleged any plausible basis in the Complaint based upon which a constructive trust could be imposed under Illinois ***443** law (*i.e.* fraud, breach of a fiduciary duty, duress, coercion or mistake). An appropriate order follows.

All Citations

441 B.R. 437

Footnotes

1 This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334 and 157(a). This is a core proceeding pursuant to 28 U.S.C. 157(b)(1) and (b)(2)(B).

2 UFC and NCBC may be referred to herein collectively as "Defendants."

3 NCBC's Motion to Dismiss is docket number 7; UFC's Motion to Dismiss is docket number 11. Oral argument on both motions was held and concluded.

4 In opposing the Motions to Dismiss, Tiare included several supplemental affidavits that were not referenced in the Complaint in its opposition to these Motions. Pursuant to Fed.R.Civ.P. 12(d), made applicable hereto by Fed.R.Bankr.P. 7012, if matters outside the pleadings are presented to the court in connection with a motion to dismiss, the motion may be treated as a summary judgment motion under Fed.R.Civ.P. 56. At oral argument, the Court stated that it was not "inclined to treat this as a summary judgment motion." (Tr. at 14). Tiare agreed. (*Id.*). Therefore, I do not consider the supplemental affidavits.

16

903 A.2d 728
Supreme Court of Delaware.

LORILLARD TOBACCO COMPANY, a Delaware corporation, Defendant Below, Appellant/Cross–Appellee,
v.
AMERICAN LEGACY FOUNDATION, a Delaware non-profit corporation, Plaintiff Below, Appellee/Cross–Appellant.

No. 579, 2005
|
Submitted: April 26, 2006.
|
Decided: July 17, 2006.

Synopsis

Background: Non-profit foundation funded with proceeds from Master Settlement Agreement (MSA) between various states and tobacco companies sought declaratory judgment to effect that certain of its advertising conformed to requirements of MSA, as well as injunctive relief against tobacco company. Tobacco company counterclaimed, alleging violation of MSA. On cross-motions for summary judgment, the Court of Chancery, New Castle County, Lamb, Vice Chancellor, entered declaratory judgment for foundation. Tobacco company appealed.

Holdings: The Supreme Court, en banc, Ridgely, J., held that:

[1] abandonment of dictionary definitions of "personal attack" and "vilification" was harmless error;

[2] "personal attack" means a verbal assault conducted in an invidious, disparaging, belligerent, offensive, and fiercely or severely critical manner;

[3] "vilification" means a denouncement that is both unfounded and abusive or slanderous;

[4] advertisements were not personal attacks or vilification of tobacco company or its employees;

[5] refusal to award declaratory relief was not an abuse of discretion; and

[6] foundation was bound by terms of MSA.

Affirmed.

West Headnotes (17)

[1] Compromise, Settlement, and Release Review

Chancery court's error, if any, in abandoning dictionary definitions of "personal attack" and "vilification" as used in Master Settlement Agreement (MSA) between various states and tobacco companies, in favor of definitions provided by legal writers and case law was harmless, for purposes of determining whether anti-tobacco advertisements disseminated by non-profit foundation funded pursuant to MSA violated the no personal attack and anti-vilification provisions of the MSA, given that chancery court's ruling that advertisements were not personal attacks or vilification of tobacco companies or its employees was warranted under the dictionary definition of those terms.

5 Cases that cite this headnote

[2] Appeal and Error De novo review

A court of chancery's grant of summary judgment is reviewed de novo.

[3] Contracts Language of Instrument

State courts look to dictionaries for assistance in determining the plain meaning of terms which are not defined in a contract because dictionaries are the customary reference source that a reasonable person in the position of a party to a contract would use to ascertain the ordinary meaning of words not defined in the contract.

162 Cases that cite this headnote

[4] **Contracts** Intention of Parties

When interpreting a contract, the role of a court is to effectuate the parties' intent.

153 Cases that cite this headnote

[5] **Contracts** Language of Instrument

In construing a contract, the court is constrained by a combination of the parties' words and the plain meaning of those words where no special meaning is intended.

82 Cases that cite this headnote

[6] **Contracts** Language of Instrument

When a contract term's definition is not altered or has no "gloss" in the relevant industry, it should be construed in accordance with its ordinary dictionary meaning.

32 Cases that cite this headnote

[7] **Contracts** Application to Contracts in General

Contracts Extrinsic circumstances

A court must accept and apply the plain meaning of an unambiguous term in the context of the contract language and circumstances, insofar as the parties themselves would have agreed ex ante.

52 Cases that cite this headnote

[8] **Contracts** Language of contract

Contracts Reasonableness of construction

The true test in construing a term in a contract is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant.

51 Cases that cite this headnote

[9] **Compromise, Settlement, and Release** Antitrust, trade regulation, fraud, and consumer protection

For purposes of Master Settlement Agreement (MSA) between tobacco companies and various states, a "personal attack," prohibited in educational advertising under the MSA, means a verbal assault conducted in an invidious, disparaging, belligerent, offensive, and fiercely or severely critical manner.

1 Case that cites this headnote

[10] **Compromise, Settlement, and Release** Health and medical care

For purposes of Master Settlement Agreement (MSA) between tobacco companies and various states, "vilification," prohibited in educational advertising under the MSA, means a denouncement that is both unfounded and abusive or slanderous.

1 Case that cites this headnote

[11] **Compromise, Settlement, and Release** Health and medical care

Anti-tobacco advertisements disseminated by non-profit foundation formed pursuant to Master Settlement Agreement (MSA) between various states and tobacco companies were not "personal attacks" or vilification of tobacco company or its employees in violation of MSA; advertisements disseminated unpleasant facts about the tobacco companies and smoking, statements by youths in the advertisements were not belligerent or fiercely or severely critical of tobacco company or its employees but were friendly and helpful, and advertisements drew attention to past conduct of tobacco companies through innocuous or even helpful sounding offers.

[12] **Declaratory Judgment** Particular Contracts

Chancery court acted within its discretion in refusing to award declaratory relief to tobacco company against non-profit foundation that maintained website that permitted consumers to send negative e-mails to tobacco company employees, in violation of tobacco litigation Master Settlement Agreement (MSA) that

prohibited personal attacks or vilification by foundation that was funded by the tobacco companies pursuant to the MSA, given that tobacco company's direct claim for monetary damages was dismissed for failure to prosecute, injunctive relief was unjustified after foundation removed website e-mail function, and declaratory relief would not terminate the controversy. 10 Del.C. § 6506.

[13] **Declaratory Judgment** Discretion of lower court

A trial court's decision to award declaratory relief is reviewed for abuse of discretion.

[14] **Corporations and Business Organizations** Contracts and indebtedness

Non-profit anti-smoking educational foundation, formed pursuant to Master Settlement Agreement (MSA) between various states and tobacco companies, was bound by anti-vilification and "no personal attacks" provisions of MSA regarding foundation's anti-tobacco advertisements, giving tobacco company standing to sue foundation for alleged violations of those provisions, even though foundation was not a signatory of MSA and had not adopted the MSA, where state attorneys general who signed MSA anticipated formation of foundation and MSA was essentially a preincorporation agreement that benefited foundation by providing funding.

[15] **Corporations and Business Organizations** Liability of corporation for contracts of incorporators and promoters in general

Under Delaware law the doctrine of preincorporation agreements allows a promoter who is establishing a corporation to enter into agreements that bind the nascent corporation.

6 Cases that cite this headnote

[16] **Corporations and Business Organizations** Contracts and indebtedness

The non-profit status of an entity does not affect its contractual duties, and the preincorporation agreement doctrine applies equally to a non-profit entity as it does a for-profit entity.

[17] **Corporations and Business Organizations** Adoption or ratification by corporation or shareholders in general

Corporations and Business Organizations Adoption or ratification by acceptance of benefits

If a subsequently formed corporation expressly adopts the preincorporation agreement or implicitly adopts it by accepting its benefits with knowledge of its terms, the corporation is bound by it.

6 Cases that cite this headnote

***730** Court Below: Court of Chancery of the State of Delaware in and for New Castle County, C.A. No. 19406.

Upon appeal from the Court of Chancery. **AFFIRMED.**

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Before HOLLAND, BERGER, JACOBS, RIDGELY, Justices and GRAVES, Judge,[*] constituting the Court en Banc.

Opinion

RIDGELY, Justice.

Defendant–Appellant Lorillard Tobacco Company appeals the declaratory judgment of the Court of Chancery in favor of the American Legacy Foundation ("ALF") arising from a contract dispute under a Master Settlement Agreement ("MSA") between the nation's largest tobacco companies and forty-six states' attorneys general. Consistent with the terms of the MSA, ALF was created to reduce tobacco usage among youth. ALF sought to do so through advertising which Lorillard contends violates the prohibition in the settlement agreement against "vilification" or "personal attacks" against tobacco companies or their executives. The Vice Chancellor granted ALF's motion for summary judgment and denied Lorillard's cross-motion for summary judgment, holding that all of the advertisements in issue comply with the MSA as a matter of law.

The primary question on appeal is whether any of ALF's advertisements in their "truth®" campaign violate the contractual language of the MSA prohibiting "vilification" or "personal attacks." The truth® campaign informs its audience of reasons to stop smoking and includes references to the conduct of tobacco ***732** companies or their executives. ALF has designed the ads to inform its target audience of manipulative marketing techniques because published research has demonstrated that these types of messages are the most effective ones for discouraging the rebellious, anti-authoritarian segment of young people who otherwise are the most likely segment of the population to begin smoking.[1] Lorillard alleges the campaign vilifies and personally attacks it, tobacco companies generally, and their executives. We agree with Lorillard that the ads do refer to tobacco companies or their executives and in one instance specifically to Lorillard. However, we conclude that Lorillard's appeal is without merit because the campaign's advertisements do not satisfy the plain meaning of "vilification" or "personal attacks." We also conclude that the Vice Chancellor did not abuse his discretion, based on the record before him, when declining to award relief on Lorillard's claim that ALF managed an email server to facilitate personal attacks on Lorillard employees.

ALF has filed a cross appeal, raising the issue of whether it may be sued for alleged breaches of the MSA. The Vice Chancellor held that the tobacco companies may sue ALF for the alleged breaches of the MSA. We agree. Under the preincorporation agreement doctrine, the states who agreed to establish ALF bound the nascent corporation to the terms of the MSA. Since ALF was bound to the terms of the agreement by its incorporators, Lorillard has standing to sue ALF for any breach by ALF of those terms.

Accordingly, we affirm the judgment of the Court of Chancery.

I. Background

A. Background of the American Legacy Foundation ("ALF")

We reiterate the background of this litigation as stated by the Vice Chancellor.[2]

> This litigation arises out of the historic 1998 tobacco settlement between the nation's largest tobacco companies and 46 of the states' attorneys general. In the settlement, the tobacco companies agreed to fund a foundation charged with creating programs to reduce youth tobacco product usage in the United States. As part of its mission, the foundation created a series of television and radio ads under the brand "the truth."
>
> The settlement agreement imposes certain limits on the content of the foundation's activities, including a requirement that its advertising not constitute a "personal attack on, or vilification of" any person or company.
>
> * * *
>
> The defendant is Lorillard Tobacco Company, the oldest tobacco company in the United States and a Delaware corporation. The plaintiff is American Legacy Foundation ("ALF"), a Delaware non-profit corporation formed pursuant to the terms of the Master Settlement Agreement (the "MSA"), a 1998 agreement whereby the nation's largest tobacco companies settled lawsuits brought against them by the attorneys general of 46 states. The MSA requires that the tobacco signatories make collective Base Fund Payments of $25,000,000 per year for nine years. The MSA also requires the tobacco signatories to make collective payments in the amount of $250,000,000 in 1999 and $ 300,000,000 ***733** per year for the next four years for ALF's National Public Education Fund ("NPEF"). These funds have been used by ALF to produce its ad campaigns.
>
> ALF's mission, as originally stated in the MSA and later incorporated into ALF's bylaws, is to educate America's youth about the dangers of tobacco products and to reduce the usage of tobacco products by young people. To fulfill its mission, ALF launched an advertising campaign universally known as "the truth" campaign. This campaign involved various television and radio ads aimed at young people that portray the negative side of tobacco products. To make sure that its ads were effective in reaching young people [specifically those young people who are most likely to smoke, *i.e.,* those who challenge authority], ALF purposefully made them edgier and more confrontational than regular television and radio ads. Many ads could be described as "in your face" and "eye-catching."
>
> The funding provided to ALF pursuant to the MSA did not come without restrictions. A majority of ALF's funding was earmarked for the public's education (*i.e.* advertising), and the content of that advertising is made subject to both requirements and prohibitions. The MSA required that the advertising concern only the "addictiveness, health effects, and social costs related to the use of tobacco products." The MSA also prohibited the advertising from being a personal attack or a vilification of tobacco company employees or tobacco companies.

Section VI of the MSA entitled "Establishment of a National Foundation" is at issue in this appeal. Subsection VI(h) establishes the prohibition that the advertising "shall not be used for any personal attack on, or vilification of, any person (whether by name or business affiliation), company, or governmental agency, whether individually or collectively." The MSA does not define the terms "personal attack" or "vilify."

B. The ALF advertisements

Lorillard claims the advertisements of the truth® campaign violate Subsection VI(h) of the MSA and focuses on four examples of ads titled: "Shredder," "Hypnosis," "Lie Detector," and "Dog Walker." We have carefully considered these examples and the other ads in the record before us and find no merit to Lorillard's claims that ALF has breached the MSA.

Our analysis begins with a summary of the examples Lorillard has cited. In "Shredder," a cargo truck with the "truth®" logo tows a large machine labeled "Shredder 2000" and stops in front of an office building on a city street. The words "Outside a major tobacco company." appear at the bottom of the television screen. Although the building is Philip Morris's New York City headquarters, the advertisement does not directly disclose its identity or even the city where the ad takes place. Even so, it is conceivable that at least some New Yorkers would recognize the building as the headquarters of Phillip Morris. At various times in the advertisement, people are visible inside the building, but their faces have been pixilated to protect their identity. Two youths stand beside the towed machine, a large wood chipper. The youths use megaphones to address employees in the building. The first announces, "Attention tobacco manufacturers! Do you have a

lot of embarrassing reports lying around the office? You can't just leave that job to any paper shredder, you need Shredder 2000!" The other youth agrees, "That is right, folks. You need Shredder 2000 to use on documents like this research report from 1981 that says 'Today's teenager is tomorrow's potential regular customer.' " He ***734** then runs to the mouth of the shredder with a paper report and throws it into the teeth, shredding it. The first youth then asks "Or this report where you actually gauge smoking patterns of sixth graders?" He proceeds to shred the report while the second youth asks another question, "And you know what folks? With the Shredder 2000, you don't even have to take those highly confidential files out of the cabinets." Two more people carry a four-drawer file cabinet to the mouth of the shredder. "You can just throw the whole darned thing in." They shred the entire filing cabinet. "The whole filing cabinet!" exclaims the second youth. The first youth then exclaims, "Heck yeah, and even your briefcase! Shredder 2000 shreds it all!" A man in a hard hat feeds a briefcase into the shredder. The first youth continues, "More effectively, quicker, better than any shredder in this building. Am I right?" The second youth replies, "You are right!" The first youth continues, "I guarantee it!" The second youth asks, "And you know those top secret files you had on your computer? Just throw the whole computer in. It's gone." A computer monitor is shredded. The first youth confirms, "Completely gone. You need Shredder 2000!" While the two youths dance behind the shredder, the ad concludes with a voice that says "Shredder 2000—now available in regular and king-size."

In "Hypnosis," three youths are driving a truck at night. The words "Somewhere in tobacco suburbia." appear at the bottom of the television screen. One youth says, "I'm feeling the vibe, Man. We're going to find these tobacco guys." They stop the van at a convenience store. They ask a passing pedestrian, "Hey, Man. Do you know if there are any tobacco executives around here?" They stop the van at a fast-food, drive-through window. Through the ordering microphone, they ask the employee, "Do you know if any tobacco executives live around here?" There is no reply. Another pedestrian gives directions, "Go three blocks down, make a left. You'll see some big houses." The youths attempt to confirm the directions, then unfold a map. They drive the van past very large, well-lit houses with large yards. One youth exclaims in awe, "Look at the size of the houses." Another youth replies, "I guess working for an industry that kills over a thousand people a day, ah, pays pretty well." One youth says, "We gotta help these people, Man. Turn on the tape." The youth driving the van agrees, "Yeah. Yeah. Cue the tape." There is a reel-to-reel tape player mounted inside the van. Loudspeakers fixed to the top of the van issue a woman's loud but soothing voice. "I am a good person. Selling a product that kills people makes me uncomfortable. I realize cigarettes are addictive." One youth comments, "It looks like money is addictive, too." The voice continues over the van's loudspeakers, "...kill over four hundred and thirty thousand people each year. Tomorrow I will look for a new job. I will be less concerned with covering my butt and more concerned with doing the right thing." The ad ends with a youth announcing that they are "just trying to help." The voice begins to repeat as the van continues driving through the upscale neighborhood. There is no indication of the city where the ad was filmed.

In "Lie Detector," several youths enter a large, corporate building. The words "Inside a major tobacco company." appear at the bottom of the television screen. The building is the headquarters of Phillip Morris, but as in "Shredder," the advertisement does not directly disclose its identity or location. The name of the building is pixilated to mask it. Again, it is conceivable that at least some New Yorkers would recognize the building as the headquarters of Phillip Morris. One youth announces to the guard at the front desk that ***735** "we have a delivery for the marketing department." The faces of the guards and everyone but the youths are pixilated to hide their identity. The guard asks, "Who are you here to see?" Another youth clarifies, "the VP of marketing." The first youth continues, "You can just tell her we're dropping off a lie detector." They place a large case labeled "lie detector" on the guard's desk. The camera cuts to a woman dressed much as the guards are dressed; her face is pixilated. One of the youths asks, "Hi, are you Rita?" She replies, "No." The youth continues, "We just thought you'd know if Rita was in." The woman says, "I already answered that. Alright? You can have a seat, or you can leave." The youths sit in the lobby and wait. A man appears in a light suit; his face is also pixilated. One youth says, "Hey, look at this guy." The first youth says, "You're not Rita." He shakes the youth's hand, "OK. Can I help you?" The youth explains, "We have a lie detector to clear up the confusion.... Your company has said that nicotine isn't addictive, and then you say that it is." The man asks, "Do you have an appointment with anyone in particular?" The youth replies, "We were told to come to see Rita." The man interrupts, "Leave her a voice mail." The youth cheerfully agrees, "OK. Great." She calls from the front desk and says into the phone, "Hi, Rita.... I just wanted to drop off a lie detector." She looks away from the phone, "She hung up on me.... Maybe it was the wrong Rita." The security guards ask

them to leave. While walking backwards to the front door, the youth explains, “OK. We're leaving, but your company has said that nicotine isn't addictive, and then you say that it is, and we're just trying to get at the truth.”

“Dog Walker” is a radio ad and begins with the ringing of a telephone. A woman answers, “Good afternoon, Lorillard.” The caller says, “Hello, Ma'am. My name is John, and I was hoping I could talk to someone about a business idea.” The woman asks, “What is the nature of this business, though?” The caller announces that, “I'm a professional dog walker by trade, and my dogs, they pee a lot, usually on—like—fire hydrants and people's flower beds. I thought, why not collect it and sell it to you tobacco people? Well, see, dog pee is full of urea, and that's one of the chemicals you guys put into cigarettes, and I was just hoping to make a little extra spending cash.... I can send you some samples. I got Chihuahua, Golden Retriever, some high-test Rottweiler pee. It's all good stuff.” She then transfers the caller to someone else, who answers the phone with his full name, heard clearly in the ad and not edited or omitted from it. The person hangs up on him at the mention of his “pee proposal.” An announcer concludes the commercial, stating, “You've been infected with a powerful contagion. Truth exposes the tobacco industry's deceptions to the light of day. And it spreads. The truth outbreak tour is here. Check out the truth dot com. Infect truth.”[3]

C. The ALF website

ALF maintained a website with an email server where visitors could complete a pre-formatted email to actual tobacco company employees by adding adjectives, verbs, and nouns. For example, one form email read:

> Dear Mr. Big Tobacco Executive,
>
> I just wanted to say that I think the way your _____ cigarette company has deceived the world really _____, and I don't understand how you can _____ with yourself selling a _____ product like cigarettes.
>
> It's bad enough that you _____ at _____ knew that smoking ***736** your cigarettes caused cancer, and kept selling them anyways, but then to be deceptive about what you knew and _____ try to cover it up is just plain _____.
>
> I also wanted to know—was it worth it? How many _____ have you been able to buy with all the money you've made addicting people to nicotine? How could all your _____ ever make up for the _____ of suffering you've caused smokers and their families as you got _____ rich hooking them on a deadly product?
>
> Just remember, in the end we _____ what we _____.
>
> May the lord have mercy on your pathetic _____.

ALF placed a warning of the website against the use of profane or harassing messages. Employees at Lorillard and other companies received these emails, sometimes containing profanity despite ALF's warning. Many emails sent to and read by tobacco company employees were malevolent. At a cost of less than $1,000 Lorillard quickly installed a filter that shielded its employees from emails sent by visitors to the website. ALF then removed this e-mail feature from its website.

D. The Court of Chancery's Declaration

The Court of Chancery held that the advertisements did not violate Subsection VI(h)'s ban on personal attacks. The court further held that the advertisements did not vilify any person or company, either individually or collectively.

To define “vilify” in the context of the MSA, the Court of Chancery did not use any dictionary. While the court referenced the parties' own usage of dictionary definitions as one of the means to define “vilify,” it expressly declined to do so in this case.[4] The court explained, that although “dictionary definitions are helpful and instructive, they are not precedent and this court need not rely on them, especially when, as in this case, there are sufficient usages in legal opinions to inform the court as to whether the advertisements in question violate the MSA.”[5]

The Vice Chancellor then looked to a variety of sources including Delaware court decisions,[6] United States Supreme Court decisions,[7] federal court decisions,[8] and other legal sources.[9] After reviewing ***737** a wide range of legal sources, the Vice Chancellor distilled a definition of “vilify” from the uses of the words by the particular authors of these writings. He concluded that:

> the state and federal case law, as well as law reviews, support a view of vilification that is consistent with

> Delaware law. First, on a textual level, the words of vilification are stronger than disparagement. Second, on a contextual level, the term "vilification" is most often used to describe situations that implicate serious social issues, such as race or gender relations.
>
> While the overwhelming majority of legal sources show a consistent use of "vilification" that is stronger than mere disparagement and frequently "vilification" is used in serious social contexts, there are a small minority of cases that appear to use "vilify" in a watered-down manner....[10]

The Vice Chancellor placed primary reliance on Delaware court decisions using the word "vilification" concluding that:

> Delaware courts have used "vilification" in conjunction with words like blasphemy, licentiousness, hatred, contempt, and ridicule. "Vilification" has also been used in two related cases that concerned an alleged fraud by swindlers who perhaps should have been put in jail. From these sources, it is clear that Delaware law regards vilification as stronger (*i.e.* more contemptuous or malicious) than disparaging someone.[11]

He then incorporated factors into this high threshold that included the truthfulness of the advertisements and their tone and concluded that the advertisements at issue did not violate Subsection VI(h)'s ban on vilifying persons or companies.

To define "personal attack" the Vice Chancellor again looked to uses of this term by authors in sources other than dictionaries as he did with his analysis of "vilify." He noted that some courts have used "personal attack" in three distinct legal contexts: referring to 1) physical violence; 2) courtroom behavior; and 3) "communications that occur outside of the courtroom."[12] He adopted the third category of "personal attack," for his analysis in this case.

After recognizing the scarcity of "personal attack" cases in both Delaware and United States Supreme Court jurisprudence,[13] the Vice Chancellor noted that "federal courts use the phrase 'personal attack' when categorizing statements that include comparing people to terminal illnesses or alleging that they are criminals."[14] In other words, the authors of both federal and state case decisions use ***738** "personal attack" to mean more than mere criticism. The Vice Chancellor concluded:

> [T]he term "personal" in the MSA's "personal attack" consists of two parts. The first part concerns the target's private characteristics, such as, for an individual, amorality. The second part concerns the specific identification of the target. Case law clearly supports the interpretation that the target must be identified. The court finds that such identification must be specific to a particular person or company. Calling the tobacco companies "the tobacco industry" or "Big Tobacco" does not identify the signatories to the MSA in a specific enough manner to be violative of Section VI(h) of the MSA. Lorillard could have, but did not, achieve a broader prohibition in the MSA by referring to "Big Tobacco" or the tobacco industry specifically. It did not, and there is no reason to suppose that the 46 attorneys general would ever have agreed to such language.[15]

Applying this definition of "personal attack," he stated that Lorillard had the burden of demonstrating that there was an attack and that the attack was personal on it specifically. The Vice Chancellor found that advertisements did not violate the personal attack provision of Subsection VI(h). With respect to the email-generating server managed by ALF, he found that the emails did constitute "personal attacks" but declined to award any damages or injunctive relief because the violation was *de minimis*.[16]

II. The MSA does not prohibit the truth® campaign advertisements.

[1] [2] [3] We review the Court of Chancery's grant of summary judgment *de novo*.[17] Lorillard's primary claim on appeal is that the Court of Chancery legally erred in the procedure it used to define the terms "personal attack" and "vilify" and, in so doing, erroneously granted summary judgment in favor of ALF. Lorillard insists that the Vice Chancellor should have used the dictionary definitions of "vilification" and "personal attack" to determine the plain meaning of these terms. We agree that the Vice Chancellor's abandonment of all dictionaries and his innovative review of how legal writers have used ordinary words in their texts to ascertain the plain meaning of the words are not supported by precedent. Under well-settled case law, Delaware courts look to dictionaries for assistance in determining the plain meaning of terms which are not defined in a contract.[18] This is because dictionaries are the customary reference source that a reasonable person in the position of a party to a

contract would use to ascertain the ordinary meaning of words not defined in the contract. Dictionary definitions change over time, provide the contemporary meaning of ordinary words, and note when a particular definition of a term has become obsolete.[19] Assuming, ***739** without deciding, that the Vice Chancellor erred in not using dictionaries in this case, we find that this error was of no moment, *i.e.* harmless, because the plain meaning of the terms "personal attack" and "vilification" shown by dictionary definitions still requires the entry of summary judgment in favor of ALF.

[4] **[5]** When interpreting a contract, the role of a court is to effectuate the parties' intent. In doing so, we are constrained by a combination of the parties' words and the plain meaning of those words where no special meaning is intended.[20] In *Rhone–Poulenc,* this Court explained the paramount importance of determining what a reasonable person in the position of the parties would have thought the language of a contract means.

> Clear and unambiguous language ... should be given its ordinary and usual meaning. Absent some ambiguity, Delaware courts will not destroy or twist policy language under the guise of construing it. When the language of a ... contract is clear and unequivocal, a party will be bound by its plain meaning because creating an ambiguity where none exists could, in effect, create a new contract with rights, liabilities and duties to which the parties had not assented....
>
> A contract is not rendered ambiguous simply because the parties do not agree upon its proper construction. Rather, a contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings. Ambiguity does not exist where a court can determine the meaning of a contract without any other guide than a knowledge of the simple facts on which, from the nature of language in general, its meaning depends. Courts will not torture contractual terms to impart ambiguity where ordinary meaning leaves no room for uncertainty. The true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant.[21]

A. The advertisements do refer to persons by business affiliations, to tobacco companies collectively, or to Lorillard.

Subsection VI(h) of the MSA refers to a personal attack on or vilification of a person, company or governmental agency. If ***740** the ad does not refer to a person, company, or governmental agency, the prohibition cannot apply. Here, the ads do refer to a person or company, *either individually or collectively.* We disagree with the Vice Chancellor's conclusion that they do not.

In the Shredder and Lie Detector ads, the settings were expressly "outside" and "inside a major tobacco company." In Hypnosis, one of the youths refers to "these tobacco guys" in a setting "somewhere in tobacco suburbia." In Lie Detector, the youths repeatedly ask for an individual employee by what sounds like her first name, audible in the ad. In Dog Walker, a woman answers "Good afternoon, Lorillard," and the caller explains to the Lorillard employee that "you tobacco people" put urea, a chemical found in dog urine, into cigarettes; the announcer concludes saying, "Truth exposes the tobacco industry's deceptions...."

We agree with Lorillard that ALF's advertisements expressly and impliedly referred to specific companies, the collective tobacco companies, and in one case, to a specific employee by name. The headquarters of Phillip Morris appears in two of the ads. When the evidence is viewed in a light most favorable to the non-moving party as is required on summary judgment, we conclude that advertisements of the truth® campaign did refer to a person (whether by name or business affiliation), tobacco companies collectively, and in one instance to Lorillard. Since they did, we must determine if the ads are "personal attacks" or "vilification" in violation of the MSA. If they are not, we must affirm the Vice Chancellor's ultimate conclusion that the ads do not violate Subsection VI(h) of the MSA.

B. The advertisements are not "personal attacks" or "vilification."

1. The plain meaning of the terms

[6] **[7]** **[8]** When a term's definition is not altered or has "no 'gloss' in the [relevant] industry it should be construed in accordance with its ordinary dictionary meaning."[22] There may be more than one dictionary definition, and parties may disagree on the meaning of the definition as applied to their case, but "if merely applying a definition in the dictionary suffices to create ambiguity, no term would be unambiguous."[23] A court must accept and apply the plain meaning of an unambiguous term in the context of the

contract language and circumstances, insofar as the parties themselves would have agreed *ex ante*.[24] As we have stated before, the "true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant."[25]

***741** Lorillard would have us define "personal attack" as "negative criticism and negative portrayal of the characteristics, traits, ethics or conduct of tobacco companies or their employees," and "vilification" as "expressions that disparage, depreciate or lower the standing of tobacco companies or their employees."[26] Lorillard cites several dictionaries to define "personal"[27] and "attack,"[28] and to define "vilification."[29] Lorillard further contends that "vilification" does not require defamation and is not determined by tone. Finally, Lorillard cites two cases from other jurisdictions defining "vilification."[30] However, both of these cases involved political speech and the First Amendment. We do not find them persuasive in resolving the issue of contract interpretation which is before us.

ALF contends that "vilification" refers to an "abusive statement about the target that is false or unfair." ALF would define "personal attack" as "a bitter or hostile verbal assault on a person identified by name or business affiliation relating to an individual's private life." In other words, ALF contends that the modifier "personal" requires an expressly named target, but neglects to explain why Subsection VI(h) contains an additional modifier "whether individually or collectively." We construe this additional language to mean that no express target is required if the target is collectively identified.

***742** **[9]** **[10]** It is apparent from the dictionary citations provided by Lorillard that a "personal attack" in the context of Section VI is a verbal assault conducted in an invidious, disparaging, belligerent, offensive, and fiercely or severely critical manner.[31] Likewise, the meaning of "vilification," according to Lorillard's own dictionary citations, is a statement that is slanderous, defamatory, or abusive that unjustly denounces its target.[32] The core ordinary meaning of vilification is a denouncement that is both unfounded and abusive or slanderous.

2. Application of the MSA to the advertisements

[11] With the boundaries established by Section VI of the MSA in mind, we turn to whether the advertisements before us violate that provision. They do not. The advertisements are not invidious, disparaging, offensive, belligerent, nor fiercely or severely critical. Nor are they denouncements that are both unfounded and abusive or slanderous. The tone of the youth in the advertisements is usually expressly friendly or helpful, even if implicitly drawing attention to unflattering facts about past actions of tobacco companies or their employees. The youth's messages, and thus the advertisements themselves, do not qualify as personal attacks or vilifications. To illustrate the basis for our conclusions, we will use the same four advertisements that Lorillard has presented as examples of breaches of contract by ALF.

In "Shredder," the youths are salesman expressly offering help to an unnamed tobacco company. They are seeking to sell a tobacco company a machine that it could use based on its history and possible need of shredding many documents. At no point do the youths expressly criticize the company for the contents of the documents or the possibility of shredding them. They reveal no disparaging behavior, belligerence, or fierce criticism. Throughout the advertisement, the youths refer to only two publications. The first report contains the phrase, "Today's teenager is tomorrow's potential regular customer." The second report "gauges smoking patterns of sixth graders." Lorillard does not dispute that these reports exist. The youths do not expressly criticize the company for the reports, nor do they unjustly denounce the company for having them. They merely call the reports "embarrassing." They attempt only to sell their shredder to the company because they appear to assume that the company would want to shred the reports. The advertisement may be effective at disseminating an unpleasant fact about an unnamed tobacco company, but it does not amount to a personal attack or vilification.

"Hypnosis" also portrays the youths as helpful. There are several statements that, while critical of the effects of tobacco, are not belligerent, or fiercely or severely critical of the tobacco companies or employees. For instance, one youth observes that "working for an industry that kills over a thousand people a day, ah, pays pretty well." Lorillard does not contend that tobacco-related disease does not kill over a thousand people a day, nor does it contend that its executives are not well paid. The youth's statement is immediately followed by insistence that the youths "help these people," reiterated at the end of the commercial. The closest statement to a personal attack or vilification is the implication that a tobacco executive needs to be "less concerned with covering [their] butt[s] and more concerned with doing the right thing." However, the message again is not slanderous or defamatory,

abusive, ***743** offensive, belligerent, or fiercely or severely critical. As with "Shredder," the "Hypnosis" advertisement may be effective at stating unpleasant facts such as tobacco "kill[ing] over four hundred and thirty thousand people each year," but it does not amount to a personal attack or vilification.

"Lie Detector" shows the attempts of several youth to deliver a lie detector to "a major tobacco company." The entire message of the advertisement is crystallized when a youth explains, "We have a lie detector to clear up the confusion. Your company has said that nicotine isn't addictive, and then you say that it is." This statement simply asserts that tobacco companies have made contradictory statements. The assertion is not presented in a disparaging, offensive, or belligerent manner. It is not fiercely or severely critical. Lorillard does not deny that a tobacco company at one time stated that nicotine is not addictive and then later stated that it is. The contention is not a denouncement that is either unfounded or slanderous. The youths are not abusive, but are merely pleading to see a certain employee. When asked to leave, they leave. We conclude that this advertisement also fails to meet the definition of personal attack or vilification.

The caller in "Dog Walker" maintains an expressly helpful tone throughout the advertisement. His tone is not belligerent, critical, argumentative, disparaging, or offensive. Even though "Dog Walker" involves a bizarre offer to sell dog urine and begins by identifying the company called as Lorillard, the caller simply makes a factually accurate assertion that cigarettes often include a chemical that is also found in dog urine. The caller does not accuse the company of adding dog urine to cigarettes. Although the Lorillard employee hangs up on the caller, there is no personal attack or vilification of Lorillard or its employees.

While the MSA creates real restrictions on ALF's advertisements, we conclude that the advertisements presented to us from ALF's truth® campaign fall within the MSA's restrictions, and do not exceed them. Merely drawing attention to the past conduct of tobacco companies through innocuous and even helpful-sounding offers such as those heard in "Shredder," "Hypnosis," "Lie Detector," and "Dog walker," is not a personal attack or vilification prohibited by the MSA.

C. The Court of Chancery acted within its discretion when it declined to award relief for ALF's website.

[12] **[13]** We review a trial court's decision on whether to award declaratory relief for abuse of discretion.[33] The Court of Chancery accepted as true that ALF at one time managed an email server that facilitated receipt by Lorillard employees of emails with expletives and that Lorillard quickly and effectively erected a filter blocking the emails for under $1,000. The Court then stated that these emails were personal attacks on individual employees in violation of Subsection VI(h).[34] Lorillard had a direct claim for requested monetary damages for its cost of blocking the emails was contained within Count V of its amended counterclaims ("Trespass to Chattel") but this claim was dismissed by the Vice Chancellor for failure to prosecute.[35] The Vice Chancellor did not award injunctive relief because the web site function allowing the emails to be sent had been removed.

***744** Under the Declaratory Judgment Act, "[t]he court may refuse to render or enter a declaratory judgment or decree where such judgment or decree, if rendered or entered, will not terminate the uncertainty or controversy giving rise to the proceeding."[36] No tobacco company employee who received the emails participated in this case. We conclude that on the record presented, the Court of Chancery acted well within its discretion when it declined to award declaratory, injunctive or monetary relief to Lorillard for the defunct ALF website activities which were directed to tobacco company employees.

III. Lorillard has standing to sue for ALF's breach of the MSA.

ALF has filed a cross-appeal in this case. First, ALF claims that its activities are not subject to the "vilification" and "personal attack" restriction of the MSA Subsection VI(h). Second, it claims that Lorillard may not enforce either the MSA or ALF's own bylaws against it.

ALF claims that the MSA imposes the vilification and personal attack restriction only on the funds in the National Public Education Fund, and not on funds derived from Base Foundation Payments. ALF contends that it has no liability for ads funded by Base Foundation Payments whether or not they vilify or personally attack. We need not address this claim because in this decision we have held that the advertisements are not vilifications or personal attacks.

[14] ALF next challenges the determination by the Court of Chancery that Lorillard had standing to sue ALF under the MSA, despite ALF not being a signatory to that agreement. ALF claims that the Court erroneously concluded that ALF could be held liable under the MSA since it was neither a signatory to the contract nor ever adopted it. It contends that the States who created ALF have the sole responsibility to seek a remedy for any vilification or personal attack. Further, the only legal mechanism that the MSA contemplated to prevent vilification or personal attacks by ALF was ALF's own bylaws, not lawsuits by the tobacco company signatories. Therefore, it argues that only the States who established ALF, not the tobacco companies, may enforce ALF's bylaws.

[15] The Court of Chancery held that ALF's formation was like that of a nascent corporation and applied the doctrine of preincorporation agreements:

> American courts generally hold that promoters' contracts made on the corporation's behalf may be adopted, accepted or ratified by the corporation when organized, and that the corporation is then liable both at law and in equity, on the contract itself, and not merely for the benefits which it has received. Accordingly, if the corporation accepts the contract's benefits, the corporation will be required to perform its obligations.[37]

Thus, under Delaware law the doctrine of preincorporation agreements allows a promoter who is establishing a corporation to enter into agreements that bind the nascent corporation.[38]

[16] The doctrine applies here because the state attorneys general establishment of ALF meets the elements of a promoter's formation of a corporation, albeit a ***745** non-profit one. The MSA's payment provisions show the parties intended that ALF be bound by the MSA provisions. ALF contends that the doctrine does not apply because this situation is atypical for several reasons, most of which stem from ALF's status as a non-profit entity. The non-profit status of an entity does not affect its contractual duties, and the preincorporation agreement doctrine applies equally to a non-profit entity.

The Vice Chancellor found that "the MSA in fact contemplates that ALF will adopt [it]."[39] We agree. The Vice Chancellor explained:

> One could almost conclude that the MSA *expressly* contemplates ALF's adoption because it provides for ALF's creation and funding, it requires ALF's board to be comprised of a predetermined group of people, and it places significant restrictions on ALF's activities. The Settling States (through NAAG) then obligated ALF, through provisions in ALF's bylaws and Certificate of Incorporation, to comply with the MSA, and the tobacco companies performed their part by providing the required funds.[40]

The Vice Chancellor then enumerated "several express provisions of the MSA that manifest the MSA's signatories' expectation that ALF would ultimately adopt it."[41] We conclude, as did the Vice Chancellor, that "the MSA should be viewed, as a matter of law, as expressly contemplating ALF's adoption."[42]

[17] "Under Delaware law, if the subsequently formed corporation expressly adopts the preincorporation agreement or implicitly adopts it by accepting its benefits with knowledge of its terms, the corporation is bound by it."[43] ALF is required to perform its obligations and can be held liable if found to have breached the MSA. The cross-appeal of ALF is without merit.

IV. Conclusion

The judgment of the Court of Chancery is AFFIRMED on appeal and cross-appeal.

All Citations

903 A.2d 728

Footnotes

* Sitting by designation pursuant to Art. IV, § 12 of the Delaware Constitution and Supreme Court Rules 2 & 4.

1 Lisa K. Goldman & Stanton A. Glantz, *Evaluation of Antismoking Advertising Campaigns,* 279 J. AM. MED. ASS'N. 772, 774 (March 11, 1998).

2 *Am. Legacy Found. v. Lorillard Tobacco Co.,* 886 A.2d 1, 7–8 (Del.Ch.2005).

3 *Lorillard Tobacco Co.,* 886 A.2d at 11–12, 14 (footnotes omitted).

4 *Id.* at 19.

5 *Id.* The Vice Chancellor also stated that "[i]f the court were to rely on dictionary definitions in this case, the court suspects that the litigation would devolve into an argument about the meaning of the words in the definition itself." *Id* at 39.

6 *Id.* at 21 citing *State v. Chandler,* 2 Del. 553, 577–78, 2 Harr. 553 (Del. Ct. of General Sessions 1837); *Rice v. Simmons,* 2 Del. 417, 428, 2 Harr. 417 (1838); *Layton v. Harris,* 3 Del. 406, 407, 3 Harr. 406 (Del.Super.Ct.1842); *Croasdale v. Bright,* 11 Del. 52, 59, 6 Houst. 52 (Del.Super.Ct.1880); *Del. State Fire & Marine Ins. Co.v. Croasdale,* 11 Del. 181, 195, 6 Houst. 181 (1880); *Capano v. State,* 781 A.2d 556, 668 (Del.2001) *aff'd in part and rev'd in part on other grounds,* 889 A.2d 968 (Del.2006).

7 *See id.* at 22 (citing, *inter alia, Phila. Newspapers v. Hepps,* 475 U.S. 767, 106 S.Ct. 1558, 89 L.Ed.2d 783 (1986); *NY Times v. Sullivan,* 376 U.S. 254, 84 S.Ct. 710, 11 L.Ed.2d 686 (1964); *Cantwell v. Connecticut,* 310 U.S. 296, 60 S.Ct. 900, 84 L.Ed. 1213 (1940)).

8 *See id.* (citing *Gibson v. Mayor & Council of Wilmington,* 355 F.3d 215, 227 (3d Cir.2004); *Spriggs v. Diamond Auto Glass,* 242 F.3d 179, 182 (4th Cir.2001); *United States v. Burke,* 80 F.3d 314, 317 (8th Cir.1996); *State v. Michaels,* 136 N.J. 299, 642 A.2d 1372 (N.J.1994)).

9 *See id.* at 24 (citing foreign state court decisions, law review articles, and other secondary sources such as Note, *Group Vilification Reconsidered,* 89 YALE L.J. 271, 308 (1979); Note, *Statutory Prohibition of Group Defamation,* 47 COLUM. L.Rev. 595, 609 (1947); *Village of Skokie v. Nat'l Socialist Party of Am.,* 51 Ill.App.3d 279, 366 N.E.2d 347, 9 Ill.Dec. 90 (Ill.App.1977), *aff'd in part and rev'd in part,* 69 Ill.2d 605, 373 N.E.2d 21, 14 Ill.Dec. 890 (Ill.1978); *Neiman–Marcus v. Lait,* 13 F.R.D. 311, 312 (S.D.N.Y.1952)).

10 *Id.* at 25.

11 *Id.* at 26. The court did, of course, rely on the aforementioned references as well.

12 *Id.* at 33–36, n. 140, n. 152 (citations omitted).

13 *Id.* The court cited *Skouras v. Admiralty Enter., Inc.,* 386 A.2d 674, 679 (Del.1978) as "label[ing] as a personal attack letters from the plaintiff to various governmental and business entities that threatened charges of wrongdoing by the defendant's directors and officers. The letters appear to be sent in connection with allegations of fraud, tax evasion, and corporate mismanagement." Additionally, the court cited to the United States Supreme Court decision in *Hazelwood School Dist. v. Kuhlmeier,* 484 U.S. 260, 276, 108 S.Ct. 562, 98 L.Ed.2d 592, (1988).

14 *Lorillard Tobacco Co.,* 886 A.2d at 35 (citations omitted).

15 *Id.* at 40–41.

16 *Id.* at 44 (citations and footnotes omitted).

17 *See Rhone–Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.,* 616 A.2d 1192, 1195 (Del.1992) (citing *Aetna Cas. and Sur. Co. v. Kenner,* 570 A.2d 1172, 1174 (Del.1990)).

18 *See, e.g., Northwestern National Ins. Co. v. Esmark, Inc.,* 672 A.2d 41, 44 (Del.1996) (using AMERICAN HERITAGE DICTIONARY (1969) to define "under" as "within the group or classification of" without further comment); *Hibbert v. Hollywood Park, Inc.,* 457 A.2d 339, 343 n. 3 (Del.1983) (using Webster's New International Dictionary (2d ed. unabr.1951) to define "party" without further comment); *The Cove on Herring Creek Homeowners' Ass'n v. Riggs,* Del.

Ch., C.A. No. 02024–S, 2005 WL 1252399, Noble, V.C., 2005 Del. Ch. LEXIS 71, *5 (May 19, 2005) (applying definition from WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (1993) to unambiguous, but disputed, language in a contract).

19 Courts have recognized that definitions can become obsolete. *See, e.g., Kelly v. Estate of Johnson,* 788 N.E.2d 933, 935 (Ind.Ct.App.2003) (after each party cited numerous sources, including dictionaries, case law, and the opinion of an auctioneer/appraiser, to support his or her version of the meaning of "furniture," the court recognized that "there is in fact a wide divergence in the meaning given to 'furniture' across sources. Interestingly, it appears that the definition of the term has, to some extent, changed over time. Older sources tend to interpret furniture as all the items in a room, including china, lamps, paintings, and candlesticks.... Newer sources tend to interpret furniture to mean only large movable items, such as chairs, couches, desks, cabinets, and tables."); *Marriott Corp. v. Combined Properties Ltd. Partnership,* 239 Va. 506, 391 S.E.2d 313 (Va.1990) (The trial court determined that the phrase "drive-in food establishment" in 1967 referred to a food establishment that permitted customers to eat food in their cars while parked in the establishment's lot. However, a possible 1990 definition of "drive-in" restaurant might be an establishment with a drive-through window where customers could order food to go. Ultimately, the Court applied the definition as contemplated by the parties in 1967 and affirmed.).

20 *See Northwestern National Ins. Co. v. Esmark, Inc.,* 672 A.2d 41, 43 (Del.1996) (citing *E.I. duPont de Nemours and Co., Inc. v. Shell Oil Co.,* 498 A.2d 1108, 1113 (Del.1985)).

21 *Rhone–Poulenc,* 616 A.2d at 1195–96 (quotations and citations omitted).

22 *USA Cable v. World Wrestling Fed'n. Entm't, Inc.,* 766 A.2d 462, 474 (Del.2000) (using RANDOM HOUSE UNABRIDGED DICTIONARY (2d ed.1993); MERRIAM WEBSTER'S COLLEGIATE DICTIONARY (10th ed.1997) to define "regularly").

23 *Monsanto Co. v. Aetna Casualty & Sur. Co.,* Del.Super. Ct., No. 88C–JA–118, 1994 WL 146005, Ridgely, P.J., 1994 Del.Super. LEXIS 172, *11 n. 5 (quoting *Fireman's Fund Ins. Cos. v. Ex–Cell–O Corp.,* 702 F.Supp. 1317, 1324 (E.D.Mich.1988)). *See E.I. du Pont de Nemours & Co. v. Admiral Ins. Co.,* 711 A.2d 45, 59 (Del.Super.Ct.1995) ("If the mere existence of different dictionary definitions constitutes an ambiguity, drafting unambiguous contractual language would be impossible without defining almost every word. Standing alone, multiple dictionary definitions do not prove all differing definitions are reasonable.") (citations omitted).

24 *See Duncan v. TheraTx, Inc.,* 775 A.2d 1019, 1021 (Del.2001) (courts should apply the rules that "generally reflect the contract term that most parties would have bargained for at the time of the agreement") (citations omitted); *Rhone–Poulenc, infra*.

25 *Rhone–Poulenc Co.,* 616 A.2d at 1196 (citing *Steigler v. Insurance Company of North America,* 384 A.2d 398, 401 (Del.1978)).

26 Appellant's opening brief, p. 18–19.

27 Appellant's opening brief, p. 29. *See* ENCARTA WORLD ENGLISH DICTIONARY, 1346 (1999) ("*That personal remark was definitely uncalled for.*") (emphasis added); WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE, 1686 (1993) ("*relating to an individual,* his character, conduct, motives, or private affairs esp. *in an invidious and offensive manner.*") (emphasis added); THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE, 1445 (2d ed.1987) ("referring or *directed to a particular person* in a *disparaging or offensive* sense or manner, usually involving character, behavior, appearance etc.") (emphasis added).

28 Appellant's opening brief, p. 28. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE, 140 (1993) ("An assault with *unfriendly or bitter* words") (emphasis added); MERRIAM–WEBSTER'S COLLEGIATE DICTIONARY, 74 (10th ed. 1995) ("Assault. A *belligerent or antagonistic* action.") (emphasis added); THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE, 118 (3d ed. 1992) ("An expression of *strong criticism; hostile* comment") (emphasis added); THE NEW OXFORD AMERICAN DICTIONARY, 102 (2001) ("*Criticize* or oppose *fiercely and publicly.*") (emphasis added); THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE, 133 (2d ed.1987) ("*criticize severely;* argue with strongly") (emphasis added).

29 Appellant's opening brief, p. 33. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE, 2552 (1993) ("To make less valuable or important: lower in estimation.... To utter *slanderous and abusive* statements against: *denounce unjustly* or abuse as hateful or vile") (emphasis added). MERRIAM–WEBSTER'S COLLEGIATE DICTIONARY, 1317 (10th ed. 1995) ("To lower in estimation or importance. To utter *slanderous and abusive* statements against") (emphasis added); XIX OXFORD ENGLISH DICTIONARY, 630 ("To depreciate with *abusive or slanderous* language; to defame or traduce; to speak evil of") (emphasis added); THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE, 1992 (3d ed. 1992) ("To make *vicious and defamatory* statements about") (emphasis added); THE NEW OXFORD AMERICAN DICTIONARY, 1884 (2001) ("Speak or write about in an abusively disparaging manner"); THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE, 2122 (2d ed. 1987) ("To speak ill of; *defame; slander* ") (emphasis added).

30 *Vanasco v. Schwartz,* 401 F.Supp. 87 (E.D.N.Y.1975), *aff'd,* 423 U.S. 1041, 96 S.Ct. 763, 46 L.Ed.2d 630 (1976); *Gietzen v. Feleciano,* 25 Kan.App.2d 487, 964 P.2d 699 (1998).

31 *See* n. 27–28 *supra.*

32 *See* n. 29 *supra.*

33 *Stabler v. Ramsay,* 88 A.2d 546, 552 (Del.1952).

34 886 A.2d at 40.

35 Final Judgement Order dated November 1, 2005. Lorillard has not appealed that dismissal.

36 10 Del. C. § 6506. Discretionary relief.

37 Carol A. Jones and Britta M. Larsen, 1A FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 207 (perm.ed., rev.vol.2002).

38 *See Spering v. Sullivan,* 361 F.Supp. 282, 286 (D.Del.1973); *Stringer v. Elec. Supply Corp.,* 2 A.2d 78, 79 (Del.Ch.1938); *see also* 18 AM. JUR. 2D CORPORATIONS, § 123 (1985); 12 WILLISTON, § 35:71; RESTATEMENT (SECOND) OF AGENCY, § 104 (1957).

39 *Am. Legacy Found. v. Lorillard Tobacco Co.,* 831 A.2d 335, 344 (Del.Ch.2003).

40 *Id.* at 345.

41 *Id.* For instance, Section IX of the MSA provides ALF shall fund public education "in the manner described in and *subject to* the provision of subsections VI(g) and VI(h)." (emphasis added). Subsection VI(h) of the MSA, instructs that ALF "shall not engage" in certain activities. Subsection VI(e) of the MSA provides that ALF "shall be formally affiliated with an educational or medical institution." *Id.* at 345–46.

42 *Id.* at 346.

43 *Lorillard Tobacco Co.,* 831 A.2d at 350 (citing *Spering,* 361 F.Supp. at 286; *Stringer,* 2 A.2d at 79).

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UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

NBC UNIVERSAL, INC., Plaintiff,

v.

PAXSON COMMUNICATIONS CORPORATION, Defendant.

No. Civ.A. 650-N.
|
Submitted Feb. 14, 2005.
|
Decided April 29, 2005.

Attorneys and Law Firms

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MEMORANDUM OPINION

LAMB, Vice Chancellor.

I.

***1** Plaintiff NBC Universal, Inc. brought this action against defendant Paxson Communications Corporation for declaratory judgment and to enforce its rights under Paxson's certificate of incorporation. Both NBC and Paxson are Delaware corporations.

In September of 1999, NBC made a $415 million investment in Paxson by purchasing 41,500 shares of 8% Series B Convertible Exchangeable Preferred Stock (the "Stock") at $10,000 per share. The dividend rate was set at 8% for the first five years. Thereafter, the dividend rate was to be adjusted based on a formula set out in the Certificate of Designation ("COD") governing the Stock. Specifically, the COD provides that on September 15, 2004, the dividend rate was to be reset to a "Cost of Capital Dividend Rate," defined in the COD as the dividend rate at which the Stock would trade at its liquidation preference on September 15, 2004 (the "Reset Rate"). The COD further provides that the Reset Rate was to be determined by a "nationally recognized independent investment banking firm" chosen by Paxson, in its sole discretion.

The dividends on the Stock accrue but remain unpaid. The holder of the Stock is entitled to realize the accrued dividends under several circumstances. These include a redemption of the shares by Paxson, certain change of control transactions, a liquidation of Paxson, or a declaration of dividends by Paxson's board. Also, upon a liquidation of Paxson, the holder of the Stock is entitled to a "liquidation preference," the amount of which is at issue in this litigation. NBC argues that the term "liquidation preference," as used in the COD, is equal to the original issue price of $10,000, plus all accumulated dividends. As of September 15, 2004, $166 million (or $4,000 per share) of dividends had accumulated. Paxson argues that the liquidation preference is equal to the original issue price of $10,000 and does not include any accumulated dividends.

In addition, NBC received certain warrants and a call option that gave NBC the right, but not the obligation, for a period of ten years, to purchase a controlling interest in Paxson. As of the time the complaint was filed, NBC has not exercised these warrants and the call option.

The COD also made the Stock subject to redemption at the option of the holder of the Stock, in accordance with certain provisions in an Investment Agreement, dated September 15, 1999, entered into between Paxson and NBC (the "Investment Agreement"). Article IX, Section 9.1 of the Investment Agreement states, in pertinent part:

> (a)(ii) beginning with the third anniversary of the Closing and on each anniversary thereafter, then, in each case, [NBC], at its sole option, will have a period of 60 days during which to demand redemption, by payment in cash, of all or any portion of the [Stock] at a price per share equal to the Original Issue Price plus any accrued and unpaid dividends through and including the date of redemption (the "Par Value Price").

***2** (b) [Paxson] or its assignee pursuant to Section 9.3 will have a period of one year (the "Involuntary Redemption Period") from the date of any such demand to consummate the redemption; provided that if at any time during such one-year period, [Paxson's] outstanding debt and preferred stock covenants do not prohibit a redemption and [Paxson] has funds on hand to consummate such redemption [Paxson] or its assignees shall consummate such redemption at such time....

On November 13, 2003, NBC sent a notice of demand for redemption to Paxson pursuant to Section 9.1(a)(ii) of the Agreement, thereby triggering the one-year Involuntary Redemption Period set forth in Section 9.1(b).

Several months later, on March 24, 2004, NBC wrote to Paxson's Chief Legal Officer regarding the process for determining the Reset Rate. In the letter, NBC advised Paxson that it did not consider either Bear Stearns & Co., Inc. or Citigroup, Inc. to be independent under the terms of the COD. NBC also informed Paxson that it had retained Goldman, Sachs & Co. and UBS Investment Bank in connection with the Reset Rate.

On May 12, 2004, Paxson's Chief Legal Officer wrote in response to NBC. In that letter, Paxson acknowledged NBC's advance objection to using either Bears Stearns or Citigroup as the investment bank to calculate the Reset Rate, and stated that it would take NBC's objection into account when selecting the investment bank. In addition, Paxson informed NBC of its opinion that it was neither able nor required to redeem the Stock for cash, pursuant to NBC's request under the Agreement.

On August 19, 2004, NBC filed its first complaint. On September 2, 2004, this court entered a Scheduling Stipulation and Order. The Scheduling Stipulation and Order required Paxson to cause an investment bank to determine the Reset Rate, as of September 15, 2004, and as provided for in the COD. After NBC advised Paxson that NBC would prefer that neither Bear Stearns nor Citibank be used, Paxson selected CIBC World Markets Corp. to determine the Reset Rate. The Scheduling Stipulation and Order also required NBC to take the deposition of the investment bank before September 24, 2004, and to file any amended complaint by September 28, 2004.

On September 28, 2004, NBC filed the First Amended Complaint (hereinafter the "complaint"). The complaint makes two main contentions. First, NBC claims that CIBC is not an "independent investment banking firm," as that term is used in the COD. Second, NBC claims that CIBC miscalculated the Reset Rate, based on improper instructions from Paxson. Specifically, NBC complains that Paxson instructed CIBC to assume that investors purchasing the Stock would receive the $166 million in accumulated, unpaid dividends, without having to pay for those dividends. As a result of this directive, CIBC declared the Reset Rate to be 16.2% per annum. Were these "free dividends" not included, CIBC found that the proper market rate would be 28.3% per annum. NBC also complains that CIBC used the incorrect "spread" to calculate the Reset Rate.

A. *CIBC's Calculation Of The Reset Rate*

***3** CIBC determined the Reset Rate by determining the rate of return (or yield-to-redemption) that an investor purchasing the Stock would require, given the risk profile of the security. Because the Stock does not trade on a liquid market, CIBC looked at Paxson's other securities for determining the proper dividend rate for the Stock. CIBC concluded that Paxson's 14.25% Preferred Stock, which is two levels more senior than the Stock, was the appropriate reference security for the Stock. It further determined that the rate of return for Paxson's 14.25% Preferred Stock was 22.3%.

To determine the rate of return (and thereby the Reset Rate) for the Stock, CIBC next needed to calculate the "spread" that the Stock would trade at over the 14.25% Preferred Stock. Generally, the yield is higher for more junior securities than it is for more senior securities in a capital structure, due to the lower priority for junior securities in liquidation. This higher yield is necessary to compensate investors for the greater risk they take on by purchasing a more junior security. This risk premium (or risk discount) is referred to as the security's "spread."

CIBC determined the spread for the Stock by looking at the 12 1/2-month trailing average spread between the 14.25% Preferred Stock and the Stock, which was 6.5%. It then determined that the proper spread was 6%. Applying the 6% spread, CIBC determined that the yield for the Stock would be 28.3% (i.e. 6% higher that the 22.3% yield for the 14.25% Preferred Stock). However, CIBC reduced the Reset Rate to 16.2%, based on the instruction from Paxson that it assume that investors purchasing the Stock would receive the accrued and unpaid dividends, without having to pay for them. As a result of this assumption, CIBC reached the incongruous decision to set the Reset Rate at a rate 6.1% *lower* than that

which CIBC determined was the proper yield for the *more senior* 14.25% Preferred Stock.

NBC claims that, in addition to improperly assuming that investors purchasing the Stock would receive the accrued and unpaid dividends, CIBC also used the wrong spread. This is because CIBC used the 12½month trailing average spread. The COD requires that the Reset Rate be based on the market conditions as of September 15, 2004. NBC further argues that, due to Paxson's increasing financial difficulties as of that date, the spread should have been 2.1% higher, i.e. 8.1%, producing a Reset Rate of 30.4%.

B. *Procedural Posture*

The complaint is set out in four Counts. Count I seeks a declaration that CIBC is not a "nationally recognized independent investment banking firm" as that term is used in the COD, and that Paxson must select a new investment banking firm consistent with the independence requirements of the COD. Count II seeks a declaration that the liquidation preference to be used in calculating the Reset Rate is $14,000 per share, and not the original liquidation preference of $10,000 per share. In the alternative, if the court concludes that the liquidation preference amount to be used in calculating the Reset Rate is $10,000 per share, Count II seeks a declaration that the Reset Rate must be calculated assuming that the Stock would trade without its previously accrued dividends. Count III seeks a declaration that the Reset Rate must be determined using a spread as of September 15, 2004, and not the 12 1/2-month trailing average used by CIBC. Finally, Count IV seeks a declaration that Paxson breached the COD and seeks specific performance of the COD.

***4** On October 14, 2004, Paxson filed its Answer and Counterclaim, wherein it contests NBC's interpretation of the COD and the Agreement and seeks declaratory relief. First, Paxson seeks a declaration that CIBC is an "independent investment banking firm." Second, Paxson seeks a declaration that the "liquidation preference" to be used in determining the Reset Rate under the COD is $10,000 per share (or an aggregate of $415 million). Third, Paxson seeks a declaration that it and NBC are bound by the 16.2% Reset Rate determined by CIBC. Fourth, Paxson seeks a declaration that it was not required by the terms of the Investment Agreement to redeem the Stock by November 13, 2004.[1]

On October 14, 2004, Paxson filed for a motion for judgment on the pleadings. On November 23, 2004, NBC filed a cross-motion for judgment on the pleadings or, in the alternative, summary judgment. This is the court's opinion on the cross-motions for judgment on the pleadings, and NBC's cross-motion for summary judgment.

II.

Motions under Court of Chancery Rules 12(b)(6) and 12(c) are governed by the same standard: the court accepts all well-pleaded facts as true and construes any inferences from those facts in the light most favorable to the nonmoving party.[2] A motion to dismiss pursuant to Rule 12(b)(6) for failure to state a claim will be granted if it appears with reasonable certainty that the plaintiff could not prevail on any set of facts that can be inferred from the pleading.[3] In considering a motion to dismiss under Rule 12(b)(6), the court is required to assume the truthfulness of all well-pleaded allegations of fact in the complaint.[4] Similarly, under Rule 12(c), this court will grant a motion for judgment on the pleadings only where there are no material issues of fact and the movant is entitled to judgment as a matter of law.[5] On a Rule 12(c) motion, the court takes the well-pleaded facts alleged in the complaint as true, and views those facts and any inferences drawn therefrom in the light most favorable to the nonmoving party.[6]

Generally, matters outside the pleadings should not be considered in ruling on a motion for judgment on the pleadings.[7] For example, Court of Chancery Rule 12(b) provides:

> If, on a motion asserting the defense numbered (6) to dismiss for failure of the pleading to state a claim upon which relief can be granted, matters outside the pleading are presented to and not excluded by the Court, the motion shall be treated as one for summary judgment and disposed of as provided in Rule 56, and all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56.
>
> Therefore, if a party presents documents in support of its Rule 12(b)(6) or 12(c) motion and the court considers the documents, it generally must treat the motion as one for summary judgment.[8] Before a motion for summary judgment is ripe for decision, the nonmovant normally should have an opportunity for some discovery.[9]

III.

***5** A corporate certificate of designation is interpreted using standard rules of contract interpretation.[10] Either judgment on the pleadings or summary judgment is a proper framework for enforcing unambiguous contracts because there is no need to resolve material disputes of fact. Rather, a determination of whether a contract is ambiguous is a question for the court to resolve as a matter of law.[11] The starting point of contract construction is to determine whether a provision is ambiguous, i.e. whether it is reasonably subject to more than one interpretation.[12] Toward that end, contract language "is not rendered ambiguous simply because the parties in litigation differ concerning its meaning."[13] Nor is it rendered ambiguous simply because the parties "do not agree upon its proper construction."[14] A contract is ambiguous "only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings."[15]

Delaware adheres to the "objective" theory of contracts, i.e. a contract's construction should be that which would be understood by an objective, reasonable third party.[16] Thus, as the Delaware Supreme Court stated: "Contract terms themselves will be controlling when they establish the parties' common meaning so that a reasonable person in the position of either party would have no expectations inconsistent with the contract language."[17]

IV.

A. *Is Either Party Entitled To Judgment On The Pleadings With Respect To The Issue Of The Proper Interpretation Of The Term "Liquidation Preference?"*

Both NBC and Paxson argue that the term "liquidation preference," as it is used in the COD, is clear and unambiguous. They differ, of course, on just what that clear and unambiguous meaning is.

While not specifically defined in the "definitions" section of the COD, the COD does unambiguously state "[t]he liquidation preference of the Series B Convertible Stock shall be $10,000.00 per share."[18] The "RESOLVED" section of the COD also states that: "[T]he Board of Directors does hereby create, authorize and provide for the issuance of 8% Series B Convertible Preferred Stock, par value $.001 per share, *with a liquidation preference of $10,000 per share* ...." (Emphasis added).

In addition, paragraph (d) of the COD (titled "Liquidation Preference") uses this definition of liquidation preference (i.e. the original issue price of the Stock of $10,000, not including accrued and unpaid dividends) consistently. The terms "liquidation payments" or "liquidation amount" are used when the COD refers to the liquidation preference, plus the accrued and unpaid dividends. For instance, paragraph (d) partially states:

> If the assets of the Corporation are not sufficient to pay in full the *liquidation payments* payable to the Holders of outstanding shares of the [Stock] and all Parity Securities, then, (x) should the holders of the [Stock] be entitled to receive the *liquidation amount* described in clause (A) above, the holders of all such shares shall share equally and ratably in such distribution of assets first in proportion to the full *liquidation preference* to which each is entitled until such preferences are paid in full, and then in proportion to their respective *accumulated but unpaid dividends* and (y) should the holders of the [Stock] be entitled to receive the liquidation amount described in clause (B) above, the holders of all such shares shall share equally and ratably in such distribution of assets in proportion to the full liquidation payments to which each is entitled. (Emphasis added).

***6** In this section, the COD makes reference to the "liquidation preference" and states that, in the event of liquidation, the holders of the stock are to be paid back their original investment (i.e. $10,000 per share) first, before being paid any accrued, unpaid dividends. The COD then makes separate reference to the accumulated, unpaid dividends which are to be given lesser priority. Therefore, this section only makes sense if liquidation preference is interpreted as the original issue price of the Stock without including the accumulated, unpaid dividends.

NBC points to two clauses in the COD in which, it contends, the liquidation preference does not, and cannot, equal the original issue price of $10,000. First, NBC cites paragraph (d)(i) of COD. This section states that upon liquidation the holders of the Stock will be paid the greater of:

> (A) *the liquidation preference* for each share outstanding, plus without duplication, an amount in cash equal to *accumulated and unpaid dividends* thereon to the date fixed

> for liquidation, dissolution or winding up, and (B) the amount per share payable upon liquidation, dissolution or winding up to the holders of shares of the Corporation's Class A Common Stock (without duplication for the *liquidation preference* otherwise payable pursuant to clause (A) hereof), multiplied by the number of such shares into which the shares of [the Stock] are then convertible. (Emphasis added).

NBC contends that the "liquidation preference" in subsection (B) refers to the liquidation preference *plus* dividends referred to in subsection (A). However, this is not necessarily so. Section (g) of the COD gives NBC the right to convert the Stock into Paxson's common stock. Obviously, in the event of a liquidation, if the amount that a common shareholder would get would be greater than the amount that NBC would get from the Stock, NBC would exercise that right. Subsection (B) merely clarifies that NBC would not get two bites at the apple, taking its liquidation preference and then attempting to convert to common stock and getting that liquidation payment as well. Instead, if it chooses to convert, it would not get the liquidation preference as well. Therefore, this provision is entirely consistent with the liquidation preference being equal to $10,000.

Second, NBC cites the definition of "Cost of Capital Dividend Rate" contained in the COD. " 'Cost of Capital Dividend Rate' means a rate per annum equal to the dividend rate on the [Stock] at which the [Stock] would trade at its liquidation preference on such date of determination." NBC argues that "on such date of determination" modifies "liquidation preference" and that, therefore, the liquidation preference changes over time to reflect the amount of unpaid dividends.

In support of this last contention, NBC cites "the last antecedent rule," which "requires that a qualifying or modifying phrase be construed as referring to its nearest antecedent."[19] However, the last antecedent rule is but one of numerous rules designed to assist in the discovery of intent and is not to be inflexibly or uniformly applied.[20] Instead, "[w]hen the sense of the entire [document] requires that a qualifying word or phrase apply to several preceding or succeeding sections, the word or phrase will not be restricted to its immediate antecedent."[21] Furthermore, "[i]n discerning the intent of the parties, the Certificate [of Designation] should be read as a whole and, if possible, interpreted to reconcile all of the provisions of the document."[22]

***7** A better reading of this clause, then, is that "on such date of determination" modifies "trades," or, more properly, the entire antecedent phrase "trades at its liquidation preference." This reading acknowledges the commonplace usage of "trading at" a particular value, such as par value, face value, or liquidation value. In any case, even if there were some slight ambiguity as to how the phrase "liquidation preference" is used in that clause, the COD plainly states, in two separate places, that the liquidation preference *will be* $10,000. A minor ambiguity in the use of the phrase cannot overcome the plain meaning of the document.

For all of the above reasons, the court concludes that the term "liquidation preference," as used in the COD means the original purchase price of the Stock, $10,000.00 per share.

B. *Is Either Party Entitled To Judgment On The Pleadings With Respect To The Issue Of Whether CIBC Is Independent?*
NBC argues that Paxson abused its discretion in choosing CIBC to calculate the Reset Rate. As noted earlier, Paxson chose CIBC after NBC stated its opposition to either Bear Stearns or Citibank being the investment bank. The COD gives Paxson the discretion to choose the investment banking firm to determine the Reset Rate, but requires that it be both nationally recognized and independent. While NBC does not, and cannot, argue that CIBC is owned or controlled by Paxson, NBC nevertheless complains that CIBC is not independent. In particular, NBC cites the following contacts between Paxson and CIBC and its affiliates: (1) CIBC was co-manager for Paxson's offering of $365 million in Senior Secured Floating Rate Notes on January 12, 2004; (2) CIBC was co-manager for Paxson's offering of $200 million in 10.75% Senior Subordinated Notes on July 12, 2001; (3) CIBC Inc. was a lender and the co-documentation agent for Paxson's $360 million credit facility on July 12, 2001; (4) CIBC Oppenheimer was the sole bookrunner for Paxson's offering of $200 million in 13.25% Preferred Stock on June 5, 1998; (5) CIBC Wood Gundy was co-manager for Paxson's initial public offering of $248 million in Class A Common Stock on March 29, 1996; (6) CIBC Inc. was a lender and the documentation agent for Paxson's credit facility of $100 million on December 19, 1995; and (7) CIBC Wood Gundy was an initial purchaser for Paxson's offering of $227 million in 11.625% Senior Subordinated Notes on September 21, 1995.[23] Paxson admits to having paid CIBC approximately $3 million since 1999.[24]

Neither Paxson nor NBC has identified a case in which a court determined whether an investment banking firm qualified as "independent" under a contract or certificate of designation. Therefore, the court looks to analogous situations of independence for guidance in interpreting the COD. In *Nakahara v. NS 1991 Am. Trust,*[25] this court held that counsel was independent when the attorney has no disqualifying conflict of interest.[26] Delaware law *does not* require that counsel have no prior contact to any party.[27] Similarly, in *Aronson v. Lewis,*[28] the Delaware Supreme Court stated that a director was independent when "a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences ." In addition, the Delaware Supreme Court held that, in order to claim that a director was not independent, a shareholder plaintiff must show "the materiality of a director's self-interest to the given director's independence."[29]

***8** The facts alleged by NBC are not sufficient to find that CIBC was not a "nationally recognized independent investment banking firm." This is true for several reasons. First, the complaint is devoid of allegations that CIBC was "materially" conflicted. The complaint simply lists the work that CIBC did for Paxson over a period of years. However, according to the financial information contained in CIBC's Form 10-K, the fees received from Paxson over the past five years represent less than 1/100 of 1% of CIBC's total revenue for the five years ending December 31, 2003.[30] As Paxson points out in its brief, this is the equivalent of saying that a director with an income of $1 million over five years is disqualified from being independent because he or she did $83 of business with the company over that period.

Second, the COD requires that the investment bank be not only "independent" but also "nationally recognized" and grants Paxson broad discretion in choosing among them. Independence obviously means not only independent of Paxson, but also independent of NBC. NBC is owned by General Electric Company ("GE"). GE also owns GE Capital Corporation. GE is one of the largest companies in the world, and GE Capital is one of the largest financial service companies in the world. There are but a handful of nationally recognized investment banks that would both be nationally recognized and would have no ties to GE, GE Capital, NBC, or Paxson. In the circumstances, it is unreasonable to conclude that the parties intended to exclude all nationally recognized investment banks that, while having some history of working for either Paxson or NBC, are not shown to derive a material part of their revenue from such engagements. NBC simply has not alleged enough to raise a litigable issue as to the selection of CIBC as the "independent" and "nationally recognized" investment banker.

This conclusion is reinforced by the fact that, NBC generally agrees with the methodology and the conclusions of CIBC. At oral arguments and in its brief, NBC acknowledged that CIBC's methodology for determining the Reset Rate (i.e. adding the spread to the 14.25% Preferred Stock's yield) was proper. NBC's only complaint with CIBC is that it used too long a period (i.e. the 12 1/2-month trailing average, as opposed to a 90-day trailing average) to calculate the spread. This is a small difference, and one that does not undermine the court's confidence in the independence of CIBC's work.

NBC's other contention, that CIBC improperly assumed that any investor would obtain the benefit of the accrued but unpaid dividends of the Stock, cannot credibly be blamed on CIBC. It originally calculated the Reset Rate *without* this assumption. In addition, in its opinion letter, CIBC expressly disavowed any opinion as to whether this assumption was correct.[31]

For all of the above reasons, the court concludes as a matter of law that Paxson did not abuse its discretion in choosing CIBC as the investment bank to calculate the Reset Rate.

C. *Should The Reset Rate Be Calculated Assuming That The Stock Would Trade Without Its Previously Accrued, Unpaid Dividends?*

***9** In calculating the Reset Rate, CIBC, as instructed by Paxson, assumed that anyone purchasing the Stock would be entitled to the Stock's accumulated, but unpaid, dividends. As a result, CIBC reduced the calculated Reset Rate from 28.3% to 16.2%. NBC argues that this violated the COD, which required the Reset Rate to be set at Paxson's then cost of capital; i.e. the market rate of return for the Stock.

Section (b)(i) of the COD states that:

> [T]he Holders of each share of the outstanding shares of [Stock] shall be entitled to receive, when, as and if declared by the Board of Directors, out of funds legally available therefor, dividends on each share of [Stock] at the higher of (determined on a cumulative basis from the Issue Date to the date of such determination) (x) a rate per annum equal to 8% of the Original Issue Price, which rate shall be adjusted on the fifth anniversary of the Issue Date to

> equal the Cost of Capital Dividend Rate, which rate shall remain in effect thereafter for so long as the [Stock] shall be outstanding[.]

The COD defines the "Cost of Capital Dividend Rate" as follows: " 'Cost of Capital Dividend Rate' means a rate per annum equal to the dividend rate on the [Stock] at which the [Stock] would trade at its liquidation preference on such date of determination."

Generally, "cost of capital" is defined as the "rate of return that a business could earn if it chose another investment with equivalent risk-in other words, the opportunity cost of the funds employed as the result of an investment decision."[32] The cost of capital "depends on the general level of interest rates and the amount of premium for risk that the market demands, as well as the risks attributable to the subject business."[33] This so-called "market" cost of capital is exactly what CIBC calculated, before Paxson instructed it to assume that the Stock's accrued, unpaid dividends would go to a purchaser of the Stock for free. This assumption led CIBC to adjust the Reset Rate dramatically from 28.3% to 16.2%.

Paxson claims that its instruction to CIBC is based on the clear language of the COD, but the court is unable to read the COD as supporting this claim. Rather, the court concludes that Paxson's reading of the COD is at odds with the plain language of the COD and is patently unreasonable.

Words in a contract are interpreted using their common and ordinary meaning, unless the contract clearly shows that the parties' intent was otherwise.[34] The COD defines the "Cost of Capital Dividend Rate" as "a rate per annum equal to the dividend rate on the [Stock] at which the [Stock] would trade at its liquidation preference on such date of determination." It is possible, as Paxson argues, to read this language as referring to the 41,500 shares of Stock owned by NBC, with all the attributes of those shares, including their accumulated and unpaid dividends. That reading, if accepted by the court, would support Paxson's argument that CIBC's job was to determine the rate of return required to make *those particular shares* trade at $10,000 on the reset date.

***10** This interpretation, however, is clearly at odds with the general understanding of cost of capital. The general understanding is that a provision of this sort is intended to reset the yield on a security at the current market level; i.e. the dividend rate (or, in the case of a debt instrument, the interest rate) that the issuer would have to pay to sell a new unit of the security at par on the reset date. This was, in fact, exactly what CIBC calculated, before being told by Paxson to change its assumptions.

Paxson's suggested reading of the COD would also lead to highly anomalous and illogical results. First, a higher risk security (the Stock) would have a lower rate of return than Paxson's more senior securities. To follow this interpretation, the court would have to assume that NBC made the choice to accept *less* return for *more* risk.

Second, accepting Paxson's reading of the COD means that the Reset Rate and the amount of accrued, unpaid dividends would be negatively correlated; i.e. the more dividends accrue, the lower the Reset Rate. Admittedly, Paxson has not paid the dividends that have accrued on the Stock, nor were they obligated to do so. However, under Paxson's interpretation of the Reset Rate, had it done so, the Reset Rate would have been *higher.* That is, had Paxson paid all or part of its obligations to NBC, Paxson would have had to pay a higher return on the Stock as of the Reset Date. Similarly, all else being equal, the sooner the reset occurs, the smaller the amount of unpaid dividends and, therefore, the higher the Reset Rate would be. These are strikingly anomalous results that fly in the face of financial theory (and common sense), which holds that a company that pays its obligations sooner rather than later is less risky, and need pay less of a risk premium. In essence, this view treats the accrued, unpaid dividends, which are a Paxson liability, as a Paxson asset.

This point can best be illustrated by an example. If Paxson had paid all of the accrued dividends to NBC, then it is undisputed that the proper Reset Rate would be 28.3%. However, because they did not pay those dividends, to which NBC is undeniably entitled, the Reset Rate is supposedly only 16.2%. As another illustration, if the initial dividend rate had been 15.3%, then the Reset Rate would be 0%. If it had been more than 15.3%, then the Reset Rate would be negative. These results flow directly from Paxson's interpretation of the COD and strongly suggest its interpretation is unreasonable.

Moreover, CIBC has expressly disavowed any opinion as to whether the inclusion of the accrued, unpaid dividends in calculating the Reset Rate was proper. The fact that even Paxson's own expert will not support its interpretation is further evidence of its unreasonableness.[35]

Finally, the court also notes that Paxson's reading of the COD would treat dividends inconsistently. It would not include

dividends in the calculation of the Liquidation Preference, but would include them in the calculation of the Reset Rate. The court finds this asymmetrical treatment of dividends to be both unreasonable and inconsistent with the terms of the COD.

***11** The court must construe the COD as a whole in light of normal principles of corporate law and finance. Taken as a whole, the meaning of the COD is unambiguous: The Reset Rate is to be determined without regard to the amount of the accumulated, unpaid dividends. In other words, the proper Reset Rate is that required by the market as of September 15, 2004 to sell a share of the Stock at $10,000 with regard to only future principal and dividend payments.

D. *Did CIBC Improperly Calculate The Spread?*

NBC also questions CIBC's judgment in determining that the proper spread was 6.0%, rather than 8.1%. CIBC calculated the spread by looking at the 12 1/2-month trailing average difference between the Stock and CIBC's 14.25% Preferred Stock. NBC contends that this was an improperly long period of comparison because the COD requires that the Reset Rate be calculated as of the "date of determination," i.e. September 15, 2004. CIBC's error is evidenced, NBC claims, by the fact that CIBC chose to use the 90-day trailing average to calculate the rate of return for CIBC's 14.25% Preferred Stock.

CIBC's choice of data sets surely is a matter of judgment, and NBC has not advanced a sufficient reason to upset CIBC's judgment in that regard. In determining what the proper Reset Rate was as of September 15, 2004, CIBC properly looked at a variety of historical data, as the court would expect any competent investment bank to do. The fact that it based its judgment about the proper spread between the Stock and the 14.25% Preferred Stock on one subset of historical data, as opposed to another that would be more beneficial to NBC, evidences neither bias nor error. NBC accepted CIBC's use of the 90-day trailing average to calculate the rate of return for CIBC's 14.25% Preferred Stock. It cannot now credibly claim that only data from September 15, 2004 can be used in calculating the rate of return. But NBC agreed to have the Reset Rate decided by an independent, nationally recognized investment bank. It is now bound to that decision.[36]

This deference to the decision of the investment bank is entirely consistent with the court's requirement that the Reset Rate be calculated without assuming that any purchaser would receive these dividends. CIBC originally calculated the Reset Rate *without* this assumption, and *recalculated* the Reset Rate at the insistence of Paxson. In fact, CIBC specifically refused to state any opinion as to the propriety of this assumption. This decision was made, therefore, not on the basis of CIBC's professional judgment, but on the basis of Paxson's self-serving misreading of the COD.

For the above reasons, the court concludes that the 28.3% Reset Rate that CIBC calculated is the correct Reset Rate.

E. *Is Either Party Entitled To Judgment On The Pleadings With Respect To The Issue Of Whether NBC Can Force Paxson To Redeem The Stock?*

Paxson has moved for a declaration that it is not required to redeem the Stock. NBC opposes that motion, and likewise seeks a declaration that Paxson is required to redeem the Stock.

***12** Paragraph (e)(iii) of the COD states: "The [Stock] is subject to redemption at the option of certain Holders in accordance with the terms and conditions set forth in Article XI of the [Agreement]." Article XI, section 9.1 states, in pertinent part:

> ... [B]eginning with the third anniversary of the Closing and on each anniversary thereafter, then, in each case, [NBC], at its sole option, will have a period of 60 days during which to demand redemption, by payment in cash, of all or any portion of the Shares at a price per share equal to the Original Issue Price plus any accrued and unpaid dividends through and including the date of redemption (the *"Par Value Price"*) ... (b) [Paxson] or its assignees ... will have a period of one year (the "*Involuntary Redemption Period"*) from the date of any such demand to consummate the redemption; *provided* that if at any time during such one-year period, [Paxson's] outstanding debt and preferred stock covenants do not prohibit a redemption and [Paxson] has funds on hand to consummate the redemption, then [Paxson] or its assignee shall consummate such redemption at such time....

Paxson argues that the COD and the Agreement do not give NBC the right to force redemption. Instead, Paxson contends that Article IX of the Agreement simply gives NBC the right to *demand* redemption. Under this reading of the Agreement, should Paxson fail to effectuate a redemption within a year of the demand, NBC would gain certain rights. For instance, in the event that Paxson fails to redeem within a year of demand, Section 9.4 of the Agreement gives NBC the right to sell

the Stock, free of the transfer restrictions contained in the Agreement. Paxson further argues that the Agreement could not have given NBC an absolute right to redeem, because this would have violated the governing provisions of indentures in other, more senior securities of Paxson.

In opposition, NBC argues that the clear language of the Agreement gives it an absolute right to redeem. It emphasizes that Section 9.1(b) of the Agreement states that Paxson "will have a period of one year ... from the date of any such [redemption demand by NBC] to consummate the redemption." NBC points out the plain meaning of "consummate" is to "bring to completion or fulfillment" or "finish."[37] NBC also argues that this one-year period is defined as the "Involuntary Redemption Period," and that Paxson's reading of the subsection does not give NBC a right of redemption, but only a right to sell free of restrictions.

It is obvious from a reading of the redemption provisions at issue that the structure and terms of this aspect of the Agreement are highly idiosyncratic. Before reaching any conclusion about the operation or meaning of these unusual provisions, the court believes that it is both necessary and prudent to allow for the development and presentation of a factual record of the parties' negotiations and dealings. Thus, the court declines to enter judgment on this issue.

IV.

***13** For the forgoing reasons, the motions for judgment on the pleadings and summary judgment are denied in part and granted in part. The parties are directed to submit an appropriate for of order within seven days of the date hereof.

All Citations

Not Reported in A.2d, 2005 WL 1038997

Footnotes

1 In its complaint, NBC does not ask for a determination that Paxson is required to redeem the Stock under the Agreement. However, in its papers and at oral argument, NBC has disputed this issue. Therefore, the disposition of this issue is properly before the court.

2 *Highlands Ins. Group, Inc. v. Halliburton Co.,* 2001 WL 287485, at *3 (Del.Ch. Mar.21, 2001).

3 *Kohls v. Kenetech Corp.,* 791 A.2d 763, 767 (Del.Ch.2000).

4 *Grobow v. Perot,* 539 A.2d 180, 187 n. 6 (Del.1988).

5 *Desert Equities v. Morgan Stanley Leveraged Equity Fund,* 624 A.2d 1199, 1205 (Del.1993).

6 *Id.*

7 *In re Santa Fe Pac. Corp. S'holder Litig.,* 669 A.2d 59, 69 (Del.1995).

8 *Id.*

9 *See* Del. Ch. Ct. R. 56(e); *Santa Fe,* 669 A.2d at 69.

10 *Kaiser Aluminum Corp. v. Matheson,* 681 A.2d 392, 395 (Del.1996).

11 *Pellaton v. The Bank of New York,* 592 A.2d 473, 478 (Del.1991); *Reardon v. Exch. Furniture Store, Inc.,* 188 A. 704, 707 (Del.1936).

12 *Cantera v. Marriott Senior Living Serv., Inc.,* 1999 WL 118823, at *4 (Del.Ch. Feb.18, 1999).

13 *City Investing Co. Liquidating Trust v. Cont'l Cas. Co.,* 624 A.2d 1191, 1198 (Del.1993); *accord Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.,* 616 A.2d 1192, 1196 (Del.1992).

14 *Rhone-Poulenc.,* 616 A.2d at 1196.

15 *Id.*

16 *Cantera,* 1999 WL 118823, at *4.

17 *Eagle Indus., Inc. v. DeVilbiss Health Care, Inc.,* 702 A.2d 1228, 1232 (Del.1997).

18 COD at 1, ¶ a.

19 *New Castle County v. Nat'l Union Fire Ins. Co.,* 174 F.3d 338, 348 (3d Cir.1999).

20 *E.I. DuPont de Nemours & Co. v. Green,* 411 A.2d 953, 956 (Del.1980).

21 *Id.* (quoting 2A Sutherland, Statutes and Statutory Constructions, § 47.33 (4th ed.1973)).

22 *Kaiser,* 681 A.2d at 395.

23 Compl. ¶ 22.

24 Countercl. ¶ 25.

25 739 A.2d 770, 789 (Del.Ch.1998).

26 *Id.*

27 *Id.*

28 473 A.2d 805, 816 (Del.1984).

29 *Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1156, 1167 (Del.1995).

30 Answer ¶ 25.

31 Compl. ¶ 34; CIBC Ltr. at 2.

32 Dictionary of Finance and Investment Terms 123 (5th ed.1995).

33 Shannon Pratt, Valuing a Business 405 (4th ed.2000).

34 *See, e.g., Northwestern Nat'l Ins. Co. v. Esmark, Inc.,* 672 A.2d 41, 44 (Del.1996) (interpreting unambiguous contract terms using dictionary definitions); *Neary v. Philadelphia, W. & B.R. Co.,* 9 A. 405, 407 (Del.1887) ("All written contracts, as well as legislative Acts, are to be read, understood and interpreted according to the plain meaning and ordinary import of the language employed in them.").

35 In contrast, NBC has introduced the affidavit of an expert in the area of corporate finance specifically supporting its reading of the COD. However, because the court decides this motion on the pleadings, it does not rely upon this extrinsic evidence.

36 Paxson argues that CIBC chose to use the 12 1/2-month trailing average to determine the spread, as opposed to the 90-day trailing average, because the threat of NBC's lawsuit added to the Stock's volatility. Paxson further contends that NBC should not be able to increase the value of its holding by threatening a lawsuit. This evidence for the basis of CIBC's decision is not properly before the court, and the court does not base its decision upon it. However, it does exemplify the myriad of complex considerations that an investment bank must evaluate in valuing a security or determining a security's proper rate of return. It is further proof that such subjective findings should be left to the sound judgment of disinterested experts in valuation, whenever possible.

37 Webster's New World Dictionary of the American Language (2d ed.1979).

End of Document

18

295 A.3d 520
Court of Chancery of Delaware.

NEW ENTERPRISE ASSOCIATES 14, L.P., NEA Ventures 2014, L.P., NEA: Seed II, LLC, and Core Capital Partners III, L.P., Plaintiffs,

v.

George S. RICH, Sr., David Rutchik, Josh Stella, Fugue, Inc., GRI Ventures, LLC, JMI Fugue, LLC, Rich Family Ventures, LLC, and Rutchik Descendants' Trust, Defendants.

C.A. No. 2022-0406-JTL
|
Date Submitted: January 24, 2023
|
Date Decided: May 2, 2023

Synopsis

Background: Stockholders brought action against investor, who stockholders had granted a contractual right to engage in certain transactions in exchange for investment, alleging breach of duty of loyalty after investor became corporation's controlling stockholder and individuals affiliated or associated with investor took over board of directors. Investor moved to dismiss based on contract's covenant not to sue.

Holdings: As matters of apparent first impression, the Court of Chancery, J. Travis Laster, Vice Chancellor, held that:

[1] covenant not to sue executed by stockholders was not facially invalid as contrary to state's public policy even though it included claims for breach of fiduciary duty;

[2] covenant was sufficiently narrowly tailored, as could support finding of validity;

[3] covenant was reasonable, as could support finding of validity;

[4] covenant was invalid to extent it was applied to preclude a claim for intentional breach of fiduciary duty; and

[5] covenant could validly apply to a claim for recklessness.

Motion granted in part and denied in part.

West Headnotes (74)

[1] **Compromise, Settlement, and Release** Pleading release or covenant as defense

The existence of a contractual bar to suit, such as a release or a covenant not to sue, is an affirmative defense that must be asserted in a responsive pleading.

1 Case that cites this headnote

[2] **Pretrial Procedure** Matters considered in general

A court can consider a contractual bar to suit asserted in a motion to dismiss for failure to state a claim if the complaint incorporates the document by reference or if the document is subject to judicial notice. Del. Ch. Ct. R. 12(b)(6).

[3] **Compromise, Settlement, and Release** Covenant not to sue

A "covenant not to sue" is a contract in which a potential claimant commits not to assert specified claims against a potential defendant.

1 Case that cites this headnote

[4] **Compromise, Settlement, and Release** Future, unknown, or after-arising claims in general

A release can extinguish claims based on past conduct that a party might learn of or assert in the future, but it cannot cover claims based on future conduct.

[5] **Contracts** Exemption from liability

New York common law prohibits contracts that prospectively limit a party from liability for willful or grossly negligent acts.

[6] **Compromise, Settlement, and Release** Torts and personal injuries

Parties can release claims for breach of fiduciary duty as part of a settlement.

2 Cases that cite this headnote

[7] **Trusts** Limitations of authority imposed in creation of trust

A trust agreement may modify nearly every aspect of a trustee's duties. 12 Del. Code § 3303(a).

1 Case that cites this headnote

[8] **Partnership** Fiduciary duty to partnership and limited partners

Fiduciary duties in general and limited partnerships are fully contractable. 6 Del. Code §§ 15-103, 17-1101.

[9] **Corporations and Business Organizations** Loyalty

Under state's corporate law, although monetary liability for fiduciary's duty of care can be eliminated, the underlying duty cannot be altered, and the duty of loyalty stands inviolate.

[10] **Corporations and Business Organizations** Exculpatory provisions in charter, articles of incorporation or bylaws

Stockholders have greater freedom to enter into private agreements that constrain their stockholder-level rights than what can be accomplished in the charter and bylaws, in light of statute addressing extent to which a provision in charter can limit or eliminate monetary liability for breach of fiduciary duty. 8 Del. Code § 102(b)(7).

2 Cases that cite this headnote

[11] **Corporations and Business Organizations** Exculpatory provisions in charter, articles of incorporation or bylaws

A covenant in a stockholder-level agreement in which the signatories agreed not to assert claims against director or officer for breach of the duty of care is not per se invalid as contrary to Delaware public policy.

[12] **Corporations and Business Organizations** Exculpatory provisions in charter, articles of incorporation or bylaws

A covenant in a stockholder-level agreement in which the signatories agreed not to assert direct claims against director or officer for breaches of duty based on recklessness is not per se invalid as contrary to Delaware public policy.

[13] **Negligence** Gross negligence

Negligence Reckless conduct

"Gross negligence" signifies more than ordinary inadvertence or inattention, but it is nevertheless a degree of negligence, while "recklessness" connotes a different type of conduct akin to the intentional infliction of harm.

[14] **Corporations and Business Organizations** Exculpatory provisions in charter, articles of incorporation or bylaws

Under state's corporate entity law, gross negligence encompasses recklessness, such that statute addressing extent to which a provision in charter can limit or eliminate monetary liability for breach of fiduciary duty permits exculpation for recklessness. 8 Del. Code § 102(b)(7).

[15] **Corporations and Business Organizations** Usurping corporate opportunities

A claim for usurpation of a corporate opportunity is a claim for breach of fiduciary duty.

1 Case that cites this headnote

[16] **Corporations and Business Organizations** Usurping corporate opportunities

Under statute authorizing corporate board to accelerate a decision it could make once a corporate opportunity arises, a fiduciary that wishes to pursue a corporate opportunity can present it to the board, and if the board renounces the opportunity, then the fiduciary can proceed. 8 Del. Code § 122(17).

[17] **Corporations and Business Organizations** Authority of directors

A board's authority to govern corporate affairs extends to decisions about what remedial actions a corporation should take after being harmed, including whether the corporation should file a lawsuit against its directors, its officers, its controller, or an outsider.

[18] **Corporations and Business Organizations** Usurping corporate opportunities

Under its authority to govern corporate affairs, a board can decide whether or not to assert a claim for usurpation of a corporate opportunity.

[19] **Corporations and Business Organizations** Limitation of powers by purposes of incorporation

Corporation with narrow purpose lacks the power to engage in activities that exceed or fall outside of that purpose, rendering those actions void.

[20] **Corporations and Business Organizations** Fiduciary Duties as to Management of Corporate Affairs in General

Absent a narrow purpose clause, corporate directors have an obligation to seek to maximize the long-term value of the corporation for the benefit of its stockholders.

[21] **Corporations and Business Organizations** Loyalty

In a corporation without a narrow purpose clause, directors are obligated to pursue the course that they believe in good faith will achieve goal of maximizing long-term value of corporation for benefit of stockholders, meaning that if the directors subjectively believe that exiting one business and entering another will maximize the value of the corporation, then acting loyally calls for acting on that substantive belief and altering the corporation's business.

[22] **Corporations and Business Organizations** Fiduciary Duties as to Management of Corporate Affairs in General

If corporation has a limited purpose, then directors cannot pursue the profit-maximizing option; rather, the purpose clause limits the directors to the identified purpose, and they have no ability or obligation to pursue a contrary purpose.

[23] **Corporations and Business Organizations** Indemnification

Corporations and Business Organizations Exculpatory provisions in charter, articles of incorporation or bylaws

While there are differences in implementation and operation of exculpation and indemnification of corporate fiduciaries, to the extent each is fully available, the endpoint is the same: the fiduciary does not bear the financial consequences of breach.

[24] **Corporations and Business Organizations** Indemnification

Corporations and Business Organizations Exculpatory provisions in charter, articles of incorporation or bylaws

In a breach of fiduciary duty action against a corporate fiduciary, exculpation operates as a pleading-stage defense, akin to sovereign immunity, while indemnification only comes into effect after final disposition of the case, although advancement can cover attorneys' fees and expenses in the interim.

[25] **Corporations and Business Organizations** Discretionary or mandatory

Any dismissal of a claim against corporate officer or director for any reason constitutes success "on the merits or otherwise" and thus triggers mandatory statutory indemnification against expenses. 8 Del. Code § 145(c).

[26] **Corporations and Business Organizations** Discretionary or mandatory

Whether a corporate director or officer acted in good faith or what she perceived to be in the corporation's best interests is irrelevant in the context of statute providing for mandatory indemnification for expenses incurred in connection with proceeding whenever director or officer is successful. 8 Del. Code § 145(c).

[27] **Corporations and Business Organizations** Discretionary or mandatory

A director charged with criminal conduct who escapes on a technicality is entitled to full indemnification for expenses incurred in connection with proceeding, under statute providing for mandatory indemnification whenever director is successful "on the merits or otherwise." 8 Del. Code § 145(c).

[28] **Corporations and Business Organizations** Time of stock ownership in general

Pursuant to statute requiring that a stockholder have owned stock at the time that the corporation suffered the wrong to have standing to assert a derivative claim, if such statute is not satisfied then, even if the wrong involved a self-dealing loyalty breach or bad faith conduct, the stockholder cannot sue. 8 Del. Code § 327.

[29] **Corporations and Business Organizations** Time of stock ownership in general

Statute requiring that a stockholder have owned stock at the time that the corporation suffered the wrong to have standing to assert a derivative claim effectively operates as a covenant not to sue derivatively for wrongs predating the stockholder's purchase of shares. 8 Del. Code § 327.

1 Case that cites this headnote

[30] **Corporations and Business Organizations** Disclosure and ratification

Common law doctrine of "ratification" permits stockholders to extinguish a claim for breach of fiduciary duty by authorizing an act that otherwise would constitute a breach.

1 Case that cites this headnote

[31] **Corporations and Business Organizations** Disclosure and ratification

Pursuant to ratification doctrine, when a corporation does not have a controlling stockholder, a fully informed, non-coerced stockholder vote cleanses an interested transaction and changes the standard of review from entire fairness to an irrebuttable version of the business judgment rule where the only remaining challenge is waste.

[32] **Corporations and Business Organizations** Directors or officers voting for or fixing own compensation

Corporate directors setting their own compensation is a self-dealing transaction

implicating the duty of loyalty, such that the directors bear the burden of showing that their compensation is entirely fair.

[33] **Corporations and Business Organizations** Disclosure and ratification

In seeking to ratify their compensation in advance, directors cannot use advance ratification to give themselves a blank check, nor can they secure broad authority subject only to a cap; they can, however, obtain authorization for specific payments or for the use of a predictable formula.

[34] **Corporations and Business Organizations** Time to sue; limitations and laches

Unless a tolling doctrine applies or other extraordinary circumstances exist, laches bars a stockholder plaintiff from asserting a claim for breach of fiduciary duty if more than three years have passed since the claim accrued; it does not matter whether the claim involves a loyalty breach or bad faith conduct.

[35] **Contracts** Freedom of contract

Contracts Effect in general; enforcement in general

State law respects the right of parties to freely contract and to be able to rely on the enforceability of their agreements.

2 Cases that cite this headnote

[36] **Contracts** Effect in general; enforcement in general

Where Delaware's law applies, with very limited exceptions, courts will enforce the contractual scheme that the parties have arrived at through their own self-ordering, both in recognition of a right to self-order and to promote certainty of obligations and benefits.

1 Case that cites this headnote

[37] **Contracts** Freedom of contract

Sophisticated parties to a contract can and should make their own judgments about the risk they should bear, and state's courts are especially chary about relieving sophisticated business entities of the burden of freely negotiated contracts.

3 Cases that cite this headnote

[38] **Contracts** Freedom of contract

More significant public policy interests than freedom of contract, as could support court's interference with parties' voluntary agreement, are not to be lightly found, as the wealth-creating and peace-inducing effects of civil contracts are undercut if citizens cannot rely on the law to enforce their voluntarily-undertaken mutual obligations.

1 Case that cites this headnote

[39] **Contracts** Rewriting, remaking, or revising contract

Courts will not rewrite a contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal.

[40] **Corporations and Business Organizations** Nature of Property in Shares

A share of stock represents a bundle of rights defined by the laws of the chartering state and the corporation's certificate of incorporation and bylaws.

[41] **Corporations and Business Organizations** Personal property

Because a share of stock is the personal property of its owner, the rights associated with and appurtenant to the share are rights that the owner can freely exercise or decline to exercise. 8 Del. Code § 159.

[42] **Corporations and Business Organizations** Rights and Liabilities as to Corporation and Other Shareholders or Members

Fundamental rights associated with and appurtenant to a share of stock are the rights to sell, vote, and sue.

1 Case that cites this headnote

[43] **Corporations and Business Organizations** Operation and effect in general

General theory of state's Corporation Law is that action taken under one section of that law is legally independent, and its validity is not dependent upon, nor to be tested by the requirements of other unrelated sections under which the same final result might be attained by different means. 8 Del. Code § 101 et seq.

[44] **Corporations and Business Organizations** Certificate or Articles of Incorporation

Corporations and Business Organizations Bylaws

A stockholders agreement is not a charter or bylaw provision, so restrictions on charter or bylaw provisions do not govern stockholders agreements.

[45] **Corporations and Business Organizations** Construction, operation, and effect

Corporations and Business Organizations Constitutional and statutory provisions

Corporations and Business Organizations Construction, operation, and effect

Corporations and Business Organizations Shareholder agreements as to management

Corporations and Business Organizations Stock Options

When evaluating corporate action for legal compliance, a court examines whether the action contravenes the hierarchical components of the entity-specific corporate contract, comprising (i) the Delaware General Corporation Law, (ii) the corporation's charter, (iii) its bylaws, and (iv) other entity-specific contractual agreements, such as a stock option plan, other equity compensation plan, or, as to the parties to it, a stockholder agreement; each of the lower components of the contractual hierarchy must conform to the higher components. 8 Del. Code § 101 et seq.

[46] **Corporations and Business Organizations** Shareholder agreements as to management

Covenant executed by stockholders in stockholder-level agreement, granting investor a contractual right to engage in certain transactions meeting specified criteria and granting in return a promise not to sue investor, including for breach of fiduciary duty, if it exercised that right, was not facially invalid as contrary to state's public policy, even when asserted in response to stockholders' claim of breach of duty of loyalty arising from exercise of right by investor after it became controlling stockholder; examples from trust, agency, and corporate law indicated that provision could be upheld in those contexts, and finding provision facially invalid would be contrary to state's contractarian perspective on law.

[47] **Jury** Application of constitution in general

Jury In Criminal Cases

Both the federal and state constitutions guarantee a criminal defendant the right to trial by jury, but that right can be waived. U.S. Const. Amend. 6; Del. Const. art. 1, § 7.

[48] **Criminal Law** Presence of Accused

Criminal Law Right of Accused to Confront Witnesses

Criminal Law Waiver of right

Both the federal and state constitutions provide a criminal defendant with a right to be present for trial and confront the witnesses against him, but that right can be waived. U.S. Const. Amend. 6; Del. Const. art. 1, § 7.

[49] **Criminal Law** Right of Defendant to Counsel

Criminal Law In general; right to appear pro se

Both the federal and state constitutions provide a defendant with a right to counsel in a criminal case, but that right can be waived. U.S. Const. Amend. 6; Del. Const. art. 1, § 7.

[50] **Self-Incrimination** Constitutional and statutory provisions

Self-Incrimination Waiver or Forfeiture

Both the federal and state constitutions protect against self-incrimination, but that right can be waived. U.S. Const. Amend. 5; Del. Const. art. 1, § 7.

[51] **Criminal Law** Waiver of Rights, Defenses, and Objections

A criminal defendant can waive all of his rights to personal liberty by entering a guilty plea, freely and voluntarily.

[52] **Property** Property Rights and Interests

A waiver of a property right is generally effective so long as it is voluntary, knowing, and intelligently made, or reflects an intentional relinquishment or abandonment or of a known right or privilege.

[53] **Constitutional Law** Contractual waiver

A debtor may waive his due process right to pre-judgment notice and a hearing by agreeing to a confession of judgment clause. U.S. Const. Amend. 14.

[54] **Jury** Necessity for demand

Jury Submission to arbitration

In a civil case, a plaintiff can waive the right to a jury trial by agreeing to arbitrate or simply by failing to request a jury trial. Del. Const. art. 1, § 4.

[55] **Estoppel** Rights subject to waiver

Delaware law generally permits individuals to waive statutory rights.

[56] **Real Property Conveyances** Conditions and Restrictions

State law allows real property owners to agree to deed restrictions that waive their ability to use their property in specified ways.

[57] **Contracts** Restraint of Trade or Competition in Trade

State law allows individuals to agree to covenants that restrict their ability to work for a competitor.

[58] **Contracts** Preventing disclosure of trade secrets or confidential information

State law allows individuals to enter into non-disclosure agreements that limit their ability to speak.

[59] **Corporations and Business Organizations** Shareholder agreements as to management

Through a stockholder-level agreement, stockholders can make commitments about how they exercise their statutory, charter, and bylaw rights, but they cannot change those rights.

2 Cases that cite this headnote

[60] **Corporations and Business Organizations** Shareholder agreements as to management

A stockholder-level agreement only binds its signatories, and other stockholders remain free to exercise their rights differently.

1 Case that cites this headnote

[61] **Corporations and Business Organizations** Organizing documents; operating agreement

A limited liability company (LLC) agreement can fully eliminate any duties existing at law or in equity, including fiduciary duties. 6 Del. Code § 18-1101(c).

2 Cases that cite this headnote

[62] **Contracts** Terms implied as part of contract

The implied covenant of good faith and fair dealing inheres in every contract governed by Delaware law and cannot be eliminated.

5 Cases that cite this headnote

[63] **Corporations and Business Organizations** Organizing documents; operating agreement

A limited liability company (LLC) agreement can provide indemnification and advancement unconstrained by any statutory standards. 6 Del. Code § 18-108.

[64] **Corporations and Business Organizations** Organizing documents; operating agreement

A limited liability company (LLC) agreement can fully eliminate any and all liabilities, except for bad faith breaches of the implied covenant of good faith and fair dealing. 6 Del. Code §§ 18-1101(c), 18-1101(e).

2 Cases that cite this headnote

[65] **Corporations and Business Organizations** Indemnification

Corporate charter and bylaws cannot provide indemnification or advancement that goes beyond statutory standards. 8 Del. Code § 145.

[66] **Corporations and Business Organizations** Exculpatory provisions in charter, articles of incorporation or bylaws

Corporate charter and bylaws cannot constrain liability for breach of the implied covenant of good faith and fair dealing.

2 Cases that cite this headnote

[67] **Corporations and Business Organizations** Shareholder agreements as to management

Court applies a two-step analysis in determining whether a covenant not to sue for breach of fiduciary duty, executed by stockholders in favor of director or officer in a stockholder-level agreement, is valid: first, provision must be narrowly tailored to address a specific transaction that would otherwise constitute a breach of fiduciary duty, and second, provision must survive close scrutiny for reasonableness.

[68] **Corporations and Business Organizations** Shareholder agreements as to management

Covenant executed by stockholders in stockholder-level agreement, granting investor a contractual right to engage in certain transactions meeting specified criteria and granting in return a promise not to sue investor, including for breach of fiduciary duty, if it exercised that right, was sufficiently narrowly tailored, as could support finding that covenant was valid even when asserted in response to stockholders' claim of breach of duty of loyalty arising from exercise of right by investor after it became controlling stockholder, where covenant only applied to

one of three types of transactions that qualified as a sale of company, and terms of any such transaction were also required to meet eight specific criteria.

[69] **Corporations and Business Organizations** Shareholder agreements as to management

Covenant executed by stockholders in stockholder-level agreement, granting investor a contractual right to engage in certain transactions meeting specified criteria and granting in return a promise not to sue investor, including for breach of fiduciary duty, if it exercised that right, was reasonable, as could support finding that covenant was valid even when asserted in response to stockholders' claim of breach of duty of loyalty arising from exercise of right by investor after it became controlling stockholder; agreement was clearly written and freely executed, parties were sophisticated, and stockholders could have rejected covenant.

[70] **Constitutional Law** Advisory Opinions

A court only decides the case at hand.

[71] **Contracts** Exemption from liability

A commercial agreement among sophisticated parties can only exonerate a party for liability for its own negligence, as opposed to fraud or bad faith.

[72] **Fraud** Fiduciary or confidential relations

A claim for breach of fiduciary duty is an equitable tort.

1 Case that cites this headnote

[73] **Corporations and Business Organizations** Shareholder agreements as to management

Covenant executed by stockholders in stockholder-level agreement, granting investor a contractual right to engage in certain transactions meeting specified criteria and granting in return a promise not to sue investor, including for breach of fiduciary duty, if it exercised that right, was invalid to extent it was applied to preclude a claim against investor, which subsequently became controlling stockholder, for intentional breach of fiduciary duty; policy limitations precluded contractual provisions from eliminating tort liability for intentional harm.

[74] **Corporations and Business Organizations** Shareholder agreements as to management

Covenant executed by stockholders in stockholder-level agreement, granting investor a contractual right to engage in certain transactions meeting specified criteria and granting in return a promise not to sue investor, including for breach of fiduciary duty, if it exercised that right, could validly apply to stockholders' claim that investor, which subsequently became controlling stockholder, engaged in self-interested transactions with reckless disregard for best interests of company; although state law precluded contractual elimination of liability for intentional harm, recklessness was different standard, and reckless conduct fell within ambit of duty of care for which statute authorized exculpation of directors and officers for monetary liability. Del. Code § 102(b)(7).

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OPINION DENYING MOTION TO DISMISS BASED ON COVENANT NOT TO SUE FOR BREACH OF FIDUCIARY DUTY

LASTER, V.C.

This decision grapples with a conflict between two elemental forces of Delaware corporate law: private ordering and fiduciary accountability. Ordinarily, those forces operate harmoniously. Here, they pull in opposite directions.

Viewed from the standpoint of private ordering, this might seem like an easy case for contract enforcement: Sophisticated stockholders granted another investor a contract right to engage in a transaction that met specified criteria, and they promised not to sue the investor or its affiliates and associates if the investor exercised that right. The investor committed capital to the corporation in reliance on the stockholders' promise. Later, the investor exercised its contract right. Now, the stockholders are doing what they said they wouldn't do: sue over the transaction.

But like an Escher lithograph, the image changes with the viewer's perspective. The claims that the stockholders promised not to assert include claims for breach of fiduciary duty. The investor became the corporation's controlling stockholder, and individuals affiliated or associated with the investor took over the board of directors. The stockholders contend that by engaging in the contractually authorized transaction, the investor and the directors breached their duty of loyalty. In contrast to Delaware's alternative entity statutes, the Delaware General Corporation Law (the "DGCL") permits only limited fiduciary tailoring. Viewed from the standpoint of fiduciary accountability, this might seem like an easy case for contractual invalidity.

With the stage set, let's dig in. The plaintiffs are investment funds (the ***529** "Funds") managed by sophisticated venture capital firms. The Funds invested in a startup company called Fugue, Inc. (the "Company"). After backing the Company for half-a-dozen years, the Funds encouraged management to seek a liquidity event. The Company spent six months looking for a buyer, but no one expressed interest. After declaring the sale process a failure, the Company needed capital.

The Funds did not want to increase their financial commitment. Management represented that the only option was a recapitalization led by George Rich (the "Recapitalization"). He would only commit if (i) all existing preferred stock became common stock, (ii) Rich and his fellow investors received a new class of preferred stock (the "Preferred Stock"), and (iii) the Funds and other significant investors executed a voting agreement (the "Voting Agreement" or "VA"). The Funds accepted Rich's terms. They were given the chance to participate in the Recapitalization, but they declined.

The Voting Agreement contains a drag-along right. It provides that if the Company's board of directors (the "Board") and the holders of a majority of the Preferred Stock approve a transaction that meets a list of eight criteria, then the signatories must participate (the "Drag-Along Sale"). Critically for this case, the signatories covenanted not to sue Rich or his affiliates or associates over a Drag-Along Sale, including by asserting claims for breach of fiduciary duty (the "Covenant").

An opportunity to sell the Company soon materialized. The Company and the acquiror negotiated a Drag-Along Sale. That transaction has now closed.

In Counts VI, VII, and VIII of their complaint (the "Sale Counts"), the Funds have challenged the Drag-Along Sale and asserted claims for breach of fiduciary duty. The defendants argue that in light of the Covenant, the Sale Counts must be dismissed.

The Funds acknowledge that the Covenant covers their claims, and they concede that it was an inducement for Rich to invest. They assert that the Covenant is facially invalid.

The argument for facial invalidity starts from the settled proposition that fiduciary relationships are creatures of equity. The key move comes next and asserts that equity does not countenance limitations on fiduciary duties except to the extent authorized by statute. The DGCL does not authorize a provision like the Covenant. Therefore, the argument goes, it is contrary to Delaware public policy and cannot be enforced.

The argument against facial invalidity takes longer to unspool. It starts by recognizing that fiduciary duties can be tailored, even without statutory authorization. At the heart of every fiduciary relationship is an obligation of loyalty that cannot be eliminated without destroying its fiduciary

character. Parties can, however, orient the obligation by specifying a purpose for the relationship, and they can authorize the fiduciary to take specific actions that otherwise would constitute a breach. Two paradigmatic fiduciary relationships—that of trustee to beneficiary and agent to principal—exemplify those opportunities for tailoring.

The argument next shows that Delaware corporate law adheres to those longstanding principles. The DGCL permits corporate planners to orient the fiduciary relationship between the directors and the corporation and its stockholders through a purpose clause. The directors must pursue the corporate purpose selflessly for the benefit of the corporation and its stockholders, but they are limited to pursuing the corporation's purpose. They cannot ***530** pick another path simply because they prefer it. The DGCL also allows more space for fiduciary tailoring and greater limits on fiduciary accountability than is widely understood. Delaware common law goes further, with existing doctrines achieving outcomes comparable to what the Covenant contemplates.

Having shown that corporate fiduciary duties are not immutable, the argument against facial invalidity turns to the contractarian nature of Delaware corporate law. A close analysis of the DGCL shows that through a private agreement, stockholders can agree to more constraints on their ability to exercise stockholder-level rights than corporate planners can impose through the charter or bylaws. The Covenant appears in a stockholder-level agreement and concerns a stockholder-level right.

This in-depth analysis indicates that the Covenant is not out of bounds as a form of fiduciary tailoring. The analysis next turns to other indications of where Delaware might draw a public policy line.

An intuitively appealing argument asserts that a claim for breach of the duty of loyalty is too big to waive. One way to evaluate that argument is to consider what else is waivable. Delaware law permits individuals to waive significant liberty and property interests that are arguably weightier than a right appurtenant to a share. The comparison suggests that the Covenant is not facially invalid.

A rhetorically powerful argument asserts that permitting stockholders to covenant not to sue for breach of the duty of loyalty would conflict with Delaware's corporate brand, which promises standardized terms, including an immutable duty of loyalty. The promise of standardized terms should not be overstated, because Delaware's support for private ordering means that an investor cannot assume that one Delaware corporation is like another. The promise of an immutable duty of loyalty is also overstated, because the duty can be oriented and tailored. Regardless, a stockholder-level agreement about the exercise of stockholder-level rights does not undermine the corporate brand, because the underlying rights remain intact. Each stockholder receives the underlying rights and can exercise them. The stockholder-level agreement only binds its signatories and only affects how they exercise their rights.

Another rhetorically powerful argument asserts that permitting a stockholder to covenant not to sue for breach of the duty of loyalty will collapse the distinction between a corporation and an LLC. That is not so, as the fundamental differences between corporations and LLCs operate at the basal level of their statutes and constitutive documents. There is a superficial similarity between the ability of investors in corporations and LLCs to contract about their investor-level rights, but that resemblance does not turn corporations into LLCs.

A final argument for invalidity relies on the Delaware Supreme Court's decision in *Manti Holdings, LLC v. Authentix Acquisition Co.*[1] There, sophisticated stockholders agreed to a drag-along provision in which they covenanted not to pursue their appraisal rights. The stockholders sought to escape their promise by arguing that the provision conflicted with the DGCL and was contrary to Delaware public policy.

A majority of the Delaware Supreme Court upheld the appraisal waiver, stressing the contractual freedom that Delaware corporate law provides and citing a list of factors that apply equally to this case. But ***531** the justices also emphasized that they were not upholding all waivers of appraisal rights, and they admonished that Delaware law might not permit a stockholder to waive other rights. A dissenting justice would not have upheld the appraisal waiver.

The majority and dissenting opinions in *Manti* raise questions about whether a provision like the Covenant goes too far. This decision's review of trust law, agency law, the DGCL, and Delaware common law reveals that each authorizes provisions that allow fiduciaries to engage in specific transactions that otherwise would constitute a breach. The Covenant is sufficiently specific because it only applies to a transaction that meets the eight criteria required for a Drag-Along Sale. The Funds did not broadly covenant not to assert

any claims for breach of fiduciary duty. They agreed not to sue over a specific transaction with specific characteristics.

The Covenant is therefore not facially invalid. It is also not invalid on the facts of the case. In *Manti*, the Delaware Supreme Court considers a series of factors, including (i) the presence of a written contract, (ii) the clarity of the waiver, (iii) the stockholder's understanding of the waiver's implications, (iv) the stockholder's ability to reject the provision, (v) the existence of bargained-for consideration, and (vi) the stockholder's sophistication. The proponent of the provision must establish that enforcement is reasonable.

This case provides an optimal scenario for enforcement. The Covenant appears in the Voting Agreement. It is clear and specific. The Funds are sophisticated repeat players who understood its implications. It tracks a provision that appears in a model agreement sponsored by the National Venture Capital Association (the "NVCA"), and one of the venture capital firms behind the Funds is a member of the NVCA. The Covenant was part of a bargained-for exchange that induced Rich to lead the Recapitalization, his fellow investors to participate, and Rich and his colleague to serve on the Board. The Funds were the dominant incumbents in the cap table. If they did not like the Recapitalization, they could have blocked it, forced the Company to seek different terms, or funded the Company themselves. If they saw no alternative but thought Rich had secured a great deal, then they could have joined the investor group. They decided to pass, agreed to the Covenant, and let Rich and his investor group take the risk.

This decision cannot conclude that the Covenant is invalid as applied to these facts. That does not mean that the Delaware courts will enforce similar provisions. A covenant not to sue resembles another powerful provision: the covenant not to compete. Like a covenant not to sue, sophisticated parties can use a covenant not to compete to create value, but covenants not to compete can be abused, and this court examines them closely.

Parties should expect a similar hard look for covenants not to sue. A broad waiver of any ability to assert claims for breach of fiduciary duty would be a non-starter. Even a narrowly tailored provision would likely be unreasonable if it appeared in an agreement that purported to restrict the rights of retail stockholders.

Although the Covenant is not wholly invalid, either facially or as applied, its scope still stretches beyond what Delaware law allows. Delaware law generally prohibits contractual provisions that purport to exculpate a party for tort liability resulting from intentional or reckless harm. Delaware corporate law is more permissive and treats recklessness as a form of gross negligence, thereby expanding the power to exculpate to encompass recklessness. There is only one situation where Delaware ***532** law has gone further and held that a provision restricting tort liability for intentional harm was not facially invalid: In *Abry Partners*,[2] this court permitted a sophisticated party to disclaim reliance on any representations that did not appear in a written contract, thereby covenanting not to sue for extracontractual fraud. Subsequent decisions have refused to authorize other types of provisions that could restrict tort liability for intentional harm.

The Covenant purports to bar all challenges to the Drag-Along Sale. It cannot insulate the defendants from tort liability based on intentional wrongdoing, but it can protect against other claims. The Sale Counts rely on facts supporting an inference that the defendants could have acted intentionally and in bad faith to benefit themselves and harm the common stockholders during the lead up to the Drag-Along Sale. The Sale Counts therefore cannot be dismissed at the pleading stage. The defendants' motion to dismiss based on the Covenant is denied.

I. FACTUAL BACKGROUND

The facts are drawn from the operative complaint and the documents that it incorporates by reference.[3] The defendants argued that the complaint failed to state a claim on which relief could be granted for reasons other than the Covenant, and the court issued an opinion addressing those contentions (the "Pleading Decision").[4] The Sale Counts survived dismissal, necessitating consideration of the Covenant. This decision incorporates the factual background from the Pleading Decision and only summarizes the information pertinent to the Covenant.

A. The Company

Founded in 2012, the Company provides tools to build, deploy, and maintain a cloud infrastructure security platform. Josh Stella served as its Chief Executive Officer.

In 2013, plaintiff Core Capital Partners III, L.P. ("Core Capital") led the Company's seed round. Core Capital is an investment fund sponsored by Core Capital Partners, a venture capital firm based in Washington, D.C.

In 2014, plaintiffs New Enterprise Associates 14, L.P., NEA Ventures 2014, L.P., and NEA: Seed II, LLC, invested in the Company. Each is an investment fund sponsored by New Enterprise Associates, a name-brand venture capital firm. The term "Funds" refers to the entities sponsored by NEA and Core Capital that invested in the Company.

Over multiple financing rounds, the Funds invested almost $39 million in the Company. In return, they received shares of preferred stock that carried special rights. Each of the Funds also received the right to appoint one member of the Board.

B. The Failed Sale Process And The Recapitalization

By 2020, Core Capital had been invested in the Company for seven years, and NEA ***533** had been invested for six. Those investments were getting long in the tooth.

The Funds urged Stella to seek a liquidity event. Starting in the second half of 2020, the Company sought a buyer.

Toward the end of the first quarter of 2021, Stella told the Board that the effort had failed. Stella represented that the Company needed capital, and he recommended that the Company engage in the Recapitalization. The Board authorized him to proceed.

C. The Terms Of The Recapitalization

In the Recapitalization, the Company raised roughly $8 million by issuing shares of Series A-1 Preferred Stock (the "Preferred Stock") to Rich and his investor group. Rich invested through two vehicles, one of which was designated as the "Lead Investor" under the transaction agreements. Rich controlled the investment vehicles through a third entity. All three entities are defendants (together, the "Rich Entities").

Twenty-three other investors participated in the Recapitalization. Eleven already owned common stock in the Company. Another five were Company employees. Only seven appear to be new investors. The Funds declined to participate.

The terms of the Recapitalization were onerous for the incumbent stockholders. Rich insisted that all of the preferred stock convert into common stock and that key stockholders execute the Voting Agreement. All of the investors in the Recapitalization executed the Voting Agreement, as did twenty-nine of the existing stockholders (the "Signatories"). The Funds were Signatories.

In the Voting Agreement, the Signatories agreed to vote for (i) one director designated by the Lead Investor, (ii) a second director designated by the holders of a majority of the Preferred Stock, (iii) a third director elected by a majority of the Preferred Stock held by investors other than the Lead Investor, (iv) the CEO, and (v) one director designated by all the outstanding stock voting together as a single class. After the Recapitalization, the Board's five members were Stella, two independent directors who carried over from before the Recapitalization, and two representatives of the new investors. Rich joined the Board as the designee of the Lead Investor. David Rutchik joined as the director designated by the holders of a majority of the Preferred Stock. Rutchik had participated in the Recapitalization through his affiliate, the Rutchik Descendants' Trust (the "Rutchik Trust").

Importantly for this decision, Section 3.2 of the Voting Agreement contains the Drag-Along Right. That provision obligates the Signatories to support a Drag-Along Sale and includes the Covenant.

D. An Expression Of Interest And The Interested Transactions

In late June 2021, a potential acquirer contacted Stella. The outreach contrasted with the Company's failed sale process. The contact was preliminary, but it put a different cast on the Company's situation.

On July 14, 2021, the two independent directors resigned, leaving Stella, Rich, and Rutchik as the only members of the Board. One week later, they authorized the Company to issue another 3,938,941 shares of Preferred Stock. The buyers were nine entities and individuals, including Rich and Rutchik. Rather than treating the issuance as a new transaction, the Board amended the terms of the Recapitalization and pretended that the second issuance was part of the original deal. That move enabled the buyers to acquire the shares at the same price and on the same terms that Rich had ***534** extracted in April 2021 when the Company was low on cash and had no alternatives.

Later that same month, on July 29, 2021, the Board approved grants of stock options. Many of the recipients were Company employees, but large grants went to the three directors.

The Funds contend that the second issuance of Preferred Stock and the grants of options to the insiders (together, the "Interested Transactions") constituted breaches of fiduciary duty. They allege that the Interested Transactions were obvious instances of self-dealing on terms that appear facially unfair to the Company and highly beneficial to Rich and his confederates.

E. The Merger

While those events were transpiring, discussions with the acquirer moved forward. By September 2021, they were negotiating a merger agreement. In December, the Board told the stockholders about an agreement in principle to sell the Company for $120 million in cash.

On February 12, 2022, the Company sent the Funds a draft merger agreement with a joinder agreement and voting form. The Company told the Funds that they were obligated to sign the joinder agreement and voting form.

Section 1.1 of the joinder agreement bound each signatory to vote in favor of the merger and against any competing proposal. In Section 1.2 of the joinder agreement, each signatory released any and all claims against the Company, the directors, and their associates and affiliates.

The Funds agreed to sign the documents if Stella and Rich attested that they had not had any communications with the acquirer about a potential transaction before the Recapitalization. Their counsel promised to provide the affirmations.

On February 17, 2022, the Company announced that it had executed the merger agreement and closed the transaction. On February 18, 2022, Stella and Rich's counsel proposed substantially narrower affirmations. The Funds refused to sign the joinder agreement and voting form. On February 21, the Company circulated a distribution waterfall that revealed the Interested Transactions.

F. This Litigation

On May 9, 2022, the Funds filed this lawsuit. The complaint contained eight counts, three of which comprise the Sale Counts. Count VI contends that Rich, Rutchik, and Stella breached their fiduciary duties as directors by approving the Drag-Along Sale. Count VII contends that the Rich Entities breached their fiduciary duties as controlling stockholders by approving the Drag-Along Sale. Count VIII alleges that the Rutchik Trust aided and abetted the fiduciaries' breaches of duty. The gist of those claims is that the Drag-Along Sale (i) failed to provide any consideration for derivative claims relating to the Interested Transactions and (ii) conferred a unique benefit on Rich, Rutchik, Stella, and their affiliates by extinguishing the standing of sell-side stockholders to pursue those claims. The Funds contend that the Drag-Along Sale was therefore an interested transaction subject to the entire fairness test and that the defendants cannot establish that it was entirely fair.

The defendants moved to dismiss the complaint. In the Pleading Decision, the court held that the Sale Counts stated claims on which relief. The Pleading Decision did not reach the defendants' argument that the Covenant foreclosed the Sale Counts.

*535 II. LEGAL ANALYSIS

The defendants contend that the Covenant bars the Funds from asserting the Sale Counts. The defendants invoked the Covenant through a motion to dismiss under Rule 12(b)(6). When considering a Rule 12(b)(6) motion, the court (i) accepts as true all well-pled factual allegations in the complaint, (ii) credits vague allegations if they give the opposing party notice of the claim, and (iii) draws all reasonable inferences in favor of the plaintiffs. Dismissal is inappropriate "unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances."[5]

[1] **[2]** The existence of a contractual bar to suit, such as a release or a covenant not to sue, is an affirmative defense that must be asserted in a responsive pleading.[6] A court can consider a contractual bar to suit under Rule 12(b)(6) if the complaint incorporates the document by reference or if the document is subject to judicial notice.[7] In this case, the court can consider the Covenant because it is part of the Voting Agreement, which the complaint incorporates by reference.

A. The Nature Of A Covenant Not To Sue

[3] **[4]** A covenant not to sue is a contract in which a potential claimant commits not to assert specified claims

against a potential defendant. A covenant not to sue and a release are different things. "A covenant not to sue or execute is distinguished from a release as a forbearance of a right rather than a discharge of liability."[8] Historically, that distinction carried significance, ***536** because in most jurisdictions, a release of one joint tortfeasor extinguished the cause of action as to all joint tortfeasors.[9] That rule created problems for partial settlements, because a settlement and release with one joint tortfeasor extinguished the settling party's claim against all other joint tortfeasors. A covenant not to sue avoided that problem, because the covenant did not extinguish the claim.[10]

When determining the scope of a covenant not to sue, a court construes its terms like any other contract.[11] When multiple claims or multiple defendants are involved, the covenant not to sue only applies to the claims and defendants that fall within its scope.[12] A covenant not to sue can apply "to future as well as to present claims."[13] Unlike a release, where the cancellation of the claim and the discharge of the released party are complete upon execution, the covenant not to sue is an executory contract that contemplates ongoing performance.[14]

[5] Covenants not to sue are generally valid, "as public policy is in no way concerned with the option which a person has to sue or to forbear suit."[15] Some jurisdictions impose public policy limitations on covenants not to sue.[16] Illinois common law prevents covenants not to sue from "exculpating persons from the consequences of their willful and wanton acts."[17] New York common law prohibits contracts that prospectively limit a party from liability for willful or grossly negligent acts.[18] Delaware applies the same public policy limitations to covenants not to sue that it applies to contracts generally. Extant decisions hold that a provision in a commercial contract cannot eliminate tort liability for intentional or reckless conduct.[19]

B. The Scope Of The Covenant

[6] The Covenant in this case is part of the Drag-Along Right. It is not part of a settlement of all claims arising out of or relating to a particular transaction or event. If it were, there would be no question about its validity, because parties can release claims for breach of fiduciary duty ***537** as part of a settlement.[20]

The Covenant creates issues because it is forward-looking. It applies when the Drag-Along Right is properly exercised. For that to happen, the transaction must qualify as a "Sale of the Company," defined as either (i) a stockholder-level sale in which the stockholders sell shares representing more than 50% of the Company's outstanding voting power, (ii) a merger in which the Company's pre-merger stockholders end up holding less than 50% of the Company's outstanding voting power, or (iii) a sale of all or substantially all of the Company's assets.[21]

For the Drag-Along Right to apply, the Sale of the Company must receive approval from both (i) the holders of a majority of the issued and outstanding shares of Preferred Stock, and (ii) the Board, including the director appointed by the Lead Investor and at least one other director approved by the holders of the Preferred Stock.[22] If the Drag-Along Right applies, then the Signatories must fulfill a series of contractual commitments. But no Signatory has to comply with those obligations unless the Sale of the Company satisfies eight requirements. This decision defines a Sale of the Company that meets the eight requirements as a Drag-Along Sale. In abbreviated form, the requirements include:

- Each holder of shares of stock of each class or series must receive the same form and amount of consideration as the other shares in their class or series,[23]
- The transaction consideration must be distributed in order of priority as set forth in the charter,[24]
- If there is a choice of consideration, then each holder receives the same choices,[25]
- Signatories cannot be required to make representations and warranties except as to the ownership of, authority over, and ability to covey title to their shares,[26]
- Signatories cannot be required to agree to restrictive covenants,[27]
- Signatories cannot be required to terminate or alter any contractual agreements with the Company,[28]
- Signatories cannot have any liability for a breach of any representation, ***538** warrant, or covenant, except to the extent paid from an escrowed portion of the transaction consideration designated for that purpose,[29] and

• Signatories cannot be required to fund the escrow beyond their pro rata share of the negotiated amount.[30]

Because of these conditions, the Drag-Along Right does not apply to a transaction in which the Rich Entities extract additional or unique consideration for themselves.

If the Drag-Along Right applies, then each Signatory must take a series of actions. They include:

• Voting for the Drag-Along Sale if it requires stockholder approval,[31]

• Executing and delivering documentation in support of the Sale of the Company that the Company reasonably requests,[32]

• Agreeing to appoint a stockholder representative with authority to take action under the transaction documents after closing,[33] and

• Agreeing to the Covenant.[34]

Under the Covenant, each Signatory commits

> to refrain from (i) exercising any dissenters' rights or rights of appraisal under applicable law at any time with respect to such Sale of the Company, or (ii) asserting any claim or commencing any suit (x) challenging the Sale of the Company or this Agreement, or (y) alleging a breach of any fiduciary duty of the Electing Holders or any affiliate or associate thereof (including, without limitation, aiding and abetting breach of fiduciary duty) in connection with the evaluation, negotiation or entry into the Sale of the Company, or the consummation of the transactions contemplated thereby.[35]

Each Signatory thus covenants both to waive appraisal rights *and* not to assert any challenge to the Sale of the Company or any claim for breach of fiduciary duty or aiding and abetting against "the Electing Holders or any affiliate or associate thereof."

The parties agree that the Drag-Along Sale met the contractual requirements and triggered the Signatories' obligations. The parties agree that the Covenant encompasses all of the defendants. They agree that it covers the Sale Counts.[36]

***539** The Funds have not argued that the Covenant was induced by fraud or overreaching. They have not claimed that they failed to understand the Covenant or its implications. Particularly for NEA, that would be a difficult argument to make, because NEA is a member of the NVCA, and the Covenant tracks a provision in the model voting agreement sponsored by that organization.[37] Under that provision, a signatory agrees

> to refrain from (i) exercising any dissenters' rights or rights of appraisal under applicable law at any time with respect to such Sale of the Company, or [(ii); asserting any claim or commencing any suit [(x)] challenging the Sale of the Company or this Agreement, or [(y) alleging a breach of any fiduciary duty of the Selling Investors or any affiliate or associate thereof (including, without limitation, aiding and abetting breach of fiduciary duty) in connection with the evaluation, negotiation or entry into the Sale of the Company, or] the consummation of the transactions contemplated thereby].[38]

The Covenant adopts the most expansive formulation of the model provision by including the bracketed language.

A comment in the model provision explains the intent of the bracketed language:

> [C]ommon and subordinate preferred stockholders are increasingly filing breach of fiduciary duty claims seeking quasi-appraisal — *i.e.*, damages that mirror the recovery available in an appraisal suit — in transactions subject to drag-along provisions where the junior preferred or common shareholders are to receive no consideration for their shares. Because the directors are often representatives of the senior preferred holders, these suits are difficult to dismiss at an early stage. Accordingly, consideration should be given to expanding the agreement ... to cover breach of fiduciary suits in transactions subject to the drag along.[39]

The commentary confirms that the Covenant is intended to do what it says and bar breach of fiduciary duty claims based on the Drag-Along Sale.

The defendants' motion squarely presents the question of the Covenant's validity. This is not a case where ambiguity exists about whether a waiver extends to breach of fiduciary duty claims.

C. The Case For Facial Invalidity

The Funds' case for holding the Covenant facially invalid is short and sweet: "Under well-settled law, parties cannot

waive fiduciary duties of loyalty in Delaware corporations."[40] In support of that proposition, the Funds cite Section 102(b)(7) of the DGCL, which limits the extent to which a charter provision can ***540** limit or eliminate a director or officer's liability for money damages for breach of fiduciary duty. They also cite three decisions (including one of my own) which, in dictum, contrast the broad flexibility of parties to waive or limit fiduciary duties in an alternative entity agreement with the more limited ability to waive or limit fiduciary duties in a corporate charter.[41] Those are relatively few authorities for an absolutist proposition. The Funds seem to treat it as self-evident that a provision like the Covenant is facially invalid.

The Funds would have done better to rely on *Totta v. CCSB Financial Corp.*,[42] where Chancellor McCormick addressed the ability of corporate planners to displace equity's power to impose fiduciary duties, evaluate compliance through standards of review, and impose equitable remedies. *Totta* involved a provision in the certificate of incorporation of a bank holding company that prohibited any stockholder from exercising more than 10% of the company's voting power in an election. To minimize disputes over the application of the provision, the charter provided that "[a]ny constructions, applications, or determinations made by the Board of Directors pursuant to this section in good faith and on the basis of such information and assistance as was then reasonably available for such purpose shall be conclusive and binding upon the Corporation and its stockholders" (the "Conclusive-And-Binding Provision").[43] Facing a proxy contest, the incumbent directors interpreted the voting power limitation to apply not only to ownership by a single stockholder, but also to stockholders acting in concert. The new interpretation resulted in the defeat of the insurgent slate.

***541** The Chancellor explained that because the incumbent directors interfered with a proxy contest, they bore the burden of justifying their actions under the form of enhanced scrutiny that applies to elections.[44] The incumbent directors argued that enhanced scrutiny did not apply because of the Conclusive-And-Binding Provision, which contemplated a standard of review comparable to the business judgment rule. Chancellor McCormick held that the Conclusive-And-Binding Provision could not alter the directors' fiduciary obligations or the attendant standard of review:

> Fiduciary duties arise in equity and are a fundamental aspect of Delaware law. The constitutive agreements that govern an entity can only eliminate or modify fiduciary duties and the attendant judicial standards of review to the extent expressly permitted by an affirmative act of the Delaware General Assembly. The General Assembly has granted broad authorization to modify or eliminate fiduciary duties and attendant standards of review in some types of entities. The General Assembly has granted only limited authority to corporations.[45]

The Chancellor cited Sections 102(b)(7) and 122(17) of the DGCL as the sole provisions through which the General Assembly has authorized limitations on equitable review and fiduciary accountability.[46] She noted that the General Assembly had never expressly authorized a charter provision that could modify the standard of review. As a result, the Chancellor concluded that the Conclusive-And-Binding Provision was invalid.

Chancellor McCormick grounded the persistent power of equity on the constitutional grant of equity jurisdiction to this court: "The Constitution of 1897 retains the distinction between law and equity, and the General Assembly has empowered [the Court of Chancery] to hear and determine all matters and causes in equity."[47] After citing the Delaware Supreme Court's decision in *DuPont v. DuPont*,[48] she made the following observation:

> In the hierarchy of law-making in a democratic regime, courts defer to legislatures. Within constitutional limits, the General Assembly can replace equity with statutory law. For purposes of entity law, that means the General Assembly has the authority to eliminate or ***542** modify fiduciary duties and the standards that are applied by this court, or to authorize their elimination or modification through private ordering.[49]

Thus, if the General Assembly has authorized provisions in the constitutive documents of an entity that eliminate or modify the fiduciary duty regime, then a court will enforce them. Otherwise, practitioners cannot use the constitutive documents of an entity for that purpose.[50]

In *Delman v. GigAcquisitions3, LLC*,[51] Vice Chancellor Will relied on *Totta* to hold that stockholders were not estopped from asserting a claim for breach of the duty of loyalty simply because the potential conflicts of interest faced by the corporate fiduciaries "were disclosed in the prospectus when the plaintiff invested ... and again in the Proxy" issued in connection with the transaction they challenged.[52] She posited that "[s]uch an approach would be inconsistent with the fundamental principles of our law" and stated that that

"Delaware corporate law 'does not allow for a ***543** waiver of the directors' duty of loyalty.' "[53] Relying on *Totta*, she observed that "[t]he Delaware General Assembly alone 'has the authority to eliminate or modify fiduciary duties and the standards that are applied by this court, or to authorize their elimination or modification.' "[54] She concluded that "[u]nless and until that occurs," an entity that chooses the "corporate form promises investors that equity will provide the important default protections it always has."[55]

The Funds argue that the Covenant disguises the wolf of an impermissible limitation on fiduciary duties in the sheep's clothing of a stockholder-level agreement. That, they say, is no distinction at all. Under their bright-line approach, the Covenant is facially invalid.

The Funds have advanced one reasonable interpretation of the law, but it is a stark account that elevates fiduciary accountability above all else, fails to explore the permissible bounds of fiduciary tailoring, and ignores the difference between limitations in the constitutive documents of an entity and limitations in a stockholder-level agreement. The Funds' absolutist framing pays no heed to the importance of private ordering, which is another fundament of Delaware entity law.

I have no quarrel with *Totta* because that case dealt with a charter provision. The creation of a body corporate through the issuance of a charter constitutes an exercise of state authority, equivalent in its efficacy to the enactment of a statute (notwithstanding the now longstanding practice of the state approving charters under a general incorporation law). Through the issuance of a charter, the state creates an otherwise impossible being—an artificial person—capable of exercising the powers conferred by the state and with the limitations that the state wishes to impose. To use the charter to modify the duties attendant to that state-created relationship, parties should need express authority from the state. I also have no quarrel with *GigAcquisitions3*, where the defendants sought to achieve fiduciary tailoring through disclosure plus a notion akin to assumption of risk. The reasoning of those cases does not apply to the current dispute, where the Funds voluntarily restricted their ability to exercise stockholder-level rights in a negotiated agreement. The Funds' position may well be correct, but their authorities do not go that far.

D. The Case Against Facial Invalidity

The argument against the Covenant's facial invalidity takes time to unspool. It starts by showing that fiduciary obligations can be tailored. At the heart of a fiduciary relationship lies a nucleus of other-regarding loyalty that cannot be altered or eliminated without rendering the relationship non-fiduciary. But the orientation and scope of the relationship can be modified. Rather than disavowing that framework, Delaware corporate law deploys it, and both the DGCL and the common law permit a greater space for fiduciary tailoring than is commonly recognized. Set within that broader landscape, the Covenant achieves an outcome that tracks what Delaware law already permits. The analysis next incorporates Delaware's support for private ordering, and the Delaware Supreme Court's embrace of the contractarian theory of corporate law in ***544** *Salzberg v. Sciabacucchi*[56] and *Manti*. The analysis also takes into account the ability of stockholders to agree to greater restrictions on their stockholder-level rights in a negotiated agreement than what corporate planners can impose through the constitutive documents. With a deeper understanding of what Delaware corporate law permits, the case against the facial invalidity of the Covenant is strong.[57]

1. Contractual Tailoring Of Fiduciary Duties

"Contractual and fiduciary relationships are the two dominant legal forms of interaction through which persons can pursue individual and shared interests."[58] The two domains, while separate, are deeply intertwined, because many fiduciary relationships are formed through contract.[59]

The extent to which fiduciary roles can be tailored implicates two competing policies:

> First, in a legal order founded on liberal values, individuals should in general be free to set the normative terms on which they interact. This points in favour [sic] of permitting opt outs, so long as relevant legal and other requirements are satisfied. On the other hand, the mediating function of social roles depends on stability in the normative constitution of these roles; where this is lost, roles may lose their traction as normative resources ***545** and people may stop organizing their affairs with reference to them. Where fiduciary law too readily permits opt outs, there is a risk that fiduciary roles might cease to be comprehensible to those whose actions engage with them, and this might generate costs.... There are reasons to think that social roles can contribute to human autonomy by providing socially recognized options that may be the subject of autonomous

> choice; thus, there are reasons to be sceptical [sic] about opt outs from a liberal point of view.[60]

Those twin concerns manifest themselves in Delaware law through the dual principles of private ordering and fiduciary accountability. For different types of fiduciaries, the law may balance the policies differently.[61]

[7] **[8]** "[T]he word 'fiduciary' is anglicized Latin, meaning trustee-like."[62] Fiduciary duties are thus obligations that are similar to those of a trustee, and a fiduciary relationship is one that is analogous to that between an express trustee and beneficiary.[63] Delaware trust law currently authorizes a trust agreement to modify nearly every aspect of a trustee's duties.[64] By statute, a trust instrument governed by Delaware law may restrict, eliminate, or otherwise vary "[a] fiduciary's powers, duties, standard of care, rights of indemnification and liability to persons whose interests arise from that instrument," subject only to a floor that prevents "exculpation or indemnification of a fiduciary for the fiduciary's own wilful [sic] misconduct" or "a court of competent jurisdiction from removing a fiduciary on account of the fiduciary's wilful [sic] misconduct."[65] For purposes of that statutory floor "[t]he term 'wilful [sic] misconduct' shall mean intentional wrongdoing, not mere negligence, gross negligence or recklessness and 'wrongdoing' means malicious conduct or conduct designed to defraud or seek an unconscionable advantage."[66] Somewhat strangely, Delaware corporate law now stands as the bastion of traditional duties, even though director duties were less onerous ***546** than those of trustees[67] and partners.[68] To the extent that trustee duties establish the model for director duties, Delaware's current trustee paradigm suggests that director duties should be almost fully contractable. In such a world, the Covenant could not be facially invalid.

Let's assume, however, that the contractarianism only conquered trust law by statute, such that that director duties remain modeled on those that a trustee owed at common law. Even then, a trust instrument could provide for fiduciary tailoring. A trust instrument could not eliminate the trustee's core fiduciary obligation to exercise its powers in pursuit of what the trustee believed was in the best interests of the beneficiary.[69] A trust instrument could specify the beneficiaries of the trust, thereby identifying for whose benefit the trustee had to selflessly pursue the trust's purpose.[70] A trust instrument could orient the trustee's fiduciary duties through a purpose clause or cabin the trustee's discretion by giving specific instructions to the trustee.[71] Most importantly for present ***547** purposes, the trust instrument could authorize the trustee to engage in transactions that otherwise would be disloyal.[72]

Those accommodations for fiduciary tailoring suggest that if the Covenant appeared in a trust instrument, then it would not be facially invalid. The Covenant is part of the Drag-Along Right, which authorizes a contractually specified transaction. That transaction might otherwise constitute a loyalty breach, but a common law trust instrument could authorize such a transaction explicitly. The Covenant becomes a belt-and-suspenders provision that adds an obligation not to sue where a court applying trust law would find no claim.

Another prototypical fiduciary relationship exists between agent and principal. As with trust law, an agency agreement cannot eliminate the core fiduciary obligation that the agent exercise its authority to fulfill its charge from the principal by acting selflessly to pursue what the agent believes to be in the principal's best interest.[73] An agency agreement can orient the agent's duties through a narrow purpose clause or cabin the agent's discretion with specific instructions.[74] Most significantly for present purposes, agency law permits a principal to consent in advance to specific conduct that otherwise would constitute a loyalty breach. Under the blackletter rule,

> Conduct by an agent that would otherwise constitute a breach of duty ... does not constitute a breach of duty if the principal consents to the conduct, provided that
>
> (a) in obtaining the principal's consent, the agent
>
> (i) acts in good faith,
>
> (ii) discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and
>
> (iii) otherwise deals fairly with the principal; and
>
> ***548** (b) the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship.[75]

The commentary explains that these conditions impose "mandatory limits on the circumstances under which an agent may be empowered to take disloyal action."[76]

The agency standard draws an important distinction between general attempts at fiduciary waivers and narrowly tailored authorizations.

> [A]n agreement that contains general or broad language purporting to release an agent in advance from the agent's general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent's fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent's position in ways not foreseeable by the principal at the time the principal agreed to the release.[77]

"In contrast, when a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable."[78] The "agent bears the burden of establishing that the requirements stated in this section have been fulfilled."[79]

If the Covenant addressed an agency relationship in which the Funds acted as principals and Rich and his affiliates and associates acted as agents, then the Covenant would not be facially invalid. Rich openly sought the Funds' consent to effectuate a Drag-Along Sale in a setting where it was clear what he wanted to accomplish. As sophisticated investors, the Funds knew what was being asked of them. The Drag-Along Sale was a specific transaction that reasonably could be expected to occur in the ordinary course of the relationship. Although a sale of the Company is not generally an ordinary course transaction for the Company itself, it is the ever-present goal for venture capital investors.[80] In VC heaven, successful exits are ordinary course events. The Funds had wanted a liquidity event and knew that Rich would want one too. In this setting, the Drag-Along Sale was not a breach of duty, and the Covenant again becomes a belt-and-suspenders provision that adds an obligation not to sue where a court applying agency law would find no claim.

The examples from trust and agency law indicate that if judged by traditional standards ***549** for fiduciary tailoring, the Covenant would not be facially invalid. It would be upheld.

2. Delaware Corporate Law And Fiduciary Tailoring

[9] The next question is whether Delaware corporate law has restricted the traditional space for fiduciary tailoring. Delaware corporate law is popularly understood to impose mandatory fiduciary duties that cannot be modified. Although monetary liability for the duty of care can be eliminated, the underlying duty cannot be altered, and the duty of loyalty stands inviolate. That view gains currency from contrasting Delaware corporations with alternatives entities, where the governing statutes authorize the full elimination of fiduciary duties. While it is true that Delaware corporate law has not forged as far afield as its alternative-entity brethren, the corporate form has not rejected the traditional methods of fiduciary tailoring. To the contrary, both the DGCL and Delaware common law accommodate the traditional forms, and the common law has gone further through a concept of contractual preemption articulated most prominently in *Nemec v. Shrader*.[81]

a. Statutorily Authorized Tailoring

Sections 102(b)(7) and 122(17) are the two widely acknowledged paths for fiduciary tailoring in the DGCL. Upon closer review, those are not the only routes that the DGCL makes available.

i. Section 102(b)(7)

The most well-known provision in the DGCL that permits fiduciary tailoring is Section 102(b)(7). It currently provides:

> The certificate of incorporation may also contain ... [a] provision eliminating or limiting the personal liability of a director or officer to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director or officer, provided that such provision shall not eliminate or limit the liability of:
>
> (i) A director or officer for any breach of the director's or officer's duty of loyalty to the corporation or its stockholders;
>
> (ii) A director or officer for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

(iii) A director under § 174 of this title;

(iv) A director or officer for any transaction from which the director or officer derived an improper personal benefit; or

(v) An officer in any action by or in the right of the corporation.[82]

The five exclusions thus prevent a charter provision from eliminating monetary liability for breaches of the duty of loyalty, including its subsidiary requirement that a fiduciary must act in good faith. For directors, the combination of exclusions only permits a charter provision to eliminate monetary liability for breaches of the duty of care. For officers, the combination of exclusions only permits a charter provision to eliminate monetary liability to the stockholders for direct claims for breaches of the duty of care.

Section 102(b)(7) does not speak directly to the Covenant because the statute addresses the extent to which the constitutive documents of the corporation can limit ***550** or eliminate monetary liability for breach of fiduciary duty. Section 102(b)(7) expressly addresses the extent to which a provision *in the corporate charter* can do so. Because a bylaw provision cannot conflict with a contrary provision in the charter or in the DGCL, Section 102(b)(7) implicitly addresses whether a bylaw can do so.[83] The plain language of 102(b)(7) does not address a stockholder-level agreement in which a stockholder commits to refrain from asserting a claim that the stockholder could freely decline to pursue.

[10] As discussed below, the structure of the DGCL demonstrates that stockholders have greater freedom to enter into private agreements that constrain their stockholder-level rights than what can be accomplished in the charter and bylaws.[84] Because of the distinction between a private stockholder agreement and a provision that appears in the charter or bylaws, Section 102(b)(7) does not render the Covenant facially invalid.

Conversely, Section 102(b)(7) does provide some signals about what stockholders can agree to in a stockholder-level agreement. To the extent a particular measure can appear in the more restricted domain of the charter or bylaws, then stockholders should be able to restrict themselves to at least the same degree in a stockholder-level agreement.

[11] By analogy to Section 102(b)(7), a covenant in a stockholder-level agreement in which the signatories agreed not to assert claims for breach of the duty of care is not contrary to Delaware public policy. The analogy to Section 102(b)(7) also indicates that, relatively speaking, Delaware law is less concerned about limiting liability for direct claims than for derivative claims. Section 102(b)(7)'s approach to officers illustrates the distinction, because Section 102(b)(7) authorizes a provision that limits or eliminates monetary liability for direct care claims while foreclosing similar exculpation for corporate care claims. The Covenant only addresses direct claims, making it relatively more acceptable.

The Covenant extends to all direct claims for breach of fiduciary duty that the Signatories could assert against a Drag-Along Sale. That broad framing includes direct claims for the duty of care, and at least that much of the Covenant should be valid.

[12] **[13]** **[14]** **[15]** By analogy to Section 102(b)(7), a covenant in a stockholder-level agreement in which the signatories agreed not to assert direct claims for breaches of duty based on recklessness is not contrary to Delaware public policy. When analyzing the scope of exculpation under Section 102(b)(7), Delaware cases have held consistently that that gross negligence encompasses recklessness.[85] In civil cases not ***551** involving business entities, the Delaware Supreme Court has defined gross negligence as "a higher level of negligence representing 'an extreme departure from the ordinary standard of care.' "[86] Under that framework, gross negligence "signifies more than ordinary inadvertence or inattention," but it is "nevertheless a degree of negligence, while recklessness connotes a different type of conduct akin to the intentional infliction of harm."[87] In Delaware entity law, by contrast, gross negligence encompasses recklessness, such that Section 102(b)(7) permits exculpation for recklessness.[88] The Covenant encompasses all direct claims for breach of fiduciary duty that the Signatories could assert against a Drag-Along Sale, which includes direct claims grounded in recklessness. That aspect of the Covenant appears valid.

Because of the Covenant validly forecloses claims for the duty of care, it is not facially invalid. Section 102(b)(7) therefore does not lead ineluctably to illegitimacy. Section 102(b)(7) imposes limitations on what can appear in the charter and bylaws, and it supports inferences about what Delaware law may otherwise permit or foreclose, but it does not answer the question of the Covenant's validity. To the contrary, analogies to what Section 102(b)(7) permits in the more constrained context of a charter ***552** indicate that

a significant portion of the Covenant's scope complies with Delaware law.

ii. Section 122(17)

A second provision in the DGCL that contemplates fiduciary tailoring is Section 122(17). Under that section, every Delaware corporation has the power to

> [r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.[89]

A claim for usurpation of a corporate opportunity is a claim for breach of fiduciary duty.[90] With the adoption of Section 122(17), "Delaware corporations and managers became free to contract out of a significant portion of the duty of loyalty."[91] Not only that, but the opt-out arrangement need not appear in the charter, disconfirming the theory that all forms of fiduciary tailoring must be charter-based. Under Section 122(17), the board of directors can renounce a specified type or class of opportunities by resolution.

[16] Conceptually, Section 122(17) achieves this result by authorizing the board to accelerate a decision it could make once a corporate opportunity arises. A fiduciary that wishes to pursue a corporate opportunity can present it to the board, and if the board renounces the opportunity, then the fiduciary can proceed.[92]

[17] **[18]** By authorizing advance renunciations of corporate opportunities, Section 122(17) enables a board to commit in advance to reject a particular type or class of opportunities. In practice, a corporate opportunity waiver functions like a covenant not to sue. "The board's authority to govern corporate affairs extends to decisions about what remedial actions a corporation should take after being harmed, including whether the corporation should file a lawsuit against its directors, its officers, its controller, or an outsider."[93] A board can decide whether or not to assert a claim for usurpation of a corporate opportunity. Through a corporate opportunity waiver, the board commits not to assert a claim for usurpation of a corporate opportunity that falls within specified parameters.

The advance renunciation of a specific type or class of corporate opportunities has obvious parallels to the ability of a trust agreement or an agency agreement to authorize a specific transaction that otherwise would constitute a breach of duty. The parallel also explains why the advance renunciation must be narrowly tailored to "specified business opportunities or specified ***553** classes or categories of business opportunities."[94]

Section 122(17) shows that the DGCL follows trust and agency law by permitting the authorization of specific transactions that otherwise could constitute a fiduciary breach. The Covenant operates at the stockholder level to achieve a comparable result. Section 122(17) is a powerful indication that that the Covenant is not contrary to Delaware public policy and is not facially invalid.

iii. Section 102(a)(3)

[19] A third way the DGCL permits corporate planners to tailor the powers of corporate fiduciaries and the duties they owe is through a limited purpose clause. A corporation's charter must state "[t]he nature of the business or purposes to be conducted or promoted."[95] The DGCL authorizes the charter to say that "the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware," with the effect that that "all lawful acts and activities shall be within the purposes of the corporation, except for express limitations."[96] Adopting that broad purpose is advisable, because if a corporation has a narrow purpose, then the corporation lacks the power to engage in activities that exceed or fall outside of its purpose, rendering those actions void.[97]

[20] **[21]** **[22]** By denying the corporation the power to engage in acts outside of a narrowly defined purpose and rendering non-compliant acts void, a narrow purpose clause limits the directors' powers and concomitant duties.[98] Absent a narrow purpose ***554** clause, corporate directors have an obligation to seek to maximize the long-term value of the corporation for the benefit of its stockholders.[99] Directors are obligated to pursue the course that they believe in good faith will achieve that goal, meaning that if the directors subjectively believe that exiting one business and entering another will maximize the value of the corporation, then acting loyally calls for acting on that substantive belief and

altering the corporation's business. But if the corporation has a limited purpose, then the directors cannot pursue the profit-maximizing option. The purpose clause limits the directors to the identified purpose, and they have no ability or obligation to pursue a contrary purpose.[100]

Through this mechanism, a limited purpose clause effectively modifies the orientation of the directors' fiduciary duties. Rather than being able to seek freely to maximize the value of the corporation, the board's options are constrained in a manner that inherently confers benefits on other stakeholders. If, for example, a corporation has the narrow purpose of pursuing only the business of operating a river ferry, then its directors cannot decide to exit that business and construct a toll bridge. In practice, the limitations imposed by the narrow purpose clause confer benefits on other stakeholders, such as workers in the ferry industry, customers who prefer ferries, and suppliers of ferry boats and tools and parts for the ferry industry.

The ability to specify a narrow corporate purpose has clear parallels to the ability of a trust agreement to specify a purpose for the trust or an agency agreement to specify a purpose for the agent. If the agreement creating the fiduciary relationship specifies a narrow purpose for the relationships, then the fiduciary must pursue that purpose selflessly and in a manner that the fiduciary subjectively believes is in the best interests of the beneficiaries, but the fiduciary cannot deviate from the purpose. The clause thereby both orients the fiduciary's duties and constrains the fiduciary's freedom of action.

Section 102(a)(3) and the implications of a narrow purpose clause demonstrate that Sections 102(b)(7) and 122(17) do not occupy the field when it comes to fiduciary tailoring. Other means are available. That suggests in turn that the Covenant is not attempting the impermissible and is not facially invalid.

iv. Section 141(a)

The next path for modifying fiduciary duties appears in Section 141(a) itself.[101] ***555** That section is the cornerstone of Delaware's board-centric regime, under which "directors, rather than shareholders, manage the business and affairs of the corporation."[102] "The existence and exercise of [the board's authority under Section 141(a)] carries with it certain fundamental fiduciary obligations to the corporation and its shareholders."[103] Because the board's authority under Section 141(a) provides the foundation for the directors' fiduciary duties, it follows that modifying the board's authority under Section 141(a) should modify the directors' fiduciary duties.

Many practitioners can recite the first twenty-four words of Section 141(a) by heart. For present purposes, the next sixty-five words are more important. In its entirety, Section 141(a) states:

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.[104]

Section 141(a) thus consists of a grant of authority followed by an exception. The first sentence gives the board nearly plenary authority over the business and affairs of the corporation "except as may be provided otherwise in this chapter or in its certificate of incorporation" (the "Board Power Exception").[105] The Board Power Exception authorizes modifications to the board-centric regime that appear in the DGCL ("in this chapter") or the charter ("in its certificate of incorporation"). The second sentence confirms that if a modification appears it the charter, then the board's powers and duties "shall be exercised ***556** or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation."[106]

The Board Power Exception hearkens back to Section 102(b)(1), which states:

> Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State.[107]

This provision explicitly authorizes a provision "defining, limiting and regulating the powers of ... the directors." In *Salzberg*, the Delaware Supreme Court interpreted Section 102(b)(1) as "broadly enabling," with the only limitation

found in the phrase "if such provisions are not contrary to the laws of this State."[108] Under this standard, a charter may depart from the common law "provided that it does not transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation law itself."[109] In *Manti*, the Delaware Supreme Court reiterated that the "public policy favoring private ordering" reflected in Section 102(b)(1) "allows a corporate charter to contain virtually any provision that is related to the corporation's governance," subject only to the requirement that it not be "contrary to the laws of this State."[110]

The Board Power Exception treats provisions that appear in the DGCL or in the charter as equally effective for tailoring the board's power and authority. It follows that extant statutory provisions should provide insight into what types of charter-based modifications are permissible and consistent with public policy.

One statutory exemplar appears in Subchapter XIV of the DGCL, titled Close Corporations,[111] and authorizes a close corporation to provide for management by its stockholders.[112] When a corporation elects to be a close corporation and for the stockholders to manage some or all aspects of its business and affairs, the Board Power Exception comes into play to eliminate any conflict with Section 141(a) and confirm that the "business and affairs of [the] corporation ... shall be managed ... as ... otherwise provided in this chapter."[113] Because the Board Power Exception treats statutory provisions and charter provisions as equally effective, charter-based allocations of the board's authority should be similarly permissible.

A second statutory exemplar also appears in Subchapter XIV and authorizes the holders of a majority of the outstanding stock entitled to vote in a close corporation to enter into a written agreement among themselves or with another party to "restrict or interfere with the discretion or ***557** powers of the board of directors."[114] The same provision states that such an agreement will "relieve the directors and impose upon the stockholders ... the liability for managerial acts or omissions which is imposed on directors to the extent and so long as the discretion or powers of the board in its management of corporate affairs is controlled by such agreement."[115] Once again, the Board Power Exception comes into play to avoid any conflict with Section 141(a). By implication, a charter provision could deploy the authority provided by the Board Power Exception to "restrict or interfere with the discretion or powers of the board of directors."[116] A charter provision also could assign discretion and power otherwise enjoyed by the board of directors to another party, with the effect of relieving the directors and imposing on the other party the liability for managerial acts or omissions which otherwise would be imposed on the directors to the extent and so long as the discretion or powers of the board are exercised by the other party.[117]

A third statutory exemplar appears in Subchapter XV of the DGCL, Public Benefits Corporations, where Section 361 authorizes the charter of a public benefit corporation to identify a public benefit, with the effect that the corporation "shall be managed in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or public benefits identified in its certificate of incorporation."[118] Both the authority provided for narrow purpose provisions in Section 102(a)(3) and the Board Power Exception suggest that a comparable charter provision would be permissible. This decision has already discussed how a narrow purpose provision can channel a board's power and associated fiduciary duties to confer benefits on stakeholders. The Board Power Exception provides a route for orienting fiduciary duties explicitly.

The ability to tailor a board's authority and concomitant fiduciary duties using the Board Power Exception parallels the ability of a trust agreement to provide specific instructions to the trustee or to name specific beneficiaries whose interests the trustee must serve. It likewise parallels the ability of an agency agreement to provide specific instructions to an agent, including parameters for carrying out the agent's duties. Those fiduciary antecedents and the existence of the statutory exemplar in Section 361 suggest other possible use cases, such as shifting the fiduciary maximand from equity value to enterprise value,[119] or authorizing conditions for a board to extend a dual-class capital structure beyond an existing sunset without generating a loyalty issue that would trigger entire fairness review.[120] The Board Power Exception shows that the DGCL provides greater space for fiduciary tailoring than is commonly understood.[121]

***558** Because the Board Power Exception only applies to a charter provision, it does not bear directly on the Covenant. It nevertheless provides further evidence that the DGCL provides greater space for fiduciary tailoring than

is commonly understood. That flexibility suggests that the Covenant is not contrary to public policy and is not facially invalid.

v. Section 145

[23] **[24]** The next DGCL provision does not accommodate fiduciary tailoring, but rather authorizes limitations on fiduciary accountability. Section 145 permits a Delaware corporation to provide indemnification and obtain insurance. Exculpation, indemnification, and insurance are means of protecting fiduciaries against the consequences ***559** of misconduct. With exculpation, monetary damages are prohibited. With indemnification, the corporation picks up the tab. With insurance, a third party pays. There are obviously differences in implementation and operation,[122] but to the extent each is fully available, the endpoint is the same: the fiduciary does not bear the financial consequences of breach.[123]

[25] **[26]** **[27]** The parameters of Section 145 provide insight into the limits of Delaware public policy for loyalty breaches. Section 145(a) addresses indemnification for direct claims and authorizes a corporation to indemnify a director or officer for "expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding," as long as "the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[124] A corporation thus can indemnify a fiduciary for all expenses, including a judgment, incurred for a direct claim for a loyalty breach, as long as the fiduciary acted in good faith and reasonably believed that the decision was not opposed to the ***560** best interests of the corporation. Not only that, but

> [t]he termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation.[125]

Like Section 145(a), the Covenant addresses direct claims. By analogy to Section 145(a), the Covenant could operate as a permissible limitation on fiduciary accountability as long as it does not foreclose a claim where the fiduciary acted in bad faith or had an unreasonable belief that the decision could be at least not opposed to the interests of the corporation. The defendants in this case undoubtedly will argue (and intimated in briefing the motion to dismiss) that they acted in good faith both when engaging in the Interested Transactions and when effectuating the Drag-Along Sale. The possibility that the Covenant could operate validly to foreclose that type of claim indicates that it is not facially invalid.

For purposes of insurance, Section 145(g) does not impose any limitations.[126] Recent amendments to Section 145(g) permit a corporation to form its own captive insurer and provide insurance for all claims except for "(i) personal profit or other financial advantage to which such person was not legally entitled or (ii) deliberate criminal or deliberate fraudulent act of such person, or a knowing violation of law by such person."[127] By analogy to Section 145(g), the Covenant could operate as a permissible limitation on fiduciary accountability as long as the Interested Transactions and the Drag-Along Sale did not confer a "personal profit" to which the defendants "were not legally entitled," and as long as the defendants did not deliberately act with criminal or fraudulent intent. The possibility that the Covenant could operate validly to foreclose claims under those circumstances indicates that it is not facially invalid.

Section 145 does not speak directly to the Covenant, but by authorizing significant protection against some types of loyalty breaches, it suggests that much of the scope of the Covenant falls within the boundaries of Delaware public policy. Section 145 thus indicates that the Covenant is not facially invalid.

vi. Litigation-Limiting Provisions

[28] **[29]** Finally, two provisions in the DGCL limit claims for breach of fiduciary ***561** duty regardless of content. One is Section 327, which imposes the contemporaneous ownership rule and requires that a stockholder have owned stock at the time that the corporation suffered the wrong to have standing to assert a derivative claim.[128] Even if the wrong involved a self-dealing loyalty breach or bad faith conduct, the stockholder cannot sue.[129] Section 327 effectively operates as a covenant not to sue derivatively for wrongs predating the stockholder's purchase of shares.

A second litigation-limiting provision is Section 367, which appears in Subchapter XV addressing Public Benefit Corporations. That section states:

> Any action to enforce the balancing requirement of § 365(a) of this title, including any individual, derivative or any other type of action, may not be brought unless the plaintiffs in such action own individually or collectively, as of the date of instituting such action, at least 2% of the corporation's outstanding shares or, in the case of a corporation with shares listed on a national securities exchange, the lesser of such percentage or shares of the corporation with a market value of at least $2,000,000 as of the date the action is instituted.[130]

The plain language of the ownership requirement applies even if the wrong involves a loyalty breach or bad faith conduct. For public benefit corporations, Section 367 operates as a covenant not to sue unless the stockholder can meet the ownership threshold.

Sections 327 and 367 demonstrate that Delaware law does not prohibit limitations on loyalty claims. Both sections apply to all stockholders and encompass all claims for breach of fiduciary duty, regardless of subject matter. The Covenant is far narrower: It only restricts the Signatories and only applies to a Drag-Along Sale. Compared to Sections 327 and 367, the Covenant attempts less. The presence of Sections 327 and 367 in the DGCL indicate that the Covenant is not facially invalid.[131]

***562 b. Common Law Tailoring**

The preceding discussion addressed statutorily authorized paths for fiduciary tailoring. The common law goes further and authorizes outcomes comparable to what the Covenant achieves. The existence of common law doctrines that authorize similar outcomes strongly indicates that the Covenant is not facially invalid.

i. Contractual Preemption Of Fiduciary Claims

One powerful common law doctrine asserts that contractual obligations preempt overlapping fiduciary duty claims that arise out of the same set of facts. In *Nemec*, the leading case, the Delaware Supreme Court stated:

> It is a well-settled principle that where a dispute arises from obligations that are expressly addressed by contract, that dispute will be treated as a breach of contract claim. In that specific context, any fiduciary claims arising out of the same facts that underlie the contract obligations would be foreclosed as superfluous.[132]

The stockholder plaintiffs contended that the defendant directors acted in their own self-interest when they caused the corporation to exercise a contractual right to redeem the plaintiffs' shares. By exercising the redemption right, the directors deprived the plaintiffs of greater consideration from a then-anticipated transaction.[133] The consideration went to the remaining stockholders, including the directors. The Delaware Supreme Court held that the contractual right preempted the fiduciary claim.[134]

Other decisions likewise hold that a claim for breach of contract occupies the field and preempts overlapping claims for breach of duty against corporate fiduciaries.[135] For example, when addressing the ***563** implication of a voting agreement, one decision summarized the rule as follows:

> Under Delaware law, if the contract claim addresses the alleged wrongdoing by the director, any fiduciary duty claim arising out of the same conduct is superfluous. The reasoning behind this is that to allow a fiduciary duty claim to coexist in parallel with a contractual claim, would undermine the primacy of contract law over fiduciary law in matters involving contractual rights and obligations.[136]

The court posited that fiduciary duty claims could only persist under "a narrow exception" that applies when "there is an independent basis for the fiduciary duty claims."[137]

***564** Under *Nemec*'s doctrine of contractual preemption, the Drag-Along Right displaces competing claims for breach of fiduciary duty. The Covenant becomes an unobjectionable belt-and-suspenders provision that confirms a result that Delaware law would already reach. That outcome suggests that the Covenant is not facially invalid.

ii. Advance Ratification

[30] **[31]** The next common law doctrine is ratification, which permits stockholders to extinguish a claim for breach of fiduciary duty by authorizing an act that otherwise would constitute a breach. When a corporation does not have

a controlling stockholder, a fully informed, non-coerced stockholder vote cleanses an interested transaction and changes the standard of review from entire fairness to an irrebuttable version of the business judgment rule where the only remaining challenge is waste.[138]

[32] **[33]** Stockholders can ratify specific types or classes of interested transactions in advance. The clearest example involves directors setting their own compensation, which is a self-dealing transaction implicating the duty of loyalty such that the directors bear the burden of showing that their compensation is entirely fair.[139] Directors cannot use advance ratification to give themselves a blank check, nor can they secure broad authority subject only to a cap. They can, however, obtain authorization for specific payments or for the use of a predictable formula.[140]

The doctrine of advance ratification has obvious parallels to the concept of advance authorization in trust law or agency law. Advance authorization permits a fiduciary to engage in a transaction that otherwise would constitute a breach of duty. Advance ratification does the same thing.

The Covenant functions like advance ratification. Through the Covenant, the ***565** Funds agreed in advance to a Drag-Along Sale. The Funds did not give the defendants a blank check. They only agreed not to sue over a transaction that met eight specific criteria. Viewed in this manner, the Covenant accomplishes what advance ratification already allows. The doctrine of advance ratification indicates that the Covenant is not facially invalid.

iii. Laches

[34] The final common law doctrine is laches. Unless a tolling doctrine applies or other extraordinary circumstances exist, laches bars a stockholder plaintiff from asserting a claim for breach of fiduciary duty if more than three years have passed since the claim accrued.[141] It does not matter whether the claim involves a loyalty breach or bad faith conduct.[142]

Stated more generally, a stockholder can choose not to assert a claim for fiduciary duty, and if the stockholder waits long enough, the claim is lost. Through the Covenant, the Funds agreed to that outcome in advance. From that standpoint, the Covenant is not facially invalid, but rather unexceptional.

c. Summing Up The Corporate Law Limitations

Delaware corporate law provides more space for fiduciary tailoring than is commonly understood. Several of those paths authorize outcomes comparable to what the Covenant achieves. Section 122(17) authorizes advance renunciation of corporate opportunities, which is equivalent to a covenant not to sue for usurpation of the renounced opportunities. The Covenant operates similarly. The common law doctrine of contractual preemption indicates that the Drag-Along Right may already foreclose a loyalty claim, leaving the Covenant as an unobjectionable add-on. Both the common law doctrine of advance ratification and the Covenant foreclose litigation over a specific transaction. Finally, the comparison to laches shows that the Funds simply agreed in advance to do something they could do of their own volition: give up their claims by declining to sue. These options make it difficult to say that the Covenant violates Delaware public policy and is facially invalid.

3. The Contractarian Framework And Private Ordering

The next step in the analysis is the role of contract. "Contractual and fiduciary relationships are the two dominant legal forms of interaction through which persons can pursue individual and shared interests."[143] Although often perceived as constituting separate domains, the boundaries between the fields are fluid rather than fixed, and the two areas, "while distinctive, are deeply intertwined."[144]

a. The Power Of Private Ordering

[35] **[36]** **[37]** To say that Delaware prides itself on the contractarian nature of its law risks understatement:

> This jurisdiction respects the right of parties to freely contract and to be able to rely on the enforceability of their agreements; where Delaware's law applies, with very limited exceptions, our courts will enforce the contractual scheme that the parties have arrived at through their own self-ordering, both in recognition of a right to self-order and ***566** to promote certainty of obligations and benefits.[145]

"Sophisticated parties" can and should "make their own judgments about the risk they should bear," and Delaware courts are "especially chary about relieving sophisticated

business entities of the burden of freely negotiated contracts."[146]

[38] **[39]** Within this framework, public policy plays a limited role. "When parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement, and will only interfere upon a strong showing that dishonoring the contract is required to vindicate a public policy interest even stronger than freedom of contract."[147] More significant interests "are not to be lightly found, as the wealth-creating and peace-inducing effects of civil contracts are undercut if citizens cannot rely on the law to enforce their voluntarily-undertaken mutual obligations."[148]

> [T]he right to contract is one of the great, inalienable rights accorded to every free citizen.... "If there is one thing more than any other which public policy requires it is that men of full age and competent understanding shall have the utmost liberty of[ ]contracting" and that this freedom of contract shall not lightly be interfered with. We also recognize that freedom of contract is the rule and restraints on this freedom the exception, and to justify this exception unusual circumstances should exist.[149]

Delaware courts will "not rewrite the contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal. Parties have a right to enter into good and bad contracts, the law enforces both."[150]

Delaware's embrace of contractarianism extends to the corporate form, where it manifests as the concept of private ordering.[151] "Delaware's corporate statute is widely regarded as the most flexible in the nation because it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints and to the policing of director misconduct through equitable review."[152] "Our law strives to enhance flexibility in order to engage in private ordering[, and] our DGCL was intended ***567** to provide directors and stockholders with flexibility and wide discretion for private ordering and adaptation to new situations."[153] Other decisions similarly stress the "great flexibility" that the DGCL provides and its role as "an enabling statute."[154]

The contractarian theory of the corporation envisions the firm as a nexus of explicit and implicit contracts.[155] Under the contractarian approach, "[c]orporate law—and in particular the fiduciary principle enforced by courts—fills in the blanks and oversights [in the corporate contract] with the terms that people would have bargained for had they anticipated the problem and been able to transact costlessly in advance."[156] Because fiduciary duties function in this framework as default rules in an otherwise incomplete corporate contact, parties can modify them by agreement. "On this view corporate law supplements but never displaces actual bargains—save in situations of third-party effects or latecomer terms."[157] For the contractarian theory of corporate law, fiduciary duties are not immutable, mandatory terms but rather freely modifiable defaults.[158]

***568** Delaware's embrace of contractarianism suggests that the Covenant is not facially invalid. Under the contractarian approach, state law—including the law of fiduciary duties—supplies contractable defaults. There are accounts of the corporation that incorporate mandatory, non-waivable fiduciary duties, but they are not contractarian ones.[159] From a contractarian standpoint, ***570** there is nothing wrong with parties contracting over a stockholder's ability to assert a specified type of claim for breach of fiduciary duty. The Covenant is therefore not facially invalid.

b. Private Ordering And Stockholder Agreements

Delaware's commitment to contractarianism should be at its height when stockholders enter into agreements about how they will exercise stockholder-level rights, because at that level, individual owners are bargaining over their private property. Consistent with that intuition, the DGCL demonstrates that stockholders can agree to greater constraints on their rights in a stockholders agreement than a corporation can impose in its charter or bylaws. As long as the contractual provision addresses a type of action that one stockholder or a group of stockholders can take, then there is greater space for private ordering, not less, when the provision appears in a stockholders agreement. The Covenant appears in a stockholder-level agreement, providing further support for the conclusion that it is not facially invalid.

[40] **[41]** **[42]** "A share of stock represents a bundle of rights defined by the laws of the chartering state and the corporation's certificate of incorporation and bylaws."[160] By statute, a share of stock is the personal property of its owner.[161] The rights associated with and appurtenant to a share of stock are therefore rights that the owner can freely

exercise or decline to exercise. Three rights are viewed as fundamental: the rights to sell, vote, and sue.[162]

Delaware law permits stockholders to contract over their right to sell:

> A restriction on the transfer or registration of transfer of securities of a corporation, or on the amount of a corporation's securities that may be owned by any person or group of persons, may be imposed ... by an agreement among any number of security holders or among such holders and the corporation.[163]

Delaware law specifically permits stockholders to (i) grant a right of first refusal on shares in favor the corporation or any person,[164] (ii) grant a right to purchase or sell the shares to the corporation or any person,[165] (iii) agree to obtain the consent of the corporation or the holders of any class or series of securities before selling shares,[166] (iv) commit to sell or transfer the shares to the corporation or any person,[167] and (v) restrict or prohibit the transfer of shares to designated persons, as long as the designation is not manifestly unreasonable.[168] Delaware law expansively permits "any other lawful restriction on transfer or registration of the restricted securities, or on the ownership of the restricted securities by any person."[169] The DGCL thus authorizes a stockholder to covenant not to sell.

***571** Delaware law also permits stockholders to contract over their right to vote:

> An agreement between 2 or more stockholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as provided by the agreement, or as the parties may agree, or as determined in accordance with a procedure agreed upon by them.[170]

The DGCL thus authorizes a stockholder to covenant not to vote.

The DGCL confirms that a stockholder has greater freedom to restrict its rights to vote or sue in a private agreement than a corporation can impose through its charter or bylaws. For the right to sell, Section 202(b) provides that a restriction on the transfer, registration, or ownership of shares can be imposed through the charter, the bylaws, or by private agreement.[171] But if a restriction is imposed through the charter or bylaws, the restriction is *not binding* "with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction."[172] Actual consent is required.

A similar structure exists for the right to vote. The DGCL requires that any "qualifications, limitations or restrictions" on the powers associated with a share of stock appear in the charter.[173] The power to vote is a power associated with a share of stock.[174] Through the charter, a corporation can create shares with or without voting rights or with tailored voting rights.[175] What the corporation cannot do through its charter is dictate how individual stockholders exercise their voting rights Yet through a voting agreement, stockholders can bind themselves to vote or not vote to any degree imaginable.[176]

[43] **[44]** The different levels of permissible constraints comport with the doctrine of independent legal significance.

> [T]he general theory of the Delaware Corporation Law is that action taken under one section of that law is legally independent, and its validity is not dependent upon, nor to be tested by the requirements of other unrelated sections under which the same final result might be attained by different means.[177]

To state the obvious, a stockholders agreement is not a charter or bylaw provision, so restrictions on charter or bylaw provisions do not govern stockholders agreements.

The different levels of permissible constraint reflect different levels of consent.[178]

- A provision in a pre-IPO charter does not receive express approval from the publicly held shares. Holders of shares become bound when they buy shares, making their consent implicit. The ***572** same is true in a private company for the original charter.[179]

- Under the DGCL, a midstream charter amendment requires both approval from the board and approval by the holders of a majority of the outstanding voting power of the corporation.[180] The adoption of a midstream charter amendment means that holders of a majority of the outstanding voting power have consented to it, which indicates some level of consent.[181] But "any shareholder who did not vote in favor of the midstream amendment did not consent at all.... At most, such a shareholder consented to the *rules* for changing [the] charter ... (to the extent these

rules were established when the company initially sold the shares)."[182] A midstream charter amendment binds stockholders regardless of actual consent.

- Under the DGCL, a bylaw amendment provides ambiguous indications of consent. The board and the stockholders can typically each adopt, amend, alter, or repeal bylaws unilaterally.[183] If a board implements a bylaw, then stockholders are bound without any affirmative act of consent, other than having accepted the rules for amendment.[184] But because stockholders can amend the provision without board approval, the continued presence of the bylaw provides some indication of stockholder consent.[185]

None of these forms of consent resembles what contract law traditionally contemplates.[186] By contrast, when stockholders execute a stockholder-level agreement, they provide the level of consent that contract law traditionally contemplates, which in turn supports greater freedom to allocate rights.

[45] At this point in the analysis, confusion can arise because of the hierarchy of authorities that govern a corporation. As I have written elsewhere,

> When evaluating corporate action for legal compliance, a court examines whether the action contravenes the hierarchical components of the entity-specific corporate contract, comprising (i) the Delaware General Corporation Law, (ii) the corporation's charter, (iii) its bylaws, and (iv) other entity-specific contractual agreements, such as a stock option plan, ***573** other equity compensation plan, or, as to the parties to it, a stockholder agreement.[187]

"Each of the lower components of the contractual hierarchy must conform to the higher components."[188]

When does a provision in a stockholders agreement conflict with the DGCL, the charter, or the bylaws such that the higher-level component overrides it? The DGCL, charter, and bylaws establish the rights that stockholders possess. If the stockholder-level agreement binds the stockholders as to how they exercise those rights, then there is no conflict. But if a stockholders agreement purports to alter or ignore the structure that the higher-level components created, then the effort is ineffective, and the higher-level component prevails.[189]

Take a provision in a stockholders agreement that attempts to define the number of directors comprising the whole board. Section 141(b) provides that the bylaws must identify the number of directors comprising the whole board, or the charter must specify a procedure for making that determination.[190] Stockholders therefore cannot contract to have a greater number of directors than the charter or bylaws specify. Stockholders can, however, contract about how to exercise their voting power to elect directors, and they could agree to maintain a *lesser* number of directors in office by making commitments about how to vote. That agreement would bind the stockholders as to the exercise of their rights *qua* stockholders, and it would not conflict with the charter or bylaws.

Schroeder v. Buhannic[191] provides a more complex illustration. The stockholders committed in a voting agreement to elect the following directors: (i) three designated by the holders of a majority of the common stock, one of whom shall be the CEO, (ii) two designated by the holders of a majority of the preferred stock, and (iii) two independent, non-employee directors selected by the holders of a majority of the common stock and approved by the holders of a majority of the preferred stock. The stockholders disagreed over whether the common stockholders could select the CEO, at which point the signatory stockholders had to vote for him as one of the three directors designated by the common stock, or whether the board selected the CEO, at which point the common stockholders had to designate him as one of their directors.[192] Appointing a CEO is a core board function, and the bylaws provided that the board selected the CEO, so the voting agreement could not override that allocation of authority. It followed that the board had the power to identify the CEO, the common stockholders bound themselves to name him as one of their three designees, and all of the signatory stockholders bound themselves to vote for him.[193]

These principles point to a simple test for determining whether a provision in a ***574** stockholders agreement conflicts with the DGCL, charter, and bylaws: Does the contractual provision address an action that a stockholder individually or a group of stockholders collectively could take? If yes, then a stockholder can contract over that action in advance, without violating the corporate hierarchy. The DGCL, charter, and bylaws specify what rights are appurtenant to the shares and available for the stockholders to exercise. The stockholder gets to choose whether to exercise those rights and can agree contractually to constrain its exercise of those rights.

By analogy to the right to vote and the right to sell, limitations on the right to sue that appear in the charter or bylaws should be more suspect than limitations in a stockholders agreement. Once the DGCL, charter, and bylaws have established the rights appurtenant to the shares, including the rights that a stockholder can sue to enforce, the stockholder should have relatively unconstrained freedom to contract about asserting those rights. Just as a stockholder can covenant not sell or vote, a stockholder should be able to covenant to not sue. This reasoning suggests that the Covenant is not facially invalid.

E. Other Considerations

[46] The preceding tour through traditional fiduciary law, the DGCL, Delaware corporate law, and Delaware's support for private ordering indicates that the Covenant is not facially invalid. But to hold that stockholders in a Delaware corporation can commit not to sue for breach of fiduciary duty is a significant step, so it is worth considering other possible arguments against it. This section considers (i) whether the right to sue for breach of fiduciary duty is too big to waive, (ii) whether enforcing a provision like the Covenant threatens Delaware's corporate brand, (iii) whether upholding a provision like the Covenant collapses the distinction between corporations and LLCs, and (iv) the majority and dissenting opinions in *Manti*. Those considerations do not support declaring the Covenant facially invalid.

1. Is A Claim For Breach Of Fiduciary Duty Too Big To Waive?

An intuitively attractive argument for declaring the Covenant facially invalid is that a claim for breach of fiduciary duty is simply too important to waive. One way to evaluate that contention is to consider what other rights are waivable.[194]

[47] **[48]** **[49]** **[50]** **[51]** Delaware law permit individuals to waive fundamental rights associated with their personal liberty:

- Both the United States Constitution and the Delaware Constitution guarantee a criminal defendant the right to trial by jury.[195] That right can be waived.[196]
- Both the United States Constitution and the Delaware Constitution provide a criminal defendant with a right to be present for trial and confront the witnesses ***575** against him.[197] That right can be waived.[198]
- Both the United States Constitution and the Delaware Constitution provide a witness with a right to counsel in a criminal case.[199] That right can be waived.[200]
- Both the United States Constitution and the Delaware Constitution protect against self-incrimination.[201] That right can be waived.[202]
- A criminal defendant can waive all of his rights to personal liberty by entering a guilty plea, freely and voluntarily.[203]

As the Delaware Supreme Court has observed, "Clearly, our legal system permits one to waive even a constitutional right."[204]

[52] **[53]** **[54]** Delaware law permits individuals to waive important rights associated with their property. A waiver of a property right is generally effective so long as it is voluntary, knowing, and intelligently made, or reflects an intentional relinquishment or abandonment or of a known right or privilege.[205] For example, under the Due Process Clause of the Fourteenth Amendment to the United States Constitution, a civil debtor has a constitutional right to notice and a hearing before judgment is entered. Delaware law permits a debtor to waive that right by agreeing to a confession of judgment clause.[206] In a civil case, a plaintiff can waive the right to a jury trial by agreeing to arbitrate[207] or simply by failing to request a jury trial.[208]

[55] **[56]** **[57]** **[58]** Delaware law generally permits individuals to waive statutory rights.[209] Real property owners can agree ***576** to deed restrictions that waive their ability to use their property in specified ways.[210] Individuals can agree to covenants that restrict their ability to work for a competitor.[211] Individuals can enter into non-disclosure agreements that limit their ability to speak.[212]

It is not self-evident why Delaware law would afford greater protection to a property interest associated with a share of stock that enables the owner to sue for breach of fiduciary duty than it does for those fundamental liberty and property interests. A comparison to what else individuals can waive suggests that the Covenant is not facially invalid.

2. The Threat To Delaware's Corporate Brand

A rhetorically powerful argument for declaring the Covenant facially invalid asserts that it would undermine Delaware's corporate brand. In a well-known article, two practitioners argue that Delaware offers a corporate product that comes with commonly understood attributes, including mandatory and generally immutable fiduciary duties.[213] Although the authors did not address stockholder-level agreements, the branding argument posits that to permit a stockholder to waive a mandatory feature of Delaware law would undermine the common understanding of a Delaware corporation. Therefore, the argument goes, a provision like the Covenant should be invalid. While maintaining the value of Delaware's corporate brand is important, it does not call for invalidating a private agreement in which stockholders make commitments about how to exercise their stockholder-level rights.

The argument about Delaware's corporate brand stresses the benefits of standardization.[214] There are benefits from standardized roles and relationships, because standardization reduces transaction costs, creates shared understandings, influences conduct, and enables the law to promote values beyond efficiency.[215]

Delaware's embrace of private ordering already goes a long way towards limiting the benefits of standardization for Delaware corporations. A prudent investor must review the charter and bylaws to understand the rights appurtenant to the corporation's shares and any limitations ***577** that exist on the exercise of those rights.. Even if a corporation has not itself engaged in private ordering, the potential for private ordering requires investigation. An investor cannot assume that one Delaware corporation is just like the others.

The practitioners who emphasize brand value argue that mandatory terms are nevertheless essential to Delaware's corporate brand:

> Merely by branding itself as a Delaware corporation, a firm can signal easily that it has certain core characteristics that provide basic protections to investors. Anyone contemplating buying shares of stock in a Delaware corporation can be confident, without having to obtain and examine the certificate of incorporation, that the directors of the corporation will be subject to a duty of loyalty; that stockholders will have the right to inspect corporate books and records for a proper purpose; and that the stockholders will have the right, periodically, to elect the directors.[216]

True, an investor need not review the certificate or bylaws to confirm those three features, but an investor needs to examine the charter and bylaws to assess all of the other features that can change. Tellingly, the authors spend much of their article discussing the considerable space for private ordering that the DGCL provides.[217]

[59] **[60]** When turning to the rare mandatory features in the DGCL, the authors focus exclusively on what corporate planners cannot modify in the charter or bylaws.[218] They do not make claims about what stockholders can agree to in stockholder-level agreements. That editorial decision is understandable, because stockholder-level agreements do not alter the rights that the DGCL, charter, and bylaws bestow. Through a stockholder-level agreement, stockholders can make commitments about how they exercise their rights, but they cannot change those rights. A stockholder-level agreement only binds its signatories, and other stockholders remain free to exercise their rights differently. Even if some of the stockholders have entered into agreements among themselves, it remains true that "[a]nyone contemplating buying shares of stock in a Delaware corporation can be confident, without having to obtain and examine the certificate of incorporation, that the directors of the corporation will be subject to a duty of loyalty; that stockholders will have the right to inspect corporate books and records for a proper purpose; and that the stockholders will have the right, periodically, to elect the directors."[219]

That said, some stockholder-level agreements are sufficiently weighty that they can affect the shared expectations created by the corporation's constitutive documents. When a critical mass of stockholders have bound themselves to exercise their stockholder-level rights in a particular way, then their agreement can exert a gravitational pull that distorts the corporate governance space. Most stockholder-level agreements do not have that effect. A proxy is a stockholder-level agreement, and the vast majority of proxies are routine. A call or put option is a stockholder-level agreement, and those are mostly routine as well. The agreement that creates a ***578** control group obviously does have a field-distorting effect, and even generally inconsequential agreements like proxies and options can become consequential, such as an irrevocable proxy to vote a control block or a call right on a majority of the shares.[220]

Investors should know about consequential stockholder-level agreements.[221] The logical answer to non-disclosure is not to invalidate the agreements, but to require disclosure. The DGCL could state that a stockholder agreement meeting

certain criteria is only enforceable if a copy is provided to the corporation, which then must either (i) file the agreement or a summary with the Delaware Secretary of State or (ii) note its existence on the stock ledger and make it available for inspection upon request. The DGCL already takes the former course for merger agreements[222] and the latter for voting trust agreements.[223] It would be important to craft the criteria with care, because so many stockholder-level contracts do not warrant that treatment.

For purposes of a Delaware corporation, a stockholder-level agreement that allocates how stockholders exercise their rights is on-brand, not off. Private ordering and fiduciary accountability are key components of Delaware's corporate brand. A stockholder-level agreement is a quintessential form of private ordering, because it involves stockholders making commitments about their own rights. Other stockholders remain free to exercise their rights as they wish, including by exercising their rights to pursue corporate accountability.

This case involves two key elements of Delaware's corporate brand, so an appeal to brand value is unlikely to be dispositive. An advocate could assemble citations suggesting that one policy or the other is more important, but the result would reveal more about the research team's skill than the relative importance of the policies. Because brand value is elusive,[224] appeals to brand value could lead to broad normative claims, less emphasis on traditional authorities, and the possibility that personal preferences sneak into the analysis. ***579** Scholars may attempt to capture or characterize the value of Delaware's brand as a way of explaining Delaware's success.[225] Practitioners and Delaware's Division of Corporations may market Delaware as a brand.[226] They are not deciding cases. To that end, when the authors who emphasize mandatory features as important to Delaware's corporate brand assess which features are mandatory, they rely on traditional legal authorities.[227] Even for them, brand value is not an input, but an output. It is not a means of determining which aspects of Delaware's corporate regime cannot be tailored; it is the result of making that determination by other means.

There may be cases where considering brand value might be helpful. Particularly when aspects of brand value are easily identified and all point in the same direction, then referring to brand value could provide support for an outcome. In this case, two core components point in opposite directions, making brand value too uncertain to use as a tiebreaker. The argument about Delaware's corporate brand does not warrant holding the Covenant facially invalid.

3. Corporate Law As LLC Law

Another rhetorically powerful argument for declaring the Covenant facially invalid asserts that to permit stockholders to waive claims for breach of fiduciary through a private agreement would blur the distinction between corporations and LLCs. There is value in distinguishing between the two types of entities, but stockholder-level contracting about stockholder-level rights does not collapse the divide.

For starters, the line between corporate law and LLC law is already blurred, albeit from the other side. Decisions frequently observe that LLCs "are creatures of contract,"[228] which they primarily are.[229] The ***580** Delaware Limited Liability Company Act (the "LLC Act") provides that "[i]t is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."[230] Because of this freedom, "[v]irtually any management structure may be implemented through the company's governing instrument."[231] Using the contractual freedom that the LLC Act confers, the drafters of an LLC agreement can create a manager-managed entity, label the managers a "board of directors," refer to the LLC interests as "shares," and provide that the LLC will be governed by the DGCL and operate as if it were a Delaware corporation.[232]

[61] **[62]** **[63]** **[64]** **[65]** **[66]** Returning to the corporate side of the divide, a stockholder-level agreement does not risk blurring the distinctions between the entities, because those distinctions exist at the level of the governing statutes and the constitutive documents.[233] Regardless of what investors might agree to in investor-level agreements, there are fundamental differences between what a certificate of formation must contain (virtually nothing) and what a certificate of incorporation must contain (six enumerated items including the number and types of shares the corporation can issue and any special rights, powers, privileges, qualifications, and limitations on those shares).[234] And there are fundamental differences between what an LLC can achieve through its constitutive document (minimally constrained) and what a corporation can achieve (moderately constrained). Most notably, the constitutive document of an LLC (the LLC agreement) can (i) fully eliminate any duties existing at law or in equity, including

fiduciary duties,[235] (ii) provide indemnification and ***581** advancement unconstrained by any statutory standards,[236] and (iii) fully eliminate any and all liabilities, except for *bad faith* breaches of the implied covenant of good faith and fair dealing.[237] By contrast, the ***582** constitutive document of a corporation (the charter and bylaws) (i) can shape fiduciary duties but cannot eliminate them,[238] (ii) cannot eliminate monetary liability for breach of fiduciary duty except for breaches of the duty of care,[239] (iii) cannot provide indemnification or advancement that goes beyond statutory standards,[240] and (iv) cannot constrain liability for breach of the implied covenant of good faith and fair dealing.[241]

Those profound differences make LLCs and corporations resolutely different things. Those differences remain even though each type of entity confers bundles of rights on investors that manifest as a form of personal property (a member interest or a share).[242] Those differences persist when the holders of those investor-level rights (i) decide in real time whether or not to exercise their rights and (ii) make contractual commitments about rights that they otherwise could exercise freely. True, there is a superficial similarity in the ability of both LLC members and stockholders to make exercise-or-refrain decisions and to enter into investor-level agreements about those decisions, but that resemblance does not alter the basal gulf between the underlying forms of state-created property (the entities themselves).[243] The argument about collapsing the entity divide is not a basis to declare the Covenant facially invalid.

4. The Opinions In *Manti*

The majority and dissenting opinions in *Manti* provide insight into how the Delaware Supreme Court viewed a similar public policy issue. In *Manti*, the justices considered whether to enforce a covenant not to assert appraisal rights, which the high court labeled the "Refrain Obligation." Like the Covenant, the Refrain Obligation appeared in a drag-along provision in a voting agreement. As in this case, investment funds who had entered into the voting agreement sought to escape their promise by arguing that the Refrain Obligation was invalid.

The majority opinion in *Manti* upheld the Refrain Obligation, but it contains language which could be read to suggest that the Covenant is facially invalid. The dissent would have invalidated the Refrain ***583** Obligation, suggesting a similar outcome for the Covenant. Spurred by the opinions in *Manti*, this decision has sought to engage deeply with traditional fiduciary principles, the DGCL, Delaware common law, and private ordering. This decision concludes that under *Manti*, a narrow provision like the Covenant in not facially invalid, but a court must scrutinize the facts and circumstances carefully to determine whether the provision is valid as applied. The *Manti* decision points to a range of factors that a court can consider. At bottom, the proponent of the provision must show that it is reasonable.

a. The *Manti* Majority

The investment funds in *Manti* advanced two grounds for invalidating the Refrain Obligation. First, they claimed that the provision violated Section 262, which governs appraisal rights. Second, they argued that the provision violated Delaware public policy. A majority of the Delaware Supreme Court rejected both arguments.

The argument for statutory invalidity relied on language in Section 262 stating that "[a]ppraisal rights shall be available for the shares of any class or series of stock of a constituent or converting corporation in a merger or consolidation or conversion [subject to specified exceptions]."[244] The investment funds contended that the statute's use of the auxiliary verb "shall" meant that appraisal rights were mandatory and could not be waived through a voting agreement. The majority rejected that assertion, citing (i) Delaware's public policy in favor of private ordering,[245] (ii) the absence of any express prohibition in the DGCL on the waiver of appraisal rights,[246] (iii) the general principal that parties can waive mandatory rights,[247] and (iv) the fact that the stockholders who signed the agreement were "sophisticated and informed investors, represented by counsel, that used their bargaining power to negotiate for funding ... in exchange for waiving their appraisal rights."[248] Under the majority's reasoning, the DGCL created a stockholder-level right to seek appraisal, and a stockholder could decide whether or not to exercise that right. Just as a stockholder could make that decision in real time, a stockholder could commit in advance to refrain from exercising that right. The Refrain Obligation therefore did not conflict with the DGCL.

The public policy argument for invalidity asserted that appraisal rights were too important for stockholders to waive.

The majority rejected that argument as well and deemed the Refrain Obligation enforceable. The reasons the majority offered can be sorted into two categories: responses to a facial challenge, and responses to an as-applied challenge. Under the first heading, the majority observed that (i) appraisal rights did not play "a sufficiently important role in regulating the balance of power between corporate constituencies to forbid sophisticated and informed stockholders from freely agreeing to an *ex ante* waiver,"[249] and (ii) the waiver of appraisal rights was a logical consequence of a drag-along provision, which generally required signatory stockholders to vote for the qualifying transaction and thereby indirectly ***584** waive their appraisal rights.[250] Under the second heading, the majority noted that (i) the Refrain Obligation was not imposed on stockholders unilaterally,[251] (ii) the signatory stockholders were not retail investors and there was no imbalance of information,[252] and (iii) the sophisticated investors who agreed to the Refrain Obligation could understand its implications and knowingly waive their rights.[253] In light of these points, the Refrain Obligation was not contrary to public policy.

At various points in the decision, the majority cited factual considerations that apply equally to the Funds, the defendants, and the Covenant:

- The Funds are "sophisticated investors, represented by counsel, that agreed to a clear waiver of their [right to challenge a Drag-Along Sale] in exchange for valuable consideration."[254]
- The Voting Agreement is "not a contract of adhesion."[255]
- The Funds "have not argued that they were ignorant of the [Covenant] when they signed the contract or that the inclusion of the [Covenant] was a mistake."[256]
- It would have been "easy for the [Funds] to predict the circumstances in which the [Covenant] would be invoked, namely, [Rich] and the board might approve a [Drag-Along Sale]."[257]
- The Covenant is not being enforced "against a retail investor that was not involved in negotiating the [Voting] Agreement."[258]
- The Covenant is not being enforced "against outsiders that lack material knowledge of [the Company's] corporate governance dynamics."[259]
- The Funds were "insiders for the purpose of negotiating the [Voting] Agreement."[260]
- There is no suggestion that Rich "coerced the [Funds] into" agreeing to the Covenant.[261]
- There is no suggestion that the Funds "did not know that the [Voting] Agreement contained the [Covenant]."[262]
- There is no suggestion that Rich "had any secret knowledge when [he] negotiated the [Voting] Agreement."[263]
- The Funds are "capable investors" who "do not need protection of the courts to escape a bad bargain."[264]
- The Covenant does not raise "concerns about a lack of consent."[265]
- The Covenant does not involve "enforce[ing] a contract of adhesion against a stockholder that lacked bargaining power."[266]

***585** • The Funds "specifically assented to the [Voting] Agreement."[267]

- The Funds were "represented by counsel and had negotiating leverage."[268]
- The Funds "freely and knowingly consented to the [Covenant] in exchange for valuable consideration."[269]

Through its analysis, the *Manti* majority built on *Salzberg*'s embrace of contractarian principles. But while upholding the Refrain Obligation, the majority cautioned that its decision did not mean that all appraisal waivers were valid:

> Allowing [the company] to enforce this Refrain Obligation against these Petitioners does not mean that all *ex ante* waivers of appraisal rights are enforceable or that the waiver of any other stockholder right would be enforceable. To the contrary, there are other contexts where an *ex ante* waiver of appraisal rights would be unenforceable for public policy reasons.[270]

The multi-factor analysis conducted by the *Manti* majority suggests that if some or all of those factors were absent, then a similar provision would be suspect.

The *Manti* majority also admonished corporate planners that all stockholder-level rights were not automatically fair game for contractual waivers:

> [T]here may be other stockholder rights that are so fundamental to the corporate form that they cannot be waived *ex ante*, such as certain rights designed to police corporate misconduct or to preserve the ability of stockholders to participate in corporate governance. Allowing [the company] to enforce the Refrain Obligation against the Petitioners does not mean that the *ex ante* waiver of all other stockholder rights would be enforceable.[271]

Fairly read, that warning seems to refer to the duty of loyalty, which is "fundamental to the corporate form" and the principal means by which Delaware courts "police corporate misconduct." The *Manti* majority did not specifically call out the duty of loyalty, but if not that duty, then what? Not the right to vote for directors or on fundamental transactions like mergers, because the DGCL permits stockholders to constrain their right to vote in a stockholder-level agreement.[272] Not the right to sell their shares, because the DGCL permits stockholders to constrain their right to sell in a stockholder-level agreement.[273] Perhaps the right to seek books and records,[274] but that right is instrumental to the ability to exercise other rights, and if a stockholder-level agreement can constrain the ultimate rights, it should be able to constrain the instrumental right. Two Court of Chancery decisions indicate that a stockholder can waive or limit its ability to exercise Section 220 rights through a clear and express provision in a bilateral agreement.[275]

***586** Prompted by the majority's cautionary statements in *Manti*, this decision has explored whether all fiduciary waivers are facially invalid. As this decision has shown, traditional fiduciary principles, the DGCL, and Delaware common law permit significant degrees of fiduciary tailoring, most pertinently through provisions that specifically authorize a fiduciary to engage in a type of transaction that otherwise would constitute a breach. In light of that authority, this decision cannot conclude that all fiduciary waivers are facially invalid. A strong argument exists that a broad, unspecified waiver is facially invalid, such as a covenant not to assert any claims for breach of fiduciary duty under any facts. A narrow and targeted provision like the Covenant, however, is not facially invalid.

But that conclusion does not end the analysis, because the justices in *Manti* also considered case-specific factors when determining that the Refrain Obligation was not contrary to public policy. Their reasoning indicates that in an as-applied challenge, a court can consider (i) the presence of the provision in a bargained-for contract, (ii) the clarity and specificity of the provision, (iii) the stockholder's level of knowledge about the provision and the surrounding circumstances, (iv) the stockholder's ability to foresee the consequences of the provision, (v) the stockholder's ability to reject the provision, (vi) the stockholders' level of sophistication, and (vii) the involvement of counsel. Those factors are necessarily illustrative and not exclusive.

The factors that the *Manti* majority considered all relate to whether it was reasonable to enforce the Refrain Obligation on the facts of the case. The *Manti* decision thus indicates that to survive an as-applied challenge, the party seeking to enforce a waiver must convince the court that the waiver is reasonable.[276]

***587** b. The *Manti* Dissent

One justice dissented in *Manti* and would have invalidated the Refrain Obligation. The dissent cited (i) ambiguity in the Refrain Obligation,[277] (ii) a mismatch between when the Refrain Obligation terminated and the operation of the appraisal statute,[278] (iii) the presence of the Refrain Obligation in a stockholder-level agreement rather than in the corporation's constitutive documents,[279] (iv) concern about permitting common stockholders to waive appraisal rights,[280] (v) concern that permitting waivers of appraisal rights and other mandatory statutory provisions in stockholder agreements "would transform the corporate governance documents into gap-filling defaults and collapse the distinction between a corporation and alternative entities,"[281] and (vi) a view that appraisal rights are a mandatory, non-waivable feature of Delaware corporate law because of their historical role in protecting minority stockholders from underpriced transactions.[282]

The dissent argued convincingly that the Refrain Obligation was ineffective because a drafting bust caused the obligation

to terminate before the time came to exercise or waive appraisal rights.[283] The dissent also raised an important concern about "stealth" corporate governance arrangements in which significant stockholders enter into stockholder-level agreements governing the exercise of their rights without other stockholders knowing about the agreements or their implications.[284] This decision differs only in the response to that concern: It proposes disclosure rather than invalidity.

Otherwise, the dissent took the other side of the arguments considered by the majority. The dissent provided an additional spur for this decision's extensive engagement with traditional fiduciary principles, the DGCL, the Delaware common law, and contractarian principles. Only after conducting that analysis has this decision concluded that the Covenant is not facially invalid.

F. The *Altor Bioscience* Decision

Although the parties did not cite it, a Delaware decision has addressed the validity ***588** of a covenant in which stockholders agreed not to assert claims for breach of fiduciary duty.[285] In the *Altor Bioscience* case, Vice Chancellor Slights held that a bargained-for covenant not to sue barred claims for breach of fiduciary duty comparable to the Sale Counts. He rejected the plaintiffs' contention that the covenant was invalid.

Altor Bioscience was a privately held company that was sold to an acquirer. Two stockholders and former directors (Gray and Waldman) asserted claims for breach of fiduciary duty against the fiduciaries who approved the deal. The defendants relied on letter agreements that Gray and Waldman had signed "to broker a 'peace in the valley,' in the midst of great tension between two factions of the Altor board."[286] Under the letter agreements, Gray and Waldman resigned from the board and received options and other consideration. In Section 7 of the agreements, Gray and Waldman covenanted that for a period of five years, they would not "directly or indirectly commence, prosecute or cause to be commenced or prosecuted against any Company Releasee any action or other proceeding of any nature before any court, tribunal, Governmental Authority or other body, except for the Company's breach of this letter agreement."[287] Vice Chancellor Slights held that this provision was "tantamount to a covenant not to sue" that had been "offered in exchange for valuable consideration" and was enforceable in accordance with its plain and unambiguous terms.[288]

Gray and Waldman argued that the covenant not to sue was invalid as a matter of public policy because it extinguished claims for breach of the duty of loyalty. In rejecting that argument, Vice Chancellor Slights distinguished between a covenant not to sue that only binds the signatories and a charter provision that purports to limit or eliminate fiduciary duties generally or that seeks to limit or eliminate liability for the duty of loyalty. He explained that a covenant not to sue does not modify either the underlying duty or the availability of a remedy; it only constitutes a commitment by the signatories not to assert the claim.

Vice Chancellor Slights next considered when a covenant might nevertheless operate constructively to limit or eliminate fiduciary duties or the ability to recover damages for a loyalty breach. Relying on *Yucaipa American Alliance Fund I, L.P. v. SBDRE, LLC*,[289] he distinguished between a case where all stockholders are signatories, such that no one can sue, and a situation where "others not bound by the contract could bring suit."[290] He concluded that as long as other parties could assert ***589** the claim and provide accountability, then the covenant did not constructively limit or eliminate fiduciary duties or the ability to recover damages for a loyalty breach. In *Altor Bioscience*, there were other stockholders who could sue, so Vice Chancellor Slights held that the provision "does not violate public policy, nor is it otherwise offensive to law or equity."[291] Vice Chancellor Slights therefore entered judgment as a matter of law dismissing the claims for breach of fiduciary duty that Gray and Waldman had tried to assert.

The ruling in *Altor Bioscience* anticipates the majority opinion in *Manti* by declining to hold the covenant facially invalid and instead carefully analyzing whether it was reasonable to enforce the provision. For purposes of a facial challenge, Vice Chancellor Slights noted that the provision did not limit or eliminate the defendants' fiduciary duties or their liability for breach. The provision only bound the signatories and prevented them from filing suit. For purposes of the as-applied challenge, Vice Chancellor Slights noted that Gray and Waldman had agreed to the provision to secure a result they desired—peace in the valley—and they accepted consideration in exchange for the agreement that contained the covenant. By filing suit, they were doing precisely what they had agreed in writing not to do.

The discussion of whether other stockholders could sue should be viewed as part of the overarching reasonableness analysis. A critic might interpret the *Altor Bioscience* ruling as

establishing a "Rule of One," under which if at least one other stockholder could sue, then a covenant would be valid. That would be a caricature. Vice Chancellor Slights considered the extent to which other stockholders could sue. The existence of a single stockholder who could assert a claim would not render a provision reasonable. The *Altor Bioscience* ruling supports evaluating a provision like the Covenant for its reasonableness.

G. The Case-By-Case Analysis Contemplated By *Manti* And *Altor Bioscience*

[67] The decisions in *Manti* and *Altor Bioscience* point to a two-step analysis for a provision like the Covenant. First, the provision must be narrowly tailored to address a specific transaction that otherwise would constitute a breach of fiduciary duty. The level of specificity must compare favorably with what would pass muster for advance authorization in a trust or agency agreement, advance renunciation of a corporate opportunity under Section 122(17), or advance ratification of an interested transaction like self-interested director compensation. If the provision is not sufficiently specific, then it is facially invalid.

[68] As this decision has explained, the Covenant meets that standard. It only applies to one of three types of transactions that qualify as a Sale of the Company. The terms of the transaction must then meet the eight specific criteria necessary to qualify as a Drag-Along Sale.[292] The provision is sufficiently specific to avoid facial invalidity.

[69] Next, the provision must survive close scrutiny for reasonableness. In this case, many of the non-exclusive factors suggested in *Manti* point to the provision being reasonable. Those factors include (i) a written contract formed through actual consent, (ii) a clear provision, (iii) knowledgeable stockholders who understood the provision's implications, (iv) the Funds' ***590** ability to reject the provision, and (v) the presence of bargained-for consideration.

First, the Covenant is an express provision that appears in the Voting Agreement. The Funds executed that contract and agreed to its terms. The Covenant did not appear as a take-it-or-leave-it provision in a pre-IPO charter. Nor was the Covenant imposed through a midstream charter amendment that the Funds voted against. The Funds freely promised in a written agreement that they would not sue over the Drag-Along Sale. For the Funds to disclaim their written promise makes them "liar[s] in the most inexcusable of commercial circumstances: in a freely negotiated written contract."[293]

Second, the Covenant is clearly written. No one argues that it does not cover the Sale Counts or the defendants.

Third, the Funds are sophisticated repeat players. They necessarily understood the implications of the Covenant, which tracks language in the NVCA's model voting agreement. Discovery might well show that the Funds or their sponsors have deployed comparable provisions to their benefit in other transactions.

Fourth, the Funds could have rejected the Covenant. As the Company's largest incumbent investors and holders of preferred stock, the Funds could have blocked the Recapitalization and forced the Company to seek a different deal. Or they could have proposed a deal of their own. They could have declined to sign the Voting Agreement. And if they thought that Rich had extracted favorable terms, they could have participated in the Recapitalization as investors. Instead, they declined to invest with Rich and his group, signed the Voting Agreement, and let Rich and his group take the risk.

Fifth, the Funds agreed to the Covenant to induce Rich and his fellow investors to fund the Recapitalization. The Covenant affects Rich's ability to exit, and without it, he might not have led the Recapitalization or could have demanded different terms. Invalidating the Covenant changes the bargained-for exchange and shifts value to the Funds by permitting them to pursue rights that they gave up. After the Recapitalization, Rich, Rutchik, and Stella served on the Board and approved the Drag-Along Sale. Invalidating the Covenant changes their litigation exposure as well.

The facts of this case provide an example of sophisticated parties using a provision like the Covenant to allocate risk and order their affairs. This is a case where a provision like the Covenant can be enforced.

Although this decision upholds the Covenant against both facial and as-applied challenges, that does not mean that provisions of this sort will be upheld on different facts.[294] Another powerful provision that Delaware courts review for reasonableness is a covenant not to compete. Parties can use covenants not to compete and other restrictive covenants to create value and facilitate commercial relationships. Yet sophisticated parties can also use restrictive covenants to take advantage of the less privileged. Humans are vulnerable to

recurring psychological blind spots, including excessively discounting the future. Unless the party bargaining over a ***591** restrictive covenant is a repeat player, it is easy to underestimate the future impact of the provision, particularly compared to a concrete job offer. Restrictive covenants frequently appear in situations where meaningful bargaining is absent, such as standardized employment agreements. Restrictive covenants can also appear in unexpected places, like equity grants.

A restrictive covenant affects an important economic right: the ability to work. A covenant not to sue affects a foundational civil right: the ability to access the courts. That right is foundational because it is necessary to protect all others. Without the ability to obtain a judgment from a court, backed by the power of the state, other rights become meaningless. Unless the holder of the right has some other source of leverage, like influence, economic power, or a willingness to deploy extra-legal force, then the counterparty can ignore the right. Without courts to enforce them, even voting rights can become nullities. In a civil society, what renders a right meaningful is access to the courts and, with a judgment in hand, the power of the state. A forward-looking covenant not to sue warrants greater scrutiny for reasonableness than a covenant not to compete precisely because it limits access to the courts.

[70] A court only decides the case at hand.[295] Nevertheless, it is easy to envision scenarios where the proponent of a provision like the Covenant would face deep skepticism and a steep uphill slog. They could include:

- An agreement binding a retail stockholder.
- An employee stock grant.
- A dividend reinvestment plan.
- An employee stock compensation plan.
- A stock transmittal letter.
- A transaction that offered an election between base consideration and incremental consideration plus a covenant not to sue.[296]

There may well be other use cases for a provision like the Covenant, but they are likely to be few and limited to agreements between *uber*-sophisticated parties like the Rich Entities and the Funds.

H. A Public Policy Limitation From Contract Law

[71] Although the Covenant is not invalid as a form of impermissible fiduciary tailoring, there is one remaining limitation on what the Covenant can accomplish. As a general matter, "[a] term exempting a party from tort liability for harm caused intentionally or recklessly is unenforceable on grounds of public policy."[297] Thus, "[a]n attempted exemption from liability for a future intentional tort ... is generally held void ...."[298] Delaware decisions addressing ***592** exculpatory provisions in commercial agreements have applied this rule, stating: "A party may not protect itself against liability for its own fraudulent act or bad faith. Even if a contract purports to give a general exoneration from 'damages,' it will not protect a party from a claim involving its own fraud or bad faith."[299] A commercial agreement among sophisticated parties can only exonerate a party for liability for its own negligence.[300]

But as with many things in the law, the public policy line is blurred. There is one area where Delaware law has reached beyond the traditional limitations on contracting by providing a path for sophisticated parties to cabin liability for an intentional tort. In *Abry Partners*, Chief Justice Strine held while serving as a member of this court that sophisticated parties, bargaining at arm's length and with the ability to walk away freely, could enter into an acquisition agreement that expressly disclaimed reliance on any representations made outside of the agreement, thereby preventing those representations from supporting a fraud claim.[301] The Chief Justice acknowledged that this outcome departed from the rule in the Restatement (Second) of Contracts and the law of other states, but he emphasized the importance that Delaware law places on the freedom of contract and "the ability of sophisticated businesses, such as the Buyer and Seller, to make their own judgments about the risk they should bear and the due diligence they undertake, recognizing that such parties are able to price factors such as limits on liability."[302]

Technically, the *Abry Partners* decision does not limit liability for fraud, but rather specifies the information on which a fraud claim can be based, which indirectly constrains liability for fraud. In substance, the party providing the anti-reliance representation covenants not to sue over any statements outside of the agreement. So viewed, *Abry Partners* authorizes a covenant not to sue that addresses an intentional tort. To date, Delaware decisions have declined to expand the *Abry Partners* principle beyond anti-reliance

provisions, holding that other attempts to limit liability for fraud violate public policy.[303] That trend suggests that *Abry Partners* should not be used to validate other provisions that seek to eliminate tort liability for intentional harm.

Recklessness is a different matter. As discussed previously, Section 102(b)(7) of the DGCL authorizes exculpation for monetary liability for the duty of care, and Delaware decisions interpreting Section 102(b)(7) hold that the reckless conduct ***593** falls within the ambit of the duty of care.[304] Making recklessness subject to exculpation also tracks the scope of indemnifiable conduct under Section 145(a) and insurable conduct under Section 145(g). Section 145(a) authorizes indemnification as long as the fiduciary acted in subjective good faith and reasonably believed that the decision was not opposed to the interests of the corporation. Section 145(g) authorizes a corporation to use a captive insurer to protect against fiduciary liability for any claim except (i) personal profit or other financial advantage to which such person was not legally entitled or (ii) deliberate criminal or deliberate fraudulent act of such person, or a knowing violation of law by such person.[305] Both standards encompass recklessness.

[72] **[73]** A claim for breach of fiduciary duty is an equitable tort.[306] To the extent the Covenant seeks to prevent the Funds from asserting a claim for an intentional breach of fiduciary duty, then the Covenant is invalid—not as an impermissible form of fiduciary tailoring, but because of policy limitations on contracting.

[74] Otherwise, the Covenant bars challenges to the Drag-Along Sale. Thus, if the defendants engaged in self-interested transactions but believed in good faith that the transactions were not contrary to the best interests of the Company, then the Covenant forecloses those claims. The Covenant also forecloses claims that the defendants engaged in the self-interested transactions with reckless disregard for the best interests of the Company.

As discussed in the Pleading Decision, the Sale Counts could support liability for a bad faith breach of duty.[307] Damages for that claim would result from an intentional tort. The Covenant therefore cannot bar the Sale Counts in their entirety.

III. CONCLUSION

The Covenant is not facially invalid as a prohibited form of fiduciary tailoring. The Covenant operates permissibly within the space for fiduciary tailoring that Delaware corporate law provides, particularly in a stockholder-level agreement that only addresses stockholder-level rights.

The Covenant is not unreasonable on the facts of this case. Sophisticated repeat players consented explicitly to a clear provision in a stockholder-level agreement that applies only to a specific transaction.

Nevertheless, the Covenant cannot relieve the defendants of tort liability for intentional harm. The Sale Counts could support that form of liability. The Covenant therefore does not foreclose the Sale Counts, and the defendants' motion to dismiss those counts based on the Covenant is denied.

All Citations

295 A.3d 520

Footnotes

1 261 A.3d 1199 (Del. 2021).

2 *See Abry P'rs V, L.P. v. F&W Acq. LLC*, 891 A.2d 1032, 1057–59 (Del. Ch. 2006). The Delaware Supreme Court subsequently endorsed that innovation. *RAA Mgmt., LLC v. Savage Sports Hldgs., Inc.*, 45 A.3d 107, 119 (Del. 2012).

3 Citations in the form "Ex. ___" refer to documents attached to the Affidavit of Sebastian Van Oudenallen, which collects documents operated by reference in the operative complaint. Dkt. 14. Citations in the form "VA § ___" refer to provisions in the Voting Agreement. Ex. 1 at Ex. E.

4 *New Enter. Assocs. 14, L.P. v. Rich*, 292 A.3d 112 (Del. Ch. Mar. 9, 2023).

5 *Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Hldgs. LLC*, 27 A.3d 531, 535 (Del. 2011).

6 *See* Ct. Ch. R. 8(c); *Seven Invs., LLC v. AD Cap., LLC*, 32 A.3d 391, 396 (Del. Ch. 2011). *See generally* 66 Am. Jur. 2d *Release* § 4, Westlaw (database updated Feb. 2023) (describing the invocation of a covenant not to sue as "an affirmative defense to an action").

7 *See, e.g.*, *Seven Invs.*, 32 A.3d at 396 (considering implications of general release at the pleading stage where it appeared in a document incorporated by reference in the complaint); *Meer v. Aharoni*, 2010 WL 2573767, at *3 (Del. Ch. June 28, 2010) ("In evaluating defendant's motion to dismiss, the Court may also consider the unambiguous terms of the Original and Amended Stipulations, the Proposed Settlement, and the Release, which are integral to the complaint and the resolution of this motion."); *Canadian Com. Workers Indus. Pension Plan v. Alden*, 2006 WL 456786, at *2 n.9 (Del. Ch. Feb. 22, 2006) ("The Court may consider the Release in deciding a motion to dismiss because the Complaint makes reference to it.").

8 76 C.J.S. *Release* § 51, Westlaw (database updated Apr. 2023); *accord* 66 Am. Jur. 2d *Release* § 4; *see* Andrew M. Hinkes, *The Limits of Code Deference*, 46 J. Corp. L. 869, 891 (2021) ("A covenant not to sue is an agreement to not file a lawsuit, rather than an abandonment of any right."). The California Supreme Court rejects the distinction as artificial on the grounds that the result for the claimant is the same regardless of whether the claimant gives a release of the claim or covenants not to assert it. Bradford P. Anderson, *Please Release Me, Let Me Go! Releases of Unknown Claims in the Penumbra of California Civil Code Section 1542*, 9 U.C. Davis Bus. L.J. 1, 7 (2008). When parties settle all claims relating to a past transaction or event, a release and a covenant likely are equivalent. But part of the value of a covenant lies in its ability to address claims relating to future conduct. A release can extinguish claims based on past conduct that a party might learn of or assert in the future, but it cannot cover claims based on future conduct. *Compare* *Christiana Care Health Servs. v. Davis*, 127 A.3d 391, 395 (Del. 2015) (upholding release of future claims arising from past conduct), *and* *Spadaro v. Abex Corp.*, 1993 WL 603378, at *2 (Del. Super. Ct. Sept. 9, 1993) (same) *with* *UniSuper Ltd. v. News Corp.*, 2006 WL 4804015, at *3 (Del. Ch. May 31, 2006) (rejecting release that attempted to release claims arising out of future conduct).

9 *See* 66 Am. Jur. 2d *Release* § 4.

10 *Id.*; 76 C.J.S. *Release* § 75. Jurisdictions also addressed the problem of claim extinction by altering the common law rule. *E.g.*, 10 *Del. C.* § 6304; *Clark v. Brooks*, 377 A.2d 365, 372 (Del. Super. Ct. 1977), *aff'd sub nom.* *Blackshear v. Clark*, 391 A.2d 747 (Del. 1978).

11 76 C.J.S. *Release* § 51.

12 66 Am. Jur. 2d *Release* § 4.

13 *Id.*

14 76 C.J.S. *Release* § 3.

15 17A C.J.S. *Contracts* § 338, Westlaw (database updated Apr. 2023).

16 76 C.J.S. *Release* § 53.

17 *Id.* (citing *Dyson, Inc. v. Bissell Homecare, Inc.*, 951 F. Supp. 2d 1009, 1035 (N.D. Ill. 2013)).

18 *See, e.g.*, *Kalisch-Jarcho, Inc. v. New York*, 58 N.Y.2d 377, 461 N.Y.S.2d 746, 448 N.E.2d 413, 416 (1983) ("But an exculpatory agreement, no matter how flat and unqualified its terms, will not exonerate a party from liability under all circumstances. Under announced public policy, it will not apply to exemption of willful or grossly negligent acts." (internal citation omitted)); *Schwartz v. Martin*, 82 A.D.3d 1201, 919 N.Y.S.2d 217, 219 (N.Y. App. Div. 2011) ("[A]n enforceable release will not insulate a party from grossly negligent conduct ...."); *Goldstein v. Carnell Assocs., Inc.*, 74 A.D.3d 745, 906 N.Y.S.2d 905, 905 (N.Y. App. Div. 2010) (collecting cases; stating that "the public policy of this State dictates that 'a party may not insulate itself from damages caused by grossly negligent conduct.' ") (quoting *Sommer v. Fed. Signal Corp.*, 79 N.Y.2d 540, 583 N.Y.S.2d 957, 593 N.E.2d 1365, 1370 (1992)).

19 *See* Part III.G, *infra.*

20 *See Nottingham P'rs v. Dana*, 564 A.2d 1089, 1105–06 (Del. 1989) (permitting release to extinguish all claims relating to the challenged transaction, including claims for breach of fiduciary duty); *Seven Invs.*, 32 A.3d at 398 ("Because Seven Investments released all claims relating to the Purported Accumulated Expenses, Seven Investments cannot bring its claim in Count III to recover the amounts paid under a theory of unjust enrichment. Seven Investments' effort to repackage all of its claims under a breach of fiduciary duty theory is likewise barred. Discala became a fiduciary of Canvas Companies in accordance with the Contribution Agreement and under the LLC Agreement. The General Release extinguished all claims arising out of or relating to these agreements."); *see also Griffith v. Stein.*, 283 A.3d 1124, 1134 (Del. 2022) ("To satisfy due process concerns, a settlement can release claims that were not specifically asserted in an action but can only release claims that are based on the same identical factual predicate or the same set of operative facts as the underlying action." (cleaned up)).

21 VA § 3.1.

22 *Id.* § 3.2.

23 *Id.* § 3.3(f).

24 *Id.*

25 *Id.* § 3.3(g).

26 *Id.* § 3.3(a).

27 *Id.* § 3.3(b).

28 *Id.* § 3.3(c).

29 *Id.* § 3.3(d).

30 *Id.* § 3.3(e).

31 *Id.* § 3.2(a).

32 *Id.* § 3.2(c).

33 *Id.* § 3.2(g).

34 *Id.* § 3.2(e).

35 *Id.*

36 The Funds might have pointed to a mismatch between the Covenant and the Funds' challenges to the Drag-Along Sale. As discussed below, commentary to the NVCA model provision describes its purpose as preventing signatories from using claims for breach of fiduciary duty to obtain a quasi-appraisal remedy. It thus most clearly covers a claim that the Board and the holders of the Preferred Stock breached their fiduciary duties by failing to disclose material information to the Company's stockholders or by approving a deal that was not the best transaction reasonably available. The Funds have not asserted that the defendants breached their duty of disclosure in connection with the Drag-Along Sale (they only assert disclosure claims based on the Interested Transactions). They also do not claim that the buyer or another bidder might have offered a better deal. They object to the Interested Transactions through which the directors allegedly enriched themselves and their affiliates at the expense of the Company and its unaffiliated stockholders during the lead up to the Drag-Along Sale. The Covenant sweeps in those claims only because Delaware law compensates for a bright-line rule that causes a cash-out merger to extinguish the sell-side stockholders' standing to sue derivatively by recharacterizing the derivative claims as direct challenges to the merger. *See* Pleading Decision, 2023 WL 2417271, at *28–45.

The Funds might have argued that the Covenant does not apply to self-dealing in the lead-up to a Drag-Along Sale. When the court raised the arguable mismatch at oral argument, the Funds picked up on it. Dkt. 34 at 26, 38. Because this decision declines to hold that the Covenant forecloses the Sale Counts, the Funds can explore this issue in discovery, and the parties can address it later should it prove salient.

37 *See* NVCA, *Model Voting Agreement* § 3.2(e) (updated Mar. 2022), available at https://nvca.org/model-legal-documents.

38 *Id.* (footnotes omitted).

39 *Id.* n.18.

40 Dkt. 16 at 56.

41 *See Miller v. HCP & Co.*, 2018 WL 656378, at *2 (Del. Ch. Feb. 1, 2018) (interpreting forced-sale provision in an LLC agreement that waived all fiduciary duties and that majority member used to effectuate a sale to a third party; noting that "if the parties had chosen to employ the corporate form here, with its common-law fiduciary duties, this matter would be subject to entire fairness review" but that "the members forwent the suite of common-law protections available with the corporate form, and instead chose to create an LLC" in which they explicitly waived fiduciary duties, "despite the presence of a controller with an incentive to take a quick sale, and a Board with sole discretion to approve such a sale, with the single safeguard that the sale must not be to an insider"), *aff'd sub nom. Miller v. HCP Trumpet Invs., LLC*, 194 A.3d 908 (Del. 2018); *Dieckman v. Regency GP LP*, 2016 WL 1223348, at *8 (Del. Ch. Mar. 29, 2016) ("In the limited partnership context, absent contractual modification, a general partner owes fiduciary duties that include a duty of full disclosure. But in stark contrast to the corporate context, in which fiduciary duties cannot be waived, a limited partnership may eliminate all fiduciary duties, including the duty of disclosure." (cleaned up)), *rev'd on other grounds,* 155 A.3d 358 (Del. 2017); *In re Ezcorp Inc. Consulting Agr. Deriv. Litig.,* 2016 WL 301245, at *23 (Del. Ch. Jan. 25, 2016) ("If a controller does not want to assume fiduciary obligations, then it can choose not to issue stock to the public, or not to acquire a dominant stake in a publicly funded firm. If a controller wants to use other people's money, it can do so using debt, which establishes a contractual relationship that does not carry fiduciary obligations. Or a controller can use an alternative entity vehicle and eliminate or restrict fiduciary duties."). Each of these decisions commented in passing on the differences between the degree to which the constitutive documents of a corporation could tailor fiduciary duties and the degree to which the constitutive documents of an alternative entity could do so. None called the question of the extent to which an investor could commit contractually in an investor-level agreement to refrain from asserting investor-level claims that the investor otherwise could freely elect not to assert.

42 2022 WL 1751741 (Del. Ch. May 31, 2022), *cert. denied*, 2022 WL 4087800 (Del. Ch. Sept. 7, 2022), *and appeal dismissed*, 284 A.3d 713 (Del. 2022).

43 *Id.* at *2.

44 *See MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1129–31 (Del. 2003); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (Allen, C.); *see generally Pell v. Kill*, 135 A.3d 764, 784–93 (Del. Ch. 2016) (collecting authorities addressing the operation of *Blasius* as a form of enhanced scrutiny).

45 *Totta*, 2022 WL 1751741, at *14.

46 *Id.* at *16–17 (discussing 8 *Del. C.* § 102(b)(7) and 8 *Del. C.* § 122(17)). The Chancellor also discussed one potential statutory limitation that the parties had not explored and one ineffective statutory limitation. *Id.* at *18, *21 n.215. The unexplored limitation appears in Section 141(a) of the DGCL, and this decision addresses that statutory path below. The ineffective statutory limitation appears in Section 152, which states that "[i]n the absence of actual fraud in the transaction," the board's determination regarding the value of the consideration that a corporation receives for its shares "shall be conclusive." 8 *Del. C.* § 152(d). Despite the seemingly clear "actual fraud" standard in the statutory text, Delaware courts have subjected the board's determination to fiduciary review by applying either the business judgment rule or the entire fairness test depending on whether or not the decision was made by a board majority comprising disinterested and independent directors. *See Parfi Hldg. AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1235 (Del. Ch. 2001) (Strine, V.C.), *rev'd on other grounds*, 817 A.2d 149 (Del. 2002).

47 *Totta*, 2022 WL 1751741, at *15.

48 85 A.2d 724 (Del. 1951).

49 *Totta*, 2022 WL 1751741, at *15 (footnote omitted).

50 I agree with the Chancellor's assessment of where the allocation of authority among the separate branches of government rests today. The *DuPont* case, however, contemplates a more muscular role for this court's equity jurisdiction. The Delaware Supreme Court analyzed Article IV, Section 10 of the Delaware Constitution of 1897, which provides that this court "shall have all the jurisdiction and powers vested by the laws of this State in the Court of Chancery." Del. Const. art. IV, § 10. After tracing the history of the provision, the high court held that the constitutional grant of jurisdiction empowers the Court of Chancery with, at a minimum, "all the general equity jurisdiction of the High Court of Chancery of Great Britain as it existed prior to the separation of the colonies," except "where a sufficient remedy exists at law." *DuPont*, 85 A.2d at 727, 729. Based on that constitutional grant, the high court held that the General Assembly cannot enact legislation that reduces this court's jurisdiction below the constitutional minimum, unless the General Assembly ensures that there is an adequate remedy at law. *Id.* at 729. The Delaware Supreme Court explained that through this grant of authority, the framers of the Constitution of 1897

> intended to establish for the benefit of the people of the state a tribunal to administer the remedies and principles of equity. They secured them for the relief of the people. This conclusion is in complete harmony with the underlying theory of written constitutions. Its result is to establish by the Judiciary Article of the Constitution the irreducible minimum of the judiciary. It secures for the protection of the people an adequate judicial system and removes it from the vagaries of legislative whim.

Id. One scholar has argued that *DuPont* creates "substantial doubt" about whether fiduciary duties can be waived or eliminated at all, even with statutory authorization from the General Assembly. Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. Rev. 701, 702 (2011). I would not go that far, because the weight of authority demonstrates that fiduciary duties can be tailored. There is arguably an open question as to whether the General Assembly can constitutionally authorize provisions that purport to eliminate all fiduciary duties or capaciously limit them without ensuring the existence of an adequate remedy at law. Experience has shown that contractual remedies and the implied covenant of good faith and fair dealing are not fiduciary substitutes. *See generally* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom,* in *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations* (Robert W. Hillman & Mark J. Loewenstein eds., 2014). Although it hardly seems likely that the Delaware courts would rely on *DuPont* to pare back the blanket authorization for waiving or limiting fiduciary duties that appear in the alternative entities statutes, the *DuPont* decision provides insight into equity's true potential.

51 288 A.3d 692 (Del. Ch. 2023).

52 *Id.* at 714.

53 *Id.* at 715 (quoting *Schock v. Nash*, 732 A.2d 217, 225 n.21 (Del. 1999)).

54 *Id.* (quoting *Totta*, 2022 WL 1751741, at *15).

55 *Id.* (internal quotations omitted).

56 227 A.3d 102 (Del. 2020).

57 As an aside, this case is not about whether fiduciaries must comply with a contract that purports to limit their ability to fulfill their duties. Some have read *Paramount Communications Inc. v. QVC Network Inc.,* 637 A.2d 34 (Del. 1994), as suggesting that a contract cannot limit fiduciary duties, thereby giving fiduciaries a get-out-of-contract-free card, but learned commentators reject that interpretation. *See, e.g.*, R. Franklin Balotti & A. Gilchrist Sparks, III, *Deal-Protection Measures and the Merger Recommendation*, 96 Nw. U. L. Rev. 467, 468–69 (2002) ("In *Smith v. Van Gorkom*, the Delaware Supreme Court established that Delaware law does not give directors, just because they are fiduciaries, the right to accept better offers, distribute information to potential new bidders, or change their recommendation with respect to a merger agreement even if circumstances have changed." (footnote omitted)); John F. Johnston, *Recent Amendments*

to the Merger Sections of the DGCL Will Eliminate Some—But Not All—Fiduciary Out Negotiation and Drafting Issues, 1 Mergers & Acquisitions L. Rep. 20, 777, 778 (July 20, 1998) (BNA) ("[T]here is ... no public policy that permits fiduciaries to terminate an otherwise binding agreement because a better deal has come along, or circumstances have changed."); John F. Johnston & Frederick H. Alexander, *Fiduciary Outs and Exclusive Merger Agreements—Delaware Law and Practice*, 11 Insights: The Corp. & Sec. L. Advisor No. 2, 15, 15 (Feb. 1997) ("[T]he Delaware Supreme Court held that directors of Delaware corporations may not rely on their status as fiduciaries as a basis for (1) terminating a merger agreement due to changed circumstances, including a better offer; or (2) negotiating with other bidders in order to develop a competing offer."); A. Gilchrist Sparks, III, *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*, 51 U. Miami L. Rev. 815, 817 (1997) ("[*Van Gorkom*] makes it clear that under Delaware law there is no implied fiduciary out or trump card permitting a board to terminate a merger agreement before it is sent to a stockholder vote."). To the extent some have viewed *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 933 (Del. 2003), as supporting a similar fiduciary trump card, I have argued otherwise. *See* J. Travis Laster, *Omnicare's Silver Lining*, 38 J. Corp. L. 795, 818–27 (2013). This case is not about fiduciaries limiting their freedom of action by contract; it is about non-fiduciary stockholders agreeing to a transaction-specific limitation on their ability to assert stockholder-level claims against fiduciaries.

58 Paul B. Miller & Andrew S. Gold, *Introduction* to Contract, Status, and Fiduciary Law 1 (Paul B. Miller & Andrew S. Gold, eds., 2016) [hereinafter Contract and Fiduciary Law].

59 *Id.* at 2, 5.

60 Matthew Harding, *Fiduciary Undertakings*, *in* Contract and Fiduciary Law 88 (footnote omitted).

61 *Id.*

62 Gregory Klass, *What if Fiduciary Obligations are like Contractual Ones?*, *in* Contract and Fiduciary Law 93.

63 *Id.* at 93–94.

64 *E.g.*, 12 *Del. C.* § 3303(a) ("The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this section. It is the policy of this section to give maximum effect to the principle of freedom of disposition and to the enforceability of governing instruments.").

65 *Id.* ("Notwithstanding any other provision of this Code or other law, the terms of a governing instrument may expand, restrict, eliminate, or otherwise vary any laws of general application to fiduciaries, trusts, and trust administration, including, but not limited to, any such laws pertaining to: ... (5) A fiduciary's powers, duties, standard of care, rights of indemnification and liability to persons whose interests arise from that instrument ... provided, however, that nothing contained in this section shall be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary's own wilful [sic] misconduct or preclude a court of competent jurisdiction from removing a fiduciary on account of the fiduciary's wilful [sic] misconduct."); *see* 12 *Del. C.* § 3586 ("A trustee who acted in good faith reliance on the terms of a written governing instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from the reliance."); 12 *Del. C.* § 3588(a) (addressing ability of beneficiary to consent conduct by trustee constituting a breach of fiduciary duty).

66 *E.g.*, 12 *Del. C.* § 3301(g).

67 Rather than declaring that directors had the same duties as trustees, Delaware decisions described their duties as in the nature of trustees. *See Bovay v. H. M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) (describing stock to be "in the nature" of a trust fund); *Bodell v. Gen. Gas & Elec. Corp.*, 132 A. 442, 446 (Del. Ch. 1926), *aff'd*, 140 A. 264 (Del. 1927) ("There is no rule better settled in the law of corporations than that directors in their conduct of the corporation stand in the situation of fiduciaries. While they are not trustees in the strict sense of the term, yet for convenience they have often been described as such."). Scholars have noted that the application of fiduciary duties to directors was "less rigorous, since the business situation demands greater flexibility than the trust situation." Adolf A. Berle, Jr., *Corporate Powers As Powers in Trust*, 44 Harv. L. Rev. 1049, 1074 (1931); *accord* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 908–09 (1988) ("As the law has developed, trustees are under more stringent restrictions

in their dealings with trust property than are corporate directors in their personal transactions with the corporation."); *see* Restatement (Third) of Trusts § 78 (Am. L. Inst. 2007), Westlaw (database updated Mar. 2023) ("The duty of loyalty is, for trustees, particularly strict even by comparison to the standards of other fiduciary relationships.").

68 When describing the duties owed by partners, Justice Cardozo famously invoked the "punctilio of an honor most sensitive." *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545 (N.Y. 1928). By statute, fiduciary duties in Delaware general and limited partnerships are fully contractable. *See* 6 *Del. C.* §§ 15-103, 17-1101.

69 Lionel D. Smith, *Contract, Consent, and Fiduciary Relationships*, in Contract and Fiduciary Law 128, 134; *accord* George G. Bogert et al., *Bogert's The Law of Trusts & Trustees* § 541 at 232 (3d ed. 2020) ("Although a settlor can modify a trustee's duties to a degree, the existence of certain duties is critical to the existence of the trust relationship."); Restatement (Third) of Trusts, *supra*, § 86 cmt. b ("A trustee's duties ... may be modified by the terms of the trust, but the duties of trusteeship are subject to certain minimum standards that are fundamental to the trust relationship and normally essential to it.").

70 *See* Bogert, *supra*, § 541 at 252–53 ("A settlor may provide guidance to the trustee to prefer one beneficiary or category of beneficiaries over others, and the trustee must follow that guidance."); *see also* Restatement (Third) of Trusts, *supra*, § 49 ("[T]he existence and extent of the trustee's duty of loyalty to the beneficiary ... may of course be imposed by the terms of the trust; or the terms of the trust may limit the extent of such duties, or in some cases may prevent such duties from being imposed.").

71 Bogert, *supra*, § 541 at 235–37 ("A fundamental duty of the trustee is to carry out the directions of the testator or settlor as expressed in the terms of the trust. Any attempt to take action contrary to the settlor's direction may be deemed to constitute a unilateral and invalid deviation from the trust terms." (footnotes omitted)); *see* Restatement (Third) of Trusts, *supra*, § 76(1) ("The trustee has a duty to administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law.").

72 Bogert, *supra*, § 543 at 371, 579–83 (noting that express grants of authority to trustees to perform specific acts that otherwise would be disloyal have often been upheld; collecting cases); *see* Restatement (Third) of Trusts, *supra*, § 78 ("*Except as otherwise provided in the terms of the trust*, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose." (emphasis added)); *id.* cmt. c(2) ("A trustee may be authorized by the terms of the trust, expressly or by implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty stated in Subsections (1) and (2). For example, the terms of a trust may permit the trustee personally to purchase trust property or borrow trust funds, or to sell or lend the trustee's own property or funds to the trust."); *cf.* Berle, *supra*, at 1073 ("In this respect, corporation law is substantially at the stage in which equity was when it faced the situation of a trustee who had been granted apparently absolute powers in his deed of trust. So far as the law and the language went, the power was absolute; the trustee could do as he pleased; could perhaps trade with himself irrespective of his adverse interests; could, perhaps, sell the trust assets at an unfairly low price.").

73 Restatement (Third) of Agency § 8.06 (Am. L. Inst. 2006), Westlaw (database updated Mar. 2023).

74 Restatement (Third) of Agency, *supra*, § 8.08, cmt. b ("A contract may also, in appropriate circumstances, raise or lower the standard of performance to be expected of an agent ...."); *see* Deborah A. DeMott, *Corporate Officers As Agents*, 74 Wash. & Lee L. Rev. 847, 869 (2017) ("Agency law acknowledges the possibility of contractual solutions by embracing a role for agreements between principals and agents that define in advance the applicable standard of performance.")

75 Restatement of Agency (Third), *supra*, § 8.06.

76 *Id.* cmt. b.

77 *Id.*

78 *Id.*

79 *Id.*

80 *See In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 50–51 (Del. Ch. 2013) (describing types of VC exits); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1, 8–9 (2008) ("In the case of venture capital funds, the portfolio companies are start-ups.... After some period of time, the fund sells its interest in the portfolio company to a strategic or financial buyer, or it takes the company public and sells its securities in a secondary offering."); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. Rev. 315, 316 (2005) ("Before venture capitalists invest, they plan for exit."); *id.* at 356 ("Any venture capitalist who desires to remain in business ... must successfully raise funds, invest them in portfolio companies, then exit the companies and return the proceeds to the fund investors, who in turn are expected to reinvest in a new fund formed by the same venture capitalist.").

81 991 A.2d 1120, 1129 (Del. 2010) (explaining that where parties have entered into a contract, competing claims for breach of fiduciary duty arising out of the same facts are "foreclosed as superfluous").

82 8 *Del. C.* § 102(b)(7).

83 *Sinchareonkul v. Fahnemann*, 2015 WL 292314, at *6 (Del. Ch. Jan. 22, 2015) ("A bylaw that conflicts with the charter is void, as is a bylaw or charter provision that conflicts with the DGCL.").

84 *See* Part II.D.3.b, *infra.* There is one decision which applies the limitations in Section 102(b)(7) to a settlement agreement. *See Hills Stores Co. v. Bozic*, 1997 WL 153823, at *6 (Del. Ch. Mar. 25, 1997) (Strine, V.C.). After citing Section 102(b)(7), the court stated simply, "I see no reason why the public policy behind § 102(b)(7) should not also apply to settlement agreements." *Id.* The court did not delve into the issue any more deeply, nor did the decision consider any other authorities.

85 *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 652 n.45 (Del. Ch. 2008) (Strine, V.C.) ("[T]he definition [of gross negligence in corporate law] is so strict that it imports the concept of recklessness into the gross negligence standard ...."); *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at *4 (Del. Ch. Aug. 26, 2005) ("Gross negligence has a stringent meaning under Delaware corporate (and partnership) law, one which involves a devil-may-care attitude or indifference to duty amounting to recklessness." (cleaned up)); *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) ("In the corporate context, gross negligence means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." (cleaned up)); *Solash v. Telex Corp.*, 1988 WL 3587, at *9 (Del. Ch. Jan. 19, 1988) (Allen, C.) (explaining that to be grossly negligent, a decision "has to be so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion" (cleaned up)); *see McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008) ("[F]rom the sphere of actions that was once classified as grossly negligent conduct that gives rise to a violation of the duty of care, the Court has carved out one specific type of conduct—the intentional dereliction of duty or the conscious disregard for one's responsibilities—and redefined it as bad faith conduct, which results in a breach of the duty of loyalty. Therefore, Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason.").

86 *Browne v. Robb*, 583 A.2d 949, 953 (Del. 1990) (quoting W. Prosser, *Handbook of the Law of Torts* 150 (2d ed. 1955)). This test "is the functional equivalent" of the test for "[c]riminal negligence." *Jardel Co., Inc. v. Hughes*, 523 A.2d 518, 530 (Del. 1987). By statute, Delaware law defines "criminal negligence" as follows:

> A person acts with criminal negligence with respect to an element of an offense when the person fails to perceive a risk that the element exists or will result from the conduct. The risk must be of such a nature and degree that failure to perceive it constitutes a gross deviation from the standard of conduct that a reasonable person would observe in the situation.

11 *Del. C.* § 231(a). The same statute provides that a person acts recklessly when "the person is aware of and consciously disregards a substantial and unjustifiable risk that the element exists or will result from the conduct." *Id.* § 231(e). As with criminal negligence, the risk "must be of such a nature and degree that disregard thereof constitutes a gross deviation from the standard of conduct that a reasonable person would observe in the situation." *Id.*; *see id.* § 231(a).

87 *Jardel*, 523 A.2d at 530.

88 *See In re Columbia Pipeline Gp., Inc.*, 2021 WL 772562, at *50 n.22 (Del. Ch. Mar. 1, 2021) ("The reality that a care claim requires recklessness warrants re-conceptualizing what exculpation accomplishes. Exculpation does not eliminate

liability for negligence, because that form of liability does not exist in the first place. In the corporate context, a breach of the duty of care requires recklessness. The real function of exculpation is to eliminate liability for recklessness.").

89 8 *Del. C.* § 122(17).

90 *See Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 442 (Del. 1996); *Guth v. Loft, Inc.*, 5 A.2d 503, 511 (Del. 1939).

91 Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 Colum. L. Rev. 1075, 1078 (2017); *see* Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, 33 Del. J. Corp. L. 845, 859 (2008) (citing Section 122(17) as a provision in the DGCL that "provide[s] some measure of protection to directors for approving transactions that might otherwise be seen as a breach of the duty of loyalty").

92 *See Johnston v. Greene*, 121 A.2d 919, 925 (Del. 1956).

93 *United Food & Com. Workers Union & Participating Food Indus. Empls. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1047 (Del. 2021).

94 8 *Del. C.* § 122(17); *accord Alarm.com Hldgs., Inc. v. ABS Cap. P'rs Inc.*, 2018 WL 3006118, at *8–9 & n.46 (Del. Ch. June 15, 2018) (discussing specificity requirement), *aff'd on other grounds*, 204 A.3d 113 (Del. 2019); Rauterberg & Talley, *supra*, at 1096 ("On its face, [Section 122(17)] requires a [corporate opportunity waiver] to be worded with some particularity."). The synopsis to the bill adopting Section 122(17) elaborates on this point by explaining that

> categories of business opportunities may be specified by any manner of defining or delineating business opportunities or the corporation's or any other party's entitlement thereto or interest therein, including, without limitation, by line or type of business, identity of the originator of the business opportunity, identity of the party or parties to or having an interest in the business opportunity, identity of the recipient of the business opportunity, periods of time or geographical location.

Senate Bill 363, 72 Del. Laws 619 (2000).

95 8 *Del.* § 102(a)(3).

96 *Id.*

97 *See Applied Energetics, Inc. v. Farley*, 239 A.3d 409, 442 (Del. Ch. 2020) ("[A] corporation retains the ability to introduce uncertainty about its capacity or power by including provisions in its charter that disavow particular powers or forbid the corporation from entering into particular lines of business or engaging in particular acts."); 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 2.1 (4th ed. & Supp. 2023-1) (explaining the general inapplicability of the *ultra vires* doctrine based on lack of corporate power or capacity, while identifying remaining applications of the doctrine, including a charter provision that forbids the corporation from into particular lines of business or engaging in particular acts); *see also Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 648–54 (Del. Ch. 2013) (discussing *ultra vires* acts and the implications of Section 124 of the DGCL), *abrogated on other grounds by El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, 152 A.3d 1248, 1264 (Del. 2016) (rejecting *Carsanaro*'s analysis of post-merger derivative standing).

98 *See* Rauterberg & Talley, *supra*, at 1090 (explaining that a Delaware corporation could "cabin the breadth of the [corporate opportunity] doctrine by narrowing the purpose articulated in its charter to specified lines of business, effectively using that scope limitation to cabin the reach of all corporate activity"); *cf.* Zenichi Shishido, *Conflicts of Interest and Fiduciary Duties in the Operation of a Joint Venture*, 39 Hastings L.J. 63, 94–95 (1987) (noting that a court cannot find a misappropriation of a corporate opportunity when the opportunity falls outside the scope of the corporation's purposes). For a decision illustrating the effect of a limited purpose provision in the context of a partnership, see *JER Hudson GP XXI LLC v. DLE Investors, LP*, 275 A.3d 755, 787–88 (Del. Ch. 2022) ("The partnership's purpose limits the general partner's authority and therefore circumscribes its fiduciary duties.... Because a general partner only has the authority to act in furtherance of the partnership's purpose, it cannot owe a duty inconsistent with that purpose.")

99 *See generally* *Frederick Hsu Living Tr. v. ODN Hldg. Corp.*, 2017 WL 1437308, at *22 (Del. Ch. Apr. 14, 2017) (collecting authorities).

100 *See* *JER Hudson*, 275 A.3d at 787–88 (explaining that narrow purpose clause in partnership agreement constrained ability of general partner to act and with it the general partner's fiduciary duties).

101 The use of Section 141(a) has been relatively unexplored by caselaw, but has been deployed by practitioners. A real world example is the tailoring of the charters of AT&T Inc. and Liberty Media Corporation after the former acquired the latter so as to preserve a broad sphere of action for John Malone and Liberty. For an allusion to that highly structured governance arrangement, *see* *Bank of New York Mellon Tr. Co. v. Liberty Media Corp.*, 29 A.3d 225, 228 (Del. 2011) (referring to a governance structure under which AT&T "allowed liberty to operate autonomously"). For a decision upholding tailoring under Section 141(a), see *Lehrman v. Cohen*, 222 A.2d 800, 807–08 (Del. 1966) (enforcing charter provision that empowered general counsel to resolve board deadlocks; noting that although directors may not delegate their duty to manage the corporation, "there is no conflict with that principle where, as here, the delegation of duty, if any, is made not by the directors but by stockholder action under [section] 141(a), via the certificate of incorporation"). *See generally* Welch & Saunders, *supra*, at 856 ("Various scholars have compiled lists of aspects of Delaware corporation law they believe are mandatory. Some of these terms are not really mandatory because the same effect can be achieved through a different method. ... Indeed, the very existence of the board of directors, which has sometimes been identified as a mandatory feature of the Delaware corporation, can be modified by provision in the certificate of incorporation adopted under [the Board Power Exception]."); Ernest L. Folk, III, *The Delaware General Corporation Law* 54 (1972) (citing *Lehrman* as recognizing "the power of stockholders to establish any type of internal corporate structure they desire so long as it does not violate some other statutory provision or public policy. At the very least, there is nothing in the Delaware statute to require rigid adherence to the traditional corporate norm, and every reason to conclude that the statute and case law tolerate, if not actually encourage, deviations from the corporate norm which have a 'proper purpose.' ").

102 *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (subsequent history omitted).

103 *Id.*

104 8 *Del. C.* § 141(a).

105 *Id.*

106 *Id.*

107 8 *Del. C.* § 102(b)(1).

108 227 A.3d at 115.

109 *Id.* (cleaned up).

110 *Manti*, 261 A.3d at 1217.

111 A close corporation under Subchapter XIV is not synonymous with a "closely held corporation." The former is a specific type of corporation contemplated by the DGCL, like a non-stock corporation or a public benefit corporation. The latter is a colloquialism for a privately held corporation with relatively few stockholders.

112 *See* 8 *Del. C.* § 351.

113 *Id.* § 141(a).

114 *Id.* § 350.

115 *Id.*

116 *Id.*

117 *See id.*

118 *See id.* § 362(a).

119 *See Trados*, 73 A.3d at 56 n.32.

120 *Cf.* David J. Berger, Jill E. Fisch, & Steven Davidoff Solomon, *Extending Dual Class Stock: A Proposal* (U. Pa. Inst. L. & Econ. Rsch. Paper, No. 13, 2023), *available at* https://ssrn.com/abstract=4399551.

121 To the extent using Section 102(a)(3) or the Board Power Exception to reorient or tailor fiduciary duties seems extreme, consider a thought experiment in which the General Assembly still granted corporate charters by special act. The General Assembly undoubtedly would have the power to provide for this type of reorientation or tailoring. Under the Constitution of 1897, the General Assembly no longer grants charters by special act; the DGCL is the sole means of obtaining a corporate charter. Del. Const. art IX §§ 1–2. What then are the restrictions on how private actors can deploy the state's chartering power? If a provision in the DGCL expressly forecloses a charter from accomplishing a result that previously could be accomplished by special act, then obviously the General Assembly has withheld that authority. For example, no corporation formed under the DGCL after April 18, 1945, may confer academic or honorary degrees. 8 *Del. C.* § 125. No corporation formed under the DGCL can exercise banking power. 8 *Del. C.* § 126(a). A Delaware corporation that is designated as a private foundation under the Internal Revenue Code must comply with certain tax provisions, unless its charter provides that the restriction is inapplicable. 8 *Del. C.* § 127. A corporation cannot include a provision in its charter that is contrary to Section 102(b)(7), and a charter "may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim." 8 *Del. C.* § 102(f). The requirements for naming a Delaware corporation reflect more trivial restriction on the ability of private actors to deploy state power. *See* 8 *Del. C.* § 101(a)(1).

Except where explicit restrictions apply, the chartering power under the DGCL would seem co-extensive with the chartering power that the General Assembly could exercise by special act. From that standpoint, the fact that the General Assembly enacted subchapters of the DGCL that *confirmed* the ability of corporate planners to use the DGCL to charter close corporations and public benefit corporations eliminated any doubt on that subject, but it does not imply that the power did not already exist. Section 102(a)(3), and the Board Power Exception, and Section 102(b)(1) indicate that it did.

This court's decision in *eBay Domestic Hldgs., Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010), is not to the contrary. There, the court rejected an attempt by corporate fiduciaries to operate a Delaware corporation for an eleemosynary purpose:

> The corporate form in which craigslist operates, however, is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment. Jim and Craig opted to form craigslist, Inc. as a for-profit Delaware corporation and voluntarily accepted millions of dollars from eBay as part of a transaction whereby eBay became a stockholder. Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that.

Id. at 34. The charter of craigslist did not contain a narrow purpose clause or a provision that sought to deploy the authority provided by the Board Power Exception or Section 102(b)(1) to reorient the board's fiduciary duties. The controllers of the corporation simply asserted that they were pursuing a philanthropic purpose, which was a confession as stark as Henry Ford's insistence on benefiting his workers. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 683–84 (Mich. 1919); *see* M. Todd Henderson, *The Story of* Dodge v. Ford Moto Company: *Everything Old Is New Again*, *in* Corporate Law Stories 37–76 (J. Mark Ramseyer ed., 2009). Without any charter-based fiduciary tailoring, the *eBay* analysis is spot on.

122 For example, the insolvency of the corporation can render indemnification ineffective, just as the insolvency of a third-party insurer can render insurance ineffective. For insurance coverage, market availability and pricing are additional constraints. For purposes of fiduciary duty litigation, the biggest difference among the three is that exculpation operates as a pleading-stage defense, akin to sovereign immunity. *See In re Ezcorp Inc. Consulting Agr. Deriv. Litig.*, 130 A.3d 934, 940 (Del. Ch. 2016). Indemnification only comes into effect after final disposition of the case, although advancement can cover attorneys' fees and expenses in the interim. *See Sun-Times Media Gp., Inc. v. Black*, 954 A.2d 380, 391 (Del.

Ch. 2008). Insurance can provide both for indemnification of liabilities and coverage of litigation expenses. Robert P. Redemann & Michael F. Smith, *Law and Prac. of Ins. Coverage Litig.* § 4:19, Westlaw (database updated July 2022) ("It is well established that the insurer may be obligated to pay the costs of defending a suit against the insured, although these expenses may bring the total amount paid beyond the coverage limits set out in the policy. Courts have read the standard duty to defend language in general liability agreements very broadly to include all costs and fees reasonably related to defending the underlying litigation." (footnotes omitted)).

123 *See generally* Joan MacLeod Heminway, *Corporate Purpose and Litigation Risk in Publicly Held U.S. Benefit Corporations*, 40 Seattle U. L. Rev. 611, 634 (2017) ("As a general matter, assuming a viable fiduciary duty claim, the liability or financial responsibility of corporate directors for breaches of fiduciary duty may be narrowed through the application of up to four mandatory or permissive aspects of corporate law. These include exculpation for breaches of the duty of care, indemnification (statutory and privately ordered), director and officer liability insurance, and the possible application of the business judgment rule in the judicial review process."); Todd M. Aman, *Cost-Benefit Analysis of the Business Judgment Rule: A Critique in Light of the Financial Meltdown*, 74 Alb. L. Rev. 1, 11 (2011) ("Exculpation provisions, indemnification, and insurance all operate to shield directors from liability risk to varying extents."); James E. Joseph, *Indemnification and Insurance: The Risk Shifting Tools (Part I)*, 79 Pa. Bar Ass'n Q. 156, 156 (2008) (describing indemnification, exculpation, and insurance as "risk shifting tools"); Welch & Saunders, *supra*, at 860 (citing the power to obtain insurance under Section 145(g) as a provision in the DGCL that "provide[s] some measure of protection to directors for approving transactions that might otherwise be seen as a breach of the duty of loyalty"); E. Norman Veasey, Jesse A. Finkelstein & C. Stephen Bigler, *Delaware Supports Directors with A Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 Bus. Law. 399, 421 (1987) (describing the triad of exculpation, indemnification, and insurance as a " 'three-legged' approach to director/officer protection ... designed to ensure that directors and officers are adequately protected from liability resulting from the performance of their duties").

124 8 *Del. C.* § 145(a).

125 *Id.* Section 145(c) goes further by providing for mandatory indemnification regardless of the fiduciary's mental state. That section states that a director or officer "shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred" in connection with an action, suit, or proceeding, "[t]o the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise." *Id.* Any dismissal of a claim for any reason constitutes success "on the merits or otherwise" and triggers mandatory indemnification. *Id.* "Whether an individual acted in good faith or what she perceived to be in the corporation's best interests is irrelevant in the context of that provision." *Evans v. Avande, Inc.*, 2021 WL 4344020, at *3 (Del. Ch. Sept. 23, 2021). A director charged with criminal conduct who escapes on a technicality is entitled to full indemnification under Section 145(c). *See Cochran v. Stifel Fin. Corp.*, 2000 WL 1847676, at *9 (Del. Ch. Dec. 13, 2000) (Strine, V.C.), *aff'd in pertinent part, rev'd in part on other grounds*, 809 A.2d 555 (Del. 2002). The Covenant does not operate analogously to Section 145(c) because the Covenant protects the defendants in the absence of a favorable adjudication.

126 *See* 8 *Del. C.* § 145(g).

127 *Id.* § 145(g)(1).

128 For reasons that I have discussed elsewhere, I do not believe that a coherent and credible policy justification has ever been offered for the contemporaneous ownership requirement. *See* J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 Del. J. Corp. L. 673 (2008). The requirement was created by the Supreme Court of the United States to address the problem of collusive federal diversity jurisdiction, and state courts (including this court) consistently rejected efforts to inject it into state corporate law. *See Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 177–80 (Del. Ch. 2014) (collecting authorities). The Delaware General Assembly enacted Section 327 in 1945, after New York's implementation of a similar provision under circumstances that smack of anti-Semitism. *See Bamford v. Penfold, L.P.*, 2020 WL 967942, at *24 n.18 (Del. Ch. Feb. 28, 2020); Lawrence E. Mitchell, *Gentleman's Agreement: The Antisemitic Origins of Restrictions on Stockholder Litigation*, 36 Queen's L.J. 71, 72 & n.1 (2010). The ill-fitting justifications that subsequent courts have offered read like rationalizations, making Section 327 a provision that cries out for reexamination. *See SDF Funding LLC v. Fry*, 2022 WL 1511594, at *6 (Del. Ch. May 13, 2022) (calling for the General Assembly to revisit Section 327).

129 *E.g.*, *In re SmileDirectclub, Inc. Deriv. Litig.*, 2021 WL 2182827, at *12 (Del. Ch. May 28, 2021), *aff'd*, 270 A.3d 239 (Del. 2022); *7547 P'rs v. Beck*, 1995 WL 106490, at *2 (Del. Ch. Feb. 24, 1995), *aff'd*, 682 A.2d 160 (Del. 1996)

130 8 *Del. C.* § 367.

131 In addition to the provisions discussed in this section, the Delaware Supreme Court held in *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001), that the short-form merger statute forecloses a stockholder's ability to assert a claim for breach of the duty of loyalty that could trigger entire fairness review:

> By enacting a statute [8 *Del. C.* § 253] that authorizes the elimination of the minority without notice, vote, or other traditional indicia of procedural fairness, the General Assembly effectively circumscribed the parent corporation's obligations to the minority in a short-form merger. The parent corporation does not have to establish entire fairness, and, absent fraud or illegality, the only recourse for a minority stockholder who is dissatisfied with the merger consideration is appraisal.

Id. at 243. Section 253 is thus another example of a DGCL provision that limits loyalty claims.

The outcome in *Glassman* reflected a conscious decision by the Delaware Supreme Court to change the law. Two decades earlier, the Delaware Supreme Court had reached precisely the opposite conclusion and rejected the same arguments that *Glassman* accepted. *See Roland Int'l Corp. v. Najjar*, 407 A.2d 1032, 1036 (Del. 1979) ("The short form permitted by [Section] 253 does simplify the steps necessary to effect a merger, and does give a parent corporation some certainty as to result and control as to timing. But, we find nothing magic about a 90% ownership of outstanding shares which would eliminate the fiduciary duty owed by the majority to the minority."). The *Glassman* decision reinforces the conclusion that limiting duty of loyalty claims is not inherently contrary to Delaware public policy, which implies that the Covenant is not facially invalid.

132 *Nemec*, 991 A.2d at 1129.

133 *Id.* at 1125.

134 *Id.* at 1128–29.

135 *See In re WeWork Litig.*, 2020 WL 6375438, at *12 (Del. Ch. Oct. 30, 2020); *Ogus v. SportTechie, Inc.*, 2020 WL 502996, at *11 (Del. Ch. Jan. 31, 2020); *MHS Cap. LLC v. Goggin*, 2018 WL 2149718, at *8 (Del. Ch. May 10, 2018); *Veloric v. J.G. Wentworth, Inc.*, 2014 WL 4639217, at *19 (Del. Ch. Sept. 18, 2014); *Blaustein v. Lord Balt. Cap. Corp.*, 2013 WL 1810956, at *13 (Del. Ch. Apr. 30, 2013), *aff'd*, 84 A.3d 954 (Del. 2014). Sometimes, the authorities cited in the corporate decisions can be traced back to one or more decisions addressing an alternative entity, but the corporate decisions invariably articulate the concept of contractual preemption as a general principle of Delaware law and do not limit its application to the alternative entity context. *See, e.g.*, *Stewart v. BF Bolthouse Holdco, LLC,* 2013 WL 5210220, at *12 (Del. Ch. Aug. 30, 2013) (asserting generally that "Delaware law recognizes the primacy of contract law over fiduciary law."); *Seibold v. Camulos P'rs LP*, 2012 WL 4076182, at *21 (Del. Ch. Sept. 17, 2012) ("It is settled that an agent may not misuse the confidential information of its principal. Here, however, Camulos' claim that Seibold breached his fiduciary duty by misusing confidential information alleges facts identical to Camulos' claim that Seibold breached his contractual duties by misusing Confidential Information, and is thus foreclosed as superfluous." (cleaned up); *Solow v. Aspect Res., LLC*, 2004 WL 2694916, at *4 (Del. Ch. Oct. 19, 2004) ("Because of the primacy of contract law over fiduciary law, if the duty sought to be enforced arises from the parties' contractual relationship, a contractual claim will preclude a fiduciary claim. This manner of inquiry permits a court to evaluate the parties' conduct within the framework created and crafted by the parties themselves. Because the four fiduciary duty counts in the complaint arise not from general fiduciary principles, but from specific contractual obligations agreed upon by the parties, the fiduciary duty claims are precluded by the contractual claims." (footnotes omitted)).

A related line of authority holds that when a corporate fiduciary exercises its rights as a creditor, the fiduciary acts free of fiduciary constraint. *See Odyssey P'rs, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386, 414 (Del. Ch. 1999); *Solomon v. Pathe Commc'ns Corp.*, 1995 WL 250374, at *5 (Del. Ch. Apr. 21, 1995) (Allen, C.), *aff'd*, 672 A.2d 35 (Del. 1996). *See generally In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397, 409 (Del. Ch. 2010) (discussing *Odyssey Partners* and *Solomon*).

136 *Grayson v. Imagination Station, Inc.*, 2010 WL 3221951, at *7 (Del. Ch. Aug. 16, 2010) (cleaned up).

137 *Id.* Isolated decisions, including my own, have pushed back against the concept of contractual preemption. *E.g.*, *Metro Storage Int'l LLC v. Harron*, 275 A.3d 810, 857–58 (Del. Ch. 2022); *In re MultiPlan Corp. S'holders Litig.*, 268 A.3d 784, 806 (Del. Ch. 2022); *ODN Hdlgs.*, 2017 WL 1437308, at *24; *Lee v. Pincus*, 2014 WL 6066108, at *7–9 (Del. Ch. Nov. 14, 2014). Scholars explain that a contract claim can coexist with a fiduciary duty claim, because fiduciary obligations overlay all of the rights and powers that the fiduciary can exercise. *See* Smith, *supra*, at 135 (describing fiduciary capacity as a "transversal concept: it cuts across the sources of legal powers, since those sources may be contractual or not"); Harding, *supra*, at 79 ("The fact that a fiduciary undertaking may be made in a given contract does not bear on what counts as sufficient performance of that undertaking as a matter of *contract* law. It instead means that non-performance of the undertaking is susceptible of analysis in more than one frame, as involving fiduciary breach as well as breach of contract. Moreover, the promisor may be liable for fiduciary breach even in circumstances where she has fully performed her undertaking from the perspective of contract law." (footnote omitted)). Under this alternative to contractual preemption, a fiduciary can face both a claim for breach of contract and a claim for breach of fiduciary duty arising from the same conduct. *Metro Storage*, 275 A.3d at 858. "If the contract provides the sole source of the specific prohibition, then the plaintiff only can sue in contract, because the duty only arises from the contractual relationship. If, however, the plaintiff also would have a claim under general fiduciary principles, then the plaintiff also can assert the claim for breach of fiduciary duty." *Id.* Agency law illustrates this approach:

> The overlap between duties derived from tort law and from an agent's contract with the principal will often provide the principal with alternative remedies when a breach of duty subjects the agent to liability. In particular, an agent is subject to liability to the principal for all harm, whether past, present, or prospective, caused the principal by the agent's breach of the duties stated in this section.

Restatement of Agency, *supra*, § 8.08 cmt. b.

In *Nemec*, the fiduciary duty claim would have failed even without preemption, because (i) directors do not owe fiduciary duties to particular stockholders but rather to the stockholders as a collective, and (ii) when exercising the redemption right, the directors did not receive any benefit other than the value that accrued to them indirectly and pro rata as remaining stockholders. *See ODN Hdlgs.*, 2017 WL 1437308, at *17, *24. But *Nemec* went in a different direction and held that a contract claim preempts overlapping fiduciary duty claims arising from the same facts.

If Delaware law were to retreat from the contractual preemption of overlapping fiduciary claims, at least in the corporate context, that would not render the Covenant facially invalid. Through the Covenant, the Funds agreed not to exercise a stockholder right (the right to sue for breach of duty) that they could freely decline to assert. If the underlying right is preempted, then the Covenant is redundant and inoffensive. If the underlying right is not preempted, then the Funds still can commit not to exercise it.

138 *Corwin v. KKR Fin. Hldgs. LLC*, 125 A.3d 304, 308–09 (Del. 2015). The waste challenge is more theoretical than realistic, because a waste claim contends that the transaction was on terms that no rational person would approve. When stockholders have ratified a transaction in a fully informed and non-coerced vote, they have demonstrated that rational people could approve the transaction. *See In re Books-A-Million, Inc. S'holders Litig.*, 2016 WL 5874974, at *19 (Del. Ch. Oct. 10, 2016).

139 *In re Invs. Bancorp, Inc. S'holder Litig.*, 177 A.3d 1208, 1222 (Del. 2017).

140 *Id.* at 1222.

141 *Lebanon Cnty. Empls.' Ret. Fund v. Collis*, 287 A.3d 1160, 1194–95 (Del. Ch. 2022).

142 *Id.* at 1219.

143 Contract and Fiduciary Law, *supra*, at 1.

144 *Id.* at 1–2.

145 *Ascension Ins. Hldgs., LLC v. Underwood*, 2015 WL 356002, at *4 (Del. Ch. Jan. 28, 2015).

146 *Abry P'rs*, 891 A.2d at 1061–62.

147 *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch. 2005), *aff'd in part, rev'd in part on other grounds*, 892 A.2d 1068 (Del. 2006).

148 *Id.* at 1056–57.

149 *State v. Tabasso Homes*, 28 A.2d 248, 252 (Del. Gen. Sess. 1942) (citations omitted).

150 *Nemec*, 991 A.2d at 1126.

151 *See generally* Mohsen Manesh, *The Corporate Contract and the Internal Affairs Doctrine*, 71 Am. L. Rev. 501, 526–34 (2021) (describing Delaware's contractarian approach to corporate law); Megan Wischmeier Shaner, *Interpreting Organizational "Contracts" and the Private Ordering of Public Company* Governance, 60 Wm. & Mary L. Rev. 985, 1010 (2019) ("[I]n Delaware, the courts have embraced and endorsed the contract metaphor, holding that contract law presides over issues involving both the enforcement and interpretation of the charter and bylaws."); Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 Cal. L. Rev. 373, 380 (2018) ("Delaware courts have largely accepted the contractual theory of corporate law."); George Geis, *Ex-Ante Corporate Governance*, 41 J. Corp. L. 609, 611 (2016) ("[T]he influential Delaware courts seem to be taking a more permissive attitude, based in part on the parallels between contract law and the corporate relationship.").

152 *Salzberg*, 227 A.3d at 116 (cleaned up).

153 *Id.* at 137.

154 *Shintom Co. v. Audiovox Corp.*, 888 A.2d 225, 227 (Del. 2005) (describing the DGCL as "an enabling statute that provides great flexibility for creating the capital structure of a Delaware corporation"); *accord In re Topps Co. S'holders Litig.*, 924 A.2d 951, 958 (Del. Ch. 2007) (Strine, V.C.); *Jones Apparel Gp., Inc. v. Maxwell Shoe Co., Inc.*, 883 A.2d 837, 845 (Del. Ch. 2004) (Strine, V.C.); *see Matter of Appraisal of Ford Hldgs., Inc. Preferred Stock*, 698 A.2d 973, 976 (Del. Ch. 1997) (Allen, C.) (explaining that "unlike the corporation law of the nineteenth century, modern corporation law contains few mandatory terms; it is largely enabling in character").

155 *See*, *e.g.*, Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 Cornell L. Rev. 856, 859 (1997) (" '[C]ontractarians' model the firm not as a single entity, but as an aggregate of various inputs acting together with the common goal of producing goods or services."); Henry N. Butler & Larry E. Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. Cin. L. Rev. 611, 616 (1988) ("According to the contractual theory of the corporation, the corporation, like any firm—whether a sole proprietorship, partnership or corporation—is a nexus of contracts among many different parties involving mutually beneficial exchanges."); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1418 (1989) ("The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy."); Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 Stan. L. Rev. 923, 933 (1984) ("The contract approach regards the corporation as a shell or form created by consenting individuals. A firm is a nexus of explicit and implicit contracts, facilitating the implementation of the contracting parties' wishes."). For recent critiques of contractarianism, see Klass, *supra*, at 93–115; Smith, *supra*, at 117–38; and Irit Samet, *Fiduciary Law as Equity's Child*, in Contract and Fiduciary Law 119–66. For an earlier critique, see Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 Colum. L. Rev. 1403, 1444 (1985) (explaining that theories of the corporation as "a 'nexus of contracts' ... embody serious descriptive inaccuracies, which, in turn, infect the normative consequences implicitly suggested by a regime of private autonomy").

156 Easterbrook & Fischel, *supra*, at 1444–45.

157 *Id.* at 1445.

158 Easterbrook & Fischel, *supra*, at 1445; *see* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1, 6 (1990) ("[T]he existence of fiduciary duties and remedies for breach should be viewed as part of this contractual protection rather than contrary to the contractual theory of the corporation."); *id.* at 19 ("While anti-contractarian writers see these duties as mandatory rules that supplement private ordering, under our analysis, fiduciary duties and remedies are actually part of this contract. It follows that shareholders should be free to alter these duties and remedies by agreement."); *id.* at 28 ("An important aspect of the contract theory of the corporation ... is that fiduciary duties are a term of the corporate contract and therefore consensual in nature."); *see also* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 Colum. L. Rev. 1618, 1623 (1989) (arguing for treating fiduciary duties as defaults but permitting optout "when [courts] can find that the term has been accurately priced," meaning that "the actual operation of the provision must be relatively clear and specific and not simply confer on management a right to behave in a way that market forces or moral standards would usually constrain"); *see generally* J. William Callison, *Seeking an Angle of Repose in U.S. Business Organization Law: Fiduciary Duty Themes and Observations*, 77 U. Pitt. L. Rev. 441, 469 (2016) ("A contractarian model of fiduciary law, which emphasizes the origin of the business association as an agreement of its owners and conceives of fiduciary duties as a form of the parties' contract, has become American law's conventional wisdom over the last several decades. This contractarian approach to fiduciary law is related to an economic perspective describing business firms as a 'nexus of contracts' among the firm's constituencies, including owners, employees, creditors, suppliers, managers, and the public."). For an example of a contractarian approach to the duty of loyalty, see Ian Ayres & Joe Bankman, *Substitutes for Insider Trading*, 54 Stan. L. Rev. 235, 267–75 (2001) (proposing "a default prohibition against insider trading by the firm (or its non-managerial delegate)" with the power to opt out in the certificate of incorporation).

159 *See, e.g.*, Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1469–70, 1480–85 (1989) (arguing that "core" fiduciary duties should be mandatory in both closely held and public corporations); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1549, 1554, 1593–97 (1989) (arguing for mandatory fiduciary duties for directors, officers, and controlling stockholders; explaining "contractarianism is not an adequate account of corporate law, and that despite contractarian strands, large chunks of corporate law continue to serve goals other than private wealth maximization" and include "procedural, power allocating, economic transformative, and fiduciary standards setting").

When it comes to corporate theory, I am not a contractarian. My conception of the corporation (and entity law generally) starts from the proposition that jural entities like corporations are creations of state power, and they have characteristics that only the state can provide, such as separate legal existence, presumptively perpetual life, limited liability for investors, the ability to contract and own property, and access to the judicial system, which gives them the ability to invoke the power of the state to obtain redress for injuries and enforce commitments. Jural entities are thus never wholly creatures of contract. Nor are they a nexus of contracts. However attractive that metaphor might be for economic modeling, entities are reified constructs. It is only because they are reified (personified) that they can move through the legal landscape.

This is a type of concession theory. *See* Manesh, *supra*, 535–47. But concession theory is only a starting point, because it leaves open the question of what the state has created when it charters an entity. The answer is an autonomous form of intangible property, with biological humans serving as the ghost in the machine that enables the form of property to engage with the world. Someday, artificial intelligence may animate corporations, but for now only biological humans can make decisions on their behalf and cause them to act. The resulting theory of the corporation starts with concession theory and adds a superstructure of property rights, so let's call it modern concession theory (MCT).

Because of the state's role in creating, maintaining, and eventually terminating the entity, the state has a persistent policy interest in establishing its characteristics, including what the entity can do and how it operates. But the state's persistent policy interest does not mean that MCT carries a pre-determined set of political commitments. Different jurisdictions can charter entities with different public policy visions. Delaware charters entities with a vision of providing significant freedom for private ordering, which MCT easily accommodates. Unlike contractarianism, MCT also explains why the state can and does impose limits on private ordering. *See* Manesh, *supra*, at 539 (describing MCT's ability to explain "facets of contemporary corporate law that conflict with pure contractarianism," including a "mandatory fiduciary duty of loyalty"); *see also In re Coinmint, LLC*, 261 A.3d 867, 908–13 (Del. Ch. 2021) (discussing role of state in creating a jural entity and its implications for a jurisdiction's power to dissolve an entity created by another state).

While accommodating private ordering, MCT acknowledges limitations on what a state can use entity law to accomplish. *See* Manesh, *supra*, at 541–43. Because an entity is a form of autonomous property that the state creates, the state can define its attributes, the interrelationships among its component parts, and the internal processes by which it acts (or the methods by which parties can select attributes, form interrelationships, and establish internal processes). The state does not, however, act in a vacuum. Just like real property in the physical world, an autonomous entity has borders, and there can be other jurisdictions on the other side of those borders. In those situations, the requirements for passage must be co-created with other sovereigns. Our neighbor to the north can determine what is required to enter Canadian soil, but the United States can dictate what is required to leave American soil. There are also senior sovereigns whose law dominates (preempts) the law of junior sovereigns. Within our own republic, the United States Constitution and the protection for interstate travel secured by Privileges & Immunities Clause dominate the ability of Delaware and Pennsylvania to regulate their shared boundary.

The concepts of borders and trans-border domains provide helpful analogies for the limits on what a state can regulate through its power to create an entity. Consider the limits on a state's ability to regulate real property. Even if the General Assembly enacted legislation that purported to govern all of the Delmarva peninsula, those statutes would have no effect south of the Transpeninsular Line, east of the low tide mark of the Delaware River, or west of Tangent Line.

The contrast between the Delaware Supreme Court's decision in *Salzberg* and my trial-level ruling illustrates how contractarianism and MCT can lead to different results. The Delaware Supreme Court grounded its analysis on Section 102(b)(1) and whether a federal forum provision came within the plain language of that statutory section. *See* *Salzberg*, 227 A.3d at 115–16. After determining that it did, the Delaware Supreme Court held that the provision was authorized by statute and therefore valid. *Id.* at 125. At the trial level, I was concerned about whether Delaware had the power to regulate a domain outside of the corporation's boundary, raising a threshold question about whether Section 102(b)(1) could be used by private actors to claim the ability to regulate that external space. *See* *Sciabacucchi v. Salzberg*, 2018 WL 6719718, at *2, *18–23 (Del. Ch. Dec. 19, 2018), *rev'd*, 227 A.3d 102 (Del. 2020). To continue the metaphor, I was concerned that Delaware both lacked authority to legislate about land north of the Twelve-Mile Circle and also could not grant its citizens the power to claim territory beyond that line.

By treating Section 102(b)(1) as coextensive with the space that Delaware law can regulate (or authorize others to regulate), the Delaware Supreme Court embraced a strongly contractarian view of the corporation. Manesh, *supra*, at 505–08. Illustrating that contractarian foundation, the Delaware Supreme Court supported the ability of a forum selection provision to encompass federal securities law claims by relying on a decision that addressed a forum-selection provision in a private agreement. *See* *Salzberg*, 227 A.3d at 132 (citing *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989)). I had not cited *Rodriguez*, because I viewed the private agreement in that case as evidencing how parties can contract regarding their own rights. The case did not speak to whether a state could use its power to create entities to regulate a domain governed by federal law.

As Professor Manesh has noted, the Delaware Supreme Court's embrace of contractarianism in *Salzberg* has broad implications. *See* Manesh, *supra*, at 547–75. For purposes of the Covenant, I do not perceive any conflict between what MCT calls for and what contractarianism would envision. The Covenant appears in a bargained-for agreement between contracting parties and is thus comparable to *Rodriguez*. The agreement addresses a stockholder right appurtenant to the shares that the Funds owned as their private property. The limitations on state power implied by MCT do not restrict the ability of stockholders to make contractual commitments regarding property rights that they could otherwise freely exercise.

160 *Bamford*, 2020 WL 967942, at *23.

161 8 *Del. C.* § 159.

162 *See* *Williams Cos. S'holder Litig.*, 2021 WL 754593, at *20 (Del. Ch. Feb. 26, 2021).

163 8 *Del. C.* § 202(b).

164 *Id.* § 202(c)(1).

165 *Id.* § 202(c)(2).

166 *Id.* § 202(c)(3).

167 *Id.* § 202(c)(4).

168 *Id.* § 202(c)(5).

169 *Id.* § 202(e).

170 *Id.* § 218(c).

171 *Id.* § 202(b).

172 *Id.*

173 *Id.* §§ 102(a)(4), 151.

174 *Id.* §§ 102(a)(4), 218(a).

175 *Id.* § 151(a).

176 *Id.* § 218(c).

177 *Orzeck v. Englehart*, 195 A.2d 375, 378 (Del. 1963).

178 Verity Winship, *Shareholder Litigation by Contract*, 96 B.U. L. Rev. 485, 495–96 (2016) (noting that "[h]ow closely ... corporate organizational documents approach robust ideas of consent depends on the type of document and when a particular provision is adopted" (footnote omitted)).

179 *See* Helen Hershkoff & Marcel Kahan, *Forum-Selection Provisions in Corporate "Contracts"*, 93 Wash. L. Rev. 265, 269 (2018) (describing this form of implied consent).

180 8 *Del. C.* § 242(b).

181 *See* Randall S. Thomas, *What Should We Do About Multijurisdictional Litigation in M&A Deals?*, 66 Vand. L. Rev. 1925, 1953–54 (2013) (describing this form of consent).

182 Hershkoff & Kahan, *supra*, at 282.

183 *See* 8 *Del. C.* § 109(a).

184 Browning Jeffries, *The Plaintiffs' Lawyer's Transaction Tax: The New Cost of Doing Business in Public Company Deals*, 11 Berkeley Bus. L.J. 55, 95–98 (2014) (noting that although "corporate bylaws and charters have frequently been analogized to contracts[,] ... the analogy to a contractual relationship weakens" in light of the fact that "the bylaws can be adopted or amended unilaterally by the board without shareholder consent").

185 Hershkoff & Kahan, *supra*, at 283–85.

186 *See* Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 Geo. L.J. 583, 608 (2016) ("The legal framework for the corporation therefore does not resemble anything like the legal framework for contracting parties."); Fisch, *supra*, at 381, 409 (describing the contractarian approach to charters and bylaws as "a powerful endorsement of contractual freedom in corporate law" while questioning whether Delaware decisions "may stretch the contract analogy too far").

187 *Quadrant Structured Prods. Co. v. Vertin*, 2014 WL 5465535, at *3 (Del. Ch. Oct. 28, 2014).

188 *Sinchareonkul*, 2015 WL 292314, at *6.

189 *See Abercrombie v. Davies*, 123 A.2d 893, 898–99 (Del. Ch. 1956) (Seitz, C.) (holding that provision in stockholders agreement that purported to bind director to vote in the same manner as a stockholder agent conflicted with Section 141(a) and was ineffective), *rev'd on other grounds*, 130 A.2d 338 (Del. 1957).

190 8 *Del. C.* § 141(b).

191 2018 WL 11264517 (Del. Ch. Jan. 10, 2018) (ORDER).

192 *Id.*

193 *Id.* at *3.

194 *See Manti*, 261 A.3d at 1219 (comparing waiver of appraisal rights to waiver of jury trial when considering whether public policy bars the former).

195 U.S. Const. art. III, § 2 ("The Trial of all Crimes, except in Cases of Impeachment, shall be by Jury ...."); U.S. Const. Amend. VI ("In all criminal prosecutions, the accused shall enjoy the right to a speedy and public trial, by an impartial jury of the state and district wherein the crime shall have been committed ...."); Del. Const. art. I, § 7 ("In all criminal prosecutions, the accused hath a right ... to ... a speedy and public trial by an impartial jury....").

196 *Davis v. State*, 809 A.2d 565, 568 (Del. 2002).

197 U.S. Const. Amend. VI ("In all criminal prosecutions, the accused shall enjoy the right ... to be confronted with the witnesses against him ...."); Del. Const. art. I, § 7 ("In all criminal prosecutions, the accused hath a right ... to meet the witnesses in their examination face to face ....").

198 *Illinois v. Allen*, 397 U.S. 337, 342–43, 90 S.Ct. 1057, 25 L.Ed.2d 353 (1970); *Wells v. State*, 396 A.2d 161, 162–63 (Del. 1978).

199 U.S. Const. Amend. VI ("In all criminal prosecutions, the accused shall enjoy the right ... to have the assistance of counsel for his defense."); Del. Const. art. I, § 7 ("In all criminal prosecutions, the accused hath a right to be heard by himself or herself and his or her counsel.").

200 *Faretta v. California*, 422 U.S. 806, 835, 95 S.Ct. 2525, 45 L.Ed.2d 562 (1975); *Briscoe v. State*, 606 A.2d 103, 107 (Del. 1992).

201 U.S. Const. Amend. V ("No person ... shall be compelled in any criminal case to be a witness against himself ...."); Del. Const. art. I, § 7 ("In all criminal prosecutions, the accused hath a right to be heard by himself or herself and his or her counsel [and] he or she shall not be compelled to give evidence against himself or herself.").

202 *Rogers v. United States*, 340 U.S. 367, 371, 71 S.Ct. 438, 95 L.Ed. 344 (1951); *Ratsep v. Mrs. Smith's Pie Co.*, 221 A.2d 598, 599 (Del. Super. Ct. 1966).

203 *Boykin v. Alabama*, 395 U.S. 238, 242, 89 S.Ct. 1709, 23 L.Ed.2d 274 (1969); *Sheppard v. State*, 367 A.2d 992, 994 (Del. 1976).

204 *Baio v. Com. Union Ins. Co.*, 410 A.2d 502, 508 (Del. 1979).

205 *D.H. Overmyer Co. Inc. v. Frick Co.*, 405 U.S. 174, 186, 92 S.Ct. 775, 31 L.Ed.2d 124 (1972); *Mazik v. Decision Making, Inc.*, 449 A.2d 202, 204 (Del. 1982).

206 *See Overmeyer*, 405 U.S. at 185, 92 S.Ct. 775; *Mazik*, 449 A.2d at 204.

207 *Graham v. State Farm Mut. Auto. Ins. Co.*, 565 A.2d 908, 913 (Del. 1989).

208 *Brown v. State*, 721 A.2d 1263, 1266 (Del. 1998).

209 *See, e.g.*, *Tang Cap. P'rs, LP v. Norton*, 2012 WL 3072347, at *7 (Del. Ch. July 27, 2012) (holding that the plaintiff contractually waived its rights to seek a receivership under Section 291 of the DGCL); *Libeau*, 880 A.2d at 1056 (holding that the plaintiff waived her right to statutory partition by contract, noting that "[b]ecause it is a statutory default provision, it is unsurprising that the absolute right to partition might be relinquished by contract, just as the right to invoke § 273 to end a joint venture or to seek liquidation may be waived in the corporate context"); *Red Clay Educ. Ass'n v. Bd. of Educ. of Red Clay Consol. Sch. Dist.*, 1992 WL 14965, at *6 (Del. Ch. Jan. 16, 1992) (holding that a provision in a collective bargaining agreement constituted an effective waiver of negotiation right under unfair labor practices statute).

210 *See Indus. Rentals, Inc. v. New Castle Cnty. Bd. Of Adjustment*, 776 A.2d 528, 529–30 (Del. 2001); *Save Our Cnty., Inc. v. New Castle Cnty.*, 2013 WL 2664187, at *2 (Del. Ch. June 11, 2013).

211 *Rsch. & Trading Corp. v. Pfuhl*, 1992 WL 345465, at *6–7 (Del. Ch. Nov. 18, 1992) (Allen, C.).

212 *SphereCommerce, LLC v. Caulfield*, 2022 WL 325952, at *1 (Del. Ch. Feb. 2, 2022).

213 *See* Welch & Saunders, *supra*, at 846–47.

214 *Id.* at 865–66.

215 *See* Harding, *supra*, at 88 ("[T]he mediating function of social roles depends on stability in the normative constitution of these roles; where this is lost, roles may lose their traction as normative resources and people may stop organizing their affairs with reference to them. Where fiduciary law too readily permits opt outs, there is a risk that fiduciary roles might cease to be comprehensible to those whose actions engage with them, and this might generate costs.").

216 Welch & Saunders, *supra*, at 866 (emphasis added).

217 *Id.* at 847-855. When the authors reach the topic of mandatory provisions, they caution that even those are subject to change, and "[i]t may be that the mandatory rules that exist today will be loosened tomorrow." *Id.* at 855.

218 *Id.* at 855-60.

219 Welch & Saunders, *supra*, at 866.

220 *E.g.*, *Daniel v. Hawkins*, 289 A.3d 631 (Del. 2023) (analyzing purportedly irrevocable proxy conferring corporate control); *Hokanson v. Petty*, 2008 WL 5169633 (Del. Ch. Dec. 10, 2008) (enforcing option to acquire a majority of the shares of the corporation and dictate the form of the transaction).

221 *See generally* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 Wash. U.L. Rev. 913, 947-53 (2021); Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 Yale J. Reg. 1124, 1144–48 (2021).

222 *See* 8 *Del. C.* § 251(c).

223 *See id.* §§ 218(a)–(b).

224 *See* Omari Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. Rich. L. Rev. 1129, 1144–45 (2008) ("Despite its undeniable importance, branding, at times, seems like an amorphous concept without a precise definition.... In a broad sense, branding describes a range of elements that form a complete service or product experience. The branding concept has traditionally focused on points of differentiation, i.e., unique benefits, which set a product or service apart from the competition." (internal footnotes omitted)); Kevin Lane Keller, *The Brand Report Card*, Harv. Bus. Rev. (Jan.–Feb. 2000), https://hbr.org/2000/01/the-brand-report-card ("Why do customers really buy a product? Not because the product is a collection of attributes but because those attributes, together with the brand's image, the service, and many other tangible and intangible factors, create an attractive whole. In some cases,

the whole isn't even something that customers know or can say they want.... In strong brands, brand equity is tied both to the actual quality of the product or service and to various intangible factors.").

225 William J. Moon, *Delaware's Global Competitiveness*, 106 Iowa L. Rev. 1683, 1692–700, 1734 & n.250 (2021) (discussing characteristics of the Delaware "brand"); Simmons, *supra*, at 1146 ("Delaware's brand equity is tied both to tangible aspects of its service and to various intangible factors."); Peter Molk, *Delaware's Dominance and the Future of Organizational Law*, 55 Ga. L. Rev. 1111, 1122–30 (2021) (discussing the role Delaware's brand plays in its "dominance" over United States corporate law).

226 *Why Businesses Choose Delaware*, Del. Div. Corp., https://corplaw.delaware.gov/why-businesses-choose-delaware/ (last visited Apr. 29, 2023).

227 *Id.* at 856-60.

228 *TravelCenters of Am., LLC v. Brog*, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008); *accord, e.g.*, *Henson v. Sousa*, 2015 WL 4640415, at *1 (Del. Ch. Aug. 4, 2015) ("LLCs, as this Court has repeatedly pointed out, are creatures of contract."); *Touch of It. Salumeria & Pasticceria, LLC v. Bascio*, 2014 WL 108895, at *4 (Del. Ch. Jan. 13, 2014) ("[R]ecognizing that LLCs are creatures of contract, I must enforce LLC agreements as written."); *Kuroda v. SPJS Hldgs., L.L.C.*, 971 A.2d 872, 880 (Del. Ch. 2009) ("Limited liability companies are creatures of contract ...."); *see Fisk Ventures LLC v. Segal*, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008) ("In the context of limited liability companies, which are creatures ... of contract, those duties or obligations [among parties] must be found in the LLC Agreement or some other contract." (footnote omitted)).

229 *See In re Seneca Invs. LLC*, 970 A.2d 259, 261 (Del. Ch. 2008) ("An LLC is primarily a creature of contract...."). The adverb "primarily" recognizes the critical non-contractual dimensions of the entity that this decision has discussed in connection with MCT, such as "separate legal existence, potentially perpetual life, and limited liability for its members." *In re Carlisle Etcetera LLC*, 114 A.3d 592, 605–06 (Del. Ch. 2015). *See generally* Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract As Deity*, 14 Fordham J. Corp. & Fin. L. 445, 460–71 (2009) (identifying historical, jurisprudential, and policy reasons why LLCs should not be regarded as purely contractual entities).

230 6 *Del. C.* § 18-1101(b).

231 Robert L. Symonds, Jr. & Matthew J. O'Toole, *Delaware Limited Liability Companies* § 9.01[B], at 9-9 (2d ed. 2019).

232 *See id.* ("A limited liability company may be structured on the basis of a corporate model ...."); *see, e.g.*, *Fla. R & D Fund Invs., LLC v. Fla. BOCA/Deerfield R & D Invs., LLC*, 2013 WL 4734834, at *2, *7 (Del. Ch. Aug. 30, 2013) (addressing LLC agreement that created a board of directors to manage the entity); *Kahn v. Portnoy*, 2008 WL 5197164, at *4 (Del. Ch. Dec. 11, 2008) (interpreting LLC agreement which created board of directors to manage the entity and which provided that the " 'authority, powers, functions and duties (including fiduciary duties)' of the board of directors will be identical to those of a board of directors of a business corporation organized under the Delaware General Corporation Law ... unless otherwise specifically provided for in the LLC Agreement"); *Seneca Invs.*, 970 A.2d at 261 (interpreting LLC agreement which provided that, subject to certain exceptions, "the Company will be governed in all respects as if it were a corporation organized under and governed by the Delaware General Corporation Law ... and the rights of its Stockholders will be governed by the DGCL"); *see also Matthew v. Laudamiel*, 2012 WL 2580572, at *1 (Del. Ch. June 29, 2012) (interpreting LLC agreement that created board of managers to oversee business and affairs of entity); *VGS, Inc. v. Castiel*, 2003 WL 723285, at *2 (Del. Ch. Feb. 28, 2003) (same).

233 *See* Welch & Saunders, *supra*, at 864-65 (contrasting what the DGCL permits the charter or bylaws of a corporation to contain with what the LLC Act permits an LLC agreement to contain; not engaging with what investors can agree to in investor-level agreements).

234 *Compare* 6 *Del. C.* § 18-201(a) *with* 8 *Del. C.* § 102(a).

235 *See* 6 *Del. C.* § 18-1101(c) ("To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is

a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."). When the General Assembly adopted Section 18-1101(e), Delaware decisions had not yet distinguished cleanly between the concept of good faith in fiduciary law and the role that the implied covenant of good faith and fair dealing plays as a source of implied contractual terms. *See, e.g.*, *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 418–19 (Del. 2013), *overruled on other grounds by Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808 (Del. 2013); *Renco Gp., Inc. v. MacAndrews AMG Hldgs. LLC*, 2015 WL 394011, at *7 n.74 (Del. Ch. Jan. 29, 2015). The statement that an LLC agreement "may not eliminate the implied contractual covenant of good faith and fair dealing" seems like an attempt to preserve some form of obligation to act in good faith. But in its role as a source of implied terms, the implied covenant cannot fulfill that mission, because the implied covenant does not operate as a fiduciary substitute. *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008) ("The implied covenant of good faith and fair dealing is a creature of contract, distinct from the fiduciary duties that the plaintiff asserts here."). And express terms displace it, enabling alternative entity agreements to authorize a decision maker to consider and act based on its own interests, irrespective of the entity's interests. *See, e.g.*, *Norton v. K-Sea Transp. P'rs L.P.*, 67 A.3d 354, 361 (Del. 2013) (enforcing provision that allowed a general partner to "consider only such interests and factors as it desires"); *Allen v. El Paso Pipeline GP Co., L.L.C.*, 113 A.3d 167, 181 (Del. Ch. 2014) (upholding provision that "confers contractual discretion on the Conflicts Committee to balance the competing interests of the Partnership's various entity constituencies when determining whether a conflict-of-interest transaction is in the best interests of the Partnership"), *aff'd*, 2015 WL 803053 (Del. Feb. 26, 2015) (TABLE); Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 Bus. Law. 1469, 1484 (2005) (recommending that alternative entity agreements provide that the decision maker be granted discretion to "consider only such interests and factors as it desires, including its own interests," and eliminate any "duty or obligation to give any consideration to any interest of or factors affecting the" entity or its investors). Nor does the statutory mandate to preserve the implied covenant provide incremental protection, because the implied covenant of good faith and fair dealing already inheres in every contract governed by Delaware law and cannot be eliminated. *See Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442–43 (Del. 2005).

236 *See* 6 *Del. C.* § 18-108 ("Subject to such standards and restrictions, if any, as are set forth in its limited liability company agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever.").

237 *See id.* § 18-1101(e) ("A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."). Like the statutory preservation of the implied covenant of good faith and fair dealing in Section 18-1101(c), the statutory preservation of liability for bad faith violations of the implied covenant was likely an attempt to retain accountability for intentional misconduct that ran contrary to the best interests of the entity. But here again, the implied covenant cannot fulfill its mission, because it is not a fiduciary substitute. *See Wood*, 953 A.2d at 143. It is also wickedly difficult under Delaware law to prove a claim for breach of the implied covenant, and all the more so to prove a *bad faith* breach of an *implied* term. "Rather than preserving a measure of accountability by imposing a meaningful floor, the statutory limit on exculpation sets the bar at the band sill." *Bamford v. Penfold, L.P.*, 2022 WL 2278867, at *33 n.18 (Del. Ch. June 24, 2022).

238 *See* Part II.D, *supra.*

239 *See* 8 *Del. C.* § 102(b)(7).

240 *See id.* § 145.

241 *See, e.g.*, *In re Delphi Fin. Gp. S'holder Litig.*, 2012 WL 729232, at *17 (Del. Ch. Mar. 6, 2012) (explaining that implied covenant of good faith and fair dealing inhered in charter and bylaws); *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1032

(Del. Ch. 2004) (deploying implied covenant of good faith and fair dealing when interpreting certificate of incorporation), *aff'd*, 872 A.2d 559 (Del. 2005).

242 *See* 6 *Del. C.* § 18-701; 8 *Del. C.* § 159.

243 To take a simplistic example, I may own a bicycle and a motorcycle, which are different types of vehicles. Regardless of which I ride on a particular day, I can select my destination, pick a route, choose to stop for coffee, and decide where to park. My ability to make similar choices does not collapse the distinction between the two forms of transportation. Nor would the distinction collapse if I made similar promises about how I would use or not use the forms of transportation, or even if I promised to not use one form of transportation in a manner prohibited for the other form of transportation. I could promise my spouse that I would not ride my bicycle on a path closed to motorized vehicles, and by making that promise, I have agreed not to use my bicycle in a manner prohibited for motorcycles. That does not make my bicycle a motorcycle. Nor does a stockholder's promise to not assert a claim for breach of fiduciary duty that a member of an LLC might not be able to assert turn the corporation into an LLC.

244 8 *Del. C.* § 262(b).

245 *Manti*, 261 A.3d at 1216, 1217–18.

246 *Id.* at 1218–20.

247 *Id.* at 1219.

248 *Id.* at 1220.

249 *Id.* at 1224.

250 *Id.* at 1225.

251 *Id.*

252 *Id.*

253 *Id.* at 1226.

254 *See id.* at 1221; *accord id.* at 1225.

255 *See id.* at 1221.

256 *See id.*

257 *See id.* at 1222.

258 *See id.* at 1225.

259 *See id.*

260 *See id.*

261 *See id.*

262 *See id.*

263 *See id.*

264 *See id.*

265 *See id.*

266 *See id.*

267 *See id.*

268 *See id.*

269 *See id.*

270 *Id.* at 1226.

271 *Id.*

272 *See* 8 *Del. C.* § 218(c).

273 *See id.* § 202(c).

274 *See id.* § 220.

275 *See Schoon v. Troy Corp.*, 2006 WL 1851481, at *2 (Del. Ch. June 27, 2006); *Kortum v. Webasto Sunroofs, Inc.*, 769 A.2d 113, 125 (Del. Ch. 2000). A charter-based waiver, however, would be invalid. *See State v. Penn-Beaver Oil Co.*, 143 A. 257, 260 (Del. 1926) ("[T]he provision in defendant's charter which permits the directors to deny any examination of the company's records by a stockholder is unauthorized and ineffective."); *Marmon v. Arbinet-Thexchange, Inc.*, 2004 WL 936512, at *5 (Del. Ch. Apr. 28, 2004) ("Nor could they rely upon a certificate provision prohibiting disclosure to avoid a shareholder's inspection right conferred by statute."); *BBC Acq. Corp. v. Durr-Fillauer Med., Inc.*, 623 A.2d 85, 90 (Del. Ch. 1992) (holding that a contract with a third party could not be used to limit inspection rights, which "cannot be abridged or abrogated by an act of the corporation"); *Loew's Theatres, Inc. v. Com. Credit Co.*, 243 A.2d 78, 81 (Del. Ch. 1968) (holding that charter provision which limited inspection rights to holder of 25% of shares was void as conflicting with statute); *State v. Loft, Inc.*, 34 Del. 538, 156 A. 170, 173 (Del. Ch. 1931) (following *Penn-Beaver*). An article by leading practitioners that identifies Section 220 rights as "mandatory" and collects authorities in support of that characterization only discusses limitations in the charter or bylaws, not in private stockholder-level agreements. Welch & Saunders, *supra*, at 858-59, 865. The differences between how a stockholder-level agreement and a charter provision can affect Section 220 rights is another manifestation of the more general distinction Delaware law draws between restrictions on stockholder-level rights in stockholder-level agreements and restrictions in the charter or bylaws. *See* Part II.D.3.b, *supra.*

276 Lawyers should be familiar with that type of requirement. As with other agency agreements, a lawyer's engagement letter can authorize a lawyer to represent a client notwithstanding a conflict of interest that otherwise would constitute a breach of duty. Restatement (Third) of the Law Governing Lawyers § 122 (Am. L. Inst. 2000), Westlaw (database updated Mar. 2023). Each affected client or former client must give informed consent, the representation cannot be prohibited by law, and the conflict cannot involve one client against the other in the same litigation. *Id.* But even where those requirements are met, the waiver must be reasonable, meaning it is ineffective if "in the circumstances, it is not reasonably likely that the lawyer will be able to provide adequate representation to one or more of the clients." *Id.* "In general, if a reasonable and disinterested lawyer would conclude that one or more of the affected clients could not consent to the conflicted representation because the representation would likely fall short in either respect, the conflict is nonconsentable." *Id.* cmt. g(iv). The *Restatement* also explains that the validity of a waiver of future conflicts turns on its breadth and the surrounding circumstances:

> Client consent to conflicts that might arise in the future is subject to special scrutiny, particularly if the consent is general. A client's open-ended agreement to consent to all conflicts normally should be ineffective unless the client possesses sophistication in the matter in question and has had the opportunity to receive independent legal advice about the consent.... On the other hand, particularly in a continuing client-lawyer relationship in which the lawyer is expected to act on behalf of the client without a new engagement for each matter, the gains to both lawyer and client from a system of advance consent to defined future conflicts might be substantial. A client might, for example, give informed consent in advance to types of conflicts that are familiar to the client. Such an agreement could effectively protect the client's interest while assuring that the lawyer did not undertake a potentially disqualifying representation.

Id. cmt. d.

277 261 A.3d at 1235 (Valihura, J., dissenting).

278 *Id.* at 1234.

279 *Id.* at 1237–41.

280 *Id.* at 1241–42.

281 *Id.* at 1243.

282 *Id.* at 1243–49.

283 *See id.* at 1233–34.

284 *Id.* at 1241.

285 *In re Altor Bioscience Corp.*, C.A. No. 2017-0466-JRS (Del. Ch. May 15, 2019) (TRANSCRIPT); *see* Juris. Subcomm. Ann. Surv. Working Gp., Priv. Equity & Venture Cap. Comm., ABA Bus. L. Section, *Annual Survey of Judicial Developments Pertaining to Private Equity and Venture Capital*, 76 Bus. Law. 237, 247–49 (2021) (discussing *Altor Bioscience*). The parties also did not cite two decisions applying New York law—a similarly contractarian jurisdiction—that relied on covenants not to sue to bar claims for breach of fiduciary duty. *E.g.*, *In re Empire State Bldg. Assocs. L.L.C. Participant Litig.*, 133 A.D.3d 538, 538, 21 N.Y.S.3d 31 (N.Y. App. Div. 2015); *Hugar v. Damon & Morey LLP*, 51 A.D.3d 1387, 1388, 856 N.Y.S.2d 434 (N.Y. App. Div. 2008). Although the legal principle is the same, the facts are not analogous.

286 *Altor Bioscience*, tr. at 9.

287 *Id.* at 10.

288 *Id.* at 13–14.

289 2014 WL 5509787, at *15 (Del. Ch. Oct. 31, 2014).

290 *Altor Bioscience*, tr. at 16.

291 *Id.* at 15.

292 *See* Part II.B, *supra.*

293 *Abry*, 891 A.2d at 1058.

294 The Covenant might not even be upheld against Signatories other than the Funds. The record does not reveal much about them, but judging from their names and hints elsewhere in the record, some might be sophisticated investors, some could be Company executives, some look like line employees, and some look like friends and family. Whether the Covenant could bind them is a different question that could require discovery to answer.

295 *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 142 n.28 (Del. 1997) (“Those issues are not before us, and we decide only the case before us.”); *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994) (“It is the nature of the judicial process that we decide only the case before us....”); *Stroud v. Milliken Enters., Inc.*, 552 A.2d 476, 480 (Del. 1989) (“The law is well settled that our courts will not ... render advisory opinions.”) (internal quotation omitted).

296 The Court of Chancery has refused to enforce a release in a transmittal letter for lack of consideration. *Cigna Health & Life Ins. Co. v. Audax Health Sols., Inc.*, 107 A.3d 1082, 1091 (Del. Ch. 2014). Incremental consideration for a covenant not to sue would solve the consideration problem. The public policy problem would remain.

297 Restatement (Second) of Contracts § 195 (Am. L. Inst. 1981), Westlaw (database updated Oct. 2022).

298 Richard A. Lord, 8 *Williston on Contracts* § 19:24 (4th ed. 2007), Westlaw (database updated May 2022).

299 *J. A. Jones Const. Co. v. City of Dover*, 372 A.2d 540, 545 (Del. Super. Ct. 1977) (citation omitted); *accord Fort Howard Cup Corp. v. Quality Kitchen Corp.*, 1992 WL 207276, at *5 (Del. Super. Ct. Aug. 17, 1992).

300 *Data Mgmt. Internationale, Inc. v. Saraga*, 2007 WL 2142848, at *5 (Del. Super. Ct. July 25, 2007).

301 *See Abry*, 891 A.2d at 1062.

302 *Id.* at 1061.

303 *See Fortis Advisors LLC v. Johnson & Johnson*, 2021 WL 5893997, at *11 (Del. Ch. Dec. 13, 2021) (exclusive remedy provision); *Online HealthNow, Inc. v. CIP OCL Invs., LLC*, 2021 WL 3557857, at *16–18 (Del. Ch. Aug. 12, 2021) (provision limiting survival of representations); *id.* at *19–20 (non-recourse provision); *FdG Logistics LLC v. A&R Logistics Hldgs., Inc.*, 131 A.3d 842, 860 (Del. Ch. 2016) (representation by seller that no extracontractual statements were made in lieu of agreement by buyer disclaiming reliance on extracontractual statements), *aff'd* 148 A.3d 1171 (Del. 2016); *Abry*, 891 A.2d at 1064 (damages cap).

304 *See* Part II.D.2, *supra.*

305 *See* Part II.D.2.a.v, *supra.*

306 *Hampshire Gp., Ltd. v. Kuttner*, 2010 WL 2739995, at *54 (Del. Ch. July 12, 2010) ("A breach of fiduciary duty is easy to conceive of as an equitable tort."); *see also* Restatement (Second) of Torts § 874 cmt. b (Am. L. Inst. 1979), Westlaw (database updated Mar. 2023) ("A fiduciary who commits a breach of his duty as a fiduciary is guilty of tortious conduct ...."). *See generally* J. Travis Laster & Michelle D. Morris, *Breaches of Fiduciary Duty and the Delaware Uniform Contribution Act*, 11 Del. L. Rev. 71 (2010).

307 2023 WL 2417271, at *45.

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KeyCite Yellow Flag - Negative Treatment
Distinguished by Eisenmann Corp. v. General Motors Corp., Del.Super., January 28, 2000

616 A.2d 1192
Supreme Court of Delaware.

RHONE–POULENC BASIC CHEMICALS COMPANY, a Delaware corporation, Defendant–Below, Appellant,
v.
AMERICAN MOTORISTS INSURANCE COMPANY, an Illinois corporation, Plaintiff–Below, Appellee.

Submitted: Sept. 9, 1992.
|
Decided: Nov. 18, 1992.

Synopsis

Insurers filed action to declare that insurers were not obligated to defend or indemnify insured chemical company under comprehensive general liability policies regarding disposal of toxic waste in landfill. The Superior Court, New Castle County, granted summary judgment against insured. Interlocutory appeals were taken. The Supreme Court, Veasey, C.J., held that insured's disavowal of its duty to mitigate further damages arising out of its prior disposal of toxic waste in a landfill was a failure to satisfy an express condition precedent to insurers' performance under the policies and, thus, the unambiguous mitigation provisions precluded coverage for the cost of measures taken or to be taken in order to prevent further release of contaminants from the landfill.

Affirmed and remanded.

West Headnotes (8)

[1] **Appeal and Error** Insurers and insurance

Proper construction of any contract, including insurance contract, is purely question of law so that trial court's decision is reviewed de novo.

98 Cases that cite this headnote

[2] **Insurance** Ambiguity in general
Insurance Plain, ordinary or popular sense of language
Insurance Construction to be unstrained

Clear and unambiguous language in insurance policy should be given its ordinary and usual meaning and, thus, courts should not destroy or twist policy language under guise of construing it, absent some ambiguity.

140 Cases that cite this headnote

[3] **Insurance** Ambiguity, Uncertainty or Conflict

To extent ambiguity exists in policy, doctrine of contra proferentum requires that language of insurance contract be construed most strongly against insurance company that drafted it.

57 Cases that cite this headnote

[4] **Contracts** Existence of ambiguity

Contract is not rendered ambiguous merely if parties do not agree upon its construction, but contract is ambiguous if provisions in controversy are reasonably or fairly susceptible to different interpretations or may have two or more different meanings.

530 Cases that cite this headnote

[5] **Contracts** Existence of ambiguity

True test for ambiguity of contract is not what parties to contract intended contract to mean, but what reasonable person in position of parties would have thought it meant.

210 Cases that cite this headnote

[6] **Insurance** Prerequisites for Claim of Breach or Bad Faith

Insured must show compliance with all conditions precedent to insurer's performance in

order for insured to establish liability of insurer for breach of insurance contract.

9 Cases that cite this headnote

[7] **Insurance** Liability or Indemnity Insurance

Public policy favored imposing duty upon insureds to mitigate damages resulting from disposal of toxic waste in order to prevent insureds from sitting back and allowing environmental damage to accumulate until they are compelled to mitigate damages through litigation.

3 Cases that cite this headnote

[8] **Insurance** Liability or Indemnity Insurance

Insured chemical company's disavowal of its duty to mitigate further damages arising out of its prior disposal of toxic waste in landfill was failure to satisfy express condition precedent to insurers' performance under policies and, thus, unambiguous mitigation provisions precluded coverage for cost of measures taken or to be taken in order to prevent further release of contaminants from landfill.

9 Cases that cite this headnote

***1193** Upon interlocutory appeal from the Superior Court. AFFIRMED AND REMANDED.

Attorneys and Law Firms

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Before VEASEY, C.J., HORSEY and MOORE, JJ.

Opinion

VEASEY, Chief Justice:

This is an interlocutory appeal[1] from two orders of the Superior Court entered on January 16, 1992 and January 31, 1992, respectively,[2] granting summary judgment against Rhone–Poulenc Basic Chemical ***1194** Company ("RPB") in a declaratory judgment action filed by certain insurance carriers (the "insurance carriers"). The insurance carriers are National Union Fire Insurance Company of Pittsburgh ("National Union"), Travelers Insurance Company ("Travelers"), and American Motorists Insurance Company ("AMICO").[3] The insurance carriers sought a declaration that they are not obligated to defend or indemnify RPB under standard-form comprehensive general liability ("CGL") insurance policies which they issued to Stauffer Chemical Company ("Stauffer"), RPB's predecessor.[4] The underlying dispute involves the proper construction of a mitigation provision in the AMICO and Travelers policies that requires the insured promptly to take, at its expense, reasonable steps to mitigate damages.

TYBOUTS CORNER LANDFILL

The relevant facts in this appeal are not in dispute. The issue before the Superior Court and this Court is purely a legal one. Stauffer operated a polyvinyl chloride ("PVC") manufacturing plant in Delaware City, Delaware between 1966 and 1981. The plant generated two principal wastes: (i) polyvinyl chloride resin and (ii) ethylene dichloride ("EDC") sludge.[5] These wastes were disposed of at a municipal landfill located near the Stauffer facility in New Castle County Delaware at Tybouts Corner. The acts of disposal took place from 1969 until July of 1971 when the landfill reached its capacity and was closed.[6] By the time the landfill ceased operating, Stauffer had dumped some 4.2 million pounds of EDC sludge and approximately 26 million pounds of other industrial wastes at the Tybouts Corner site. The sludge was

transported to the landfill in open 55–gallon drums and was poured directly into the ground.

Pursuant to State permitting requirements, the County established a program for testing the hydrological characteristics of the surface and subsurface waters at the landfill. In February 1969 the University of Delaware was employed to monitor the quality of the groundwater at Tybouts Corner and to issue periodic reports to the State and County. Data collected by the University between July 1969 and June 1971 indicated that leachate from the landfill was percolating downward through the soil into an aquifer. Although the reports indicated a progressive deterioration of the groundwater, the level of pollution was not considered to be serious at that time. It was not until May 1976 that the State Department of Natural Resources and Environmental Control ("DNREC") informed the County that a private well near Tybouts Corner was contaminated and that the landfill was the probable source. By 1984 the site was ranked second on the EPA National Priorities List.

PROCEDURAL HISTORY

On October 4, 1980, the federal government filed suit against Stauffer pursuant to § 7003 of the Resource Conservation and Recovery Act of 1976, 42 U.S.C. § 6973, and §§ 104, 106, and 107, of the Comprehensive Environmental Response, Conservation and Liability Act of 1980 ("CERCLA"), 42 U.S.C. §§ 9604, 9606, 9607, and 9613. *United States v. New Castle County,* C.A. No. 80–489 (D.Del. filed Oct. 4, 1980). The government sought ***1195** injunctive relief to abate any danger the waste at Tybouts Corner posed to the health and welfare of area residents and the environment. In addition, the government sought reimbursement for costs incurred in responding to the contamination and a declaratory judgment awarding monies for future remediation. The action was settled in April 1989 when RPB and the other parties to the litigation entered into a consent decree. Pursuant to the consent decree, RPB was required to share the expense of designing and implementing a remediation plan at the site. In order to foreclose the possibility of having to indemnify RPB for the environmental liability it incurred, AMICO, National Union, and Travelers filed a declaratory judgment action in Superior Court seeking a declaration that they are not liable under the respective CGL policies they issued to Stauffer. In the procedural context of cross-motions for summary judgment, the trial court ruled that a mitigation provision in the AMICO and Travelers policies precludes coverage for the cost of measures taken or to be taken to prevent the further release of contaminants from the landfill. *National Union Fire Insurance Co. of Pittsburgh v. Rhone–Poulenc Basic Chemicals Co.,* Del.Super., C.A. No. 87C–SE–11, slip op. at 37, Poppiti, J., 1992 WL 22690 (Jan. 16, 1992). RPB's motion for reargument was denied on January 31, 1992, 1992 WL 22689, and this appeal followed. We affirm.

CONSTRUCTION OF CONDITION 4(a) OF THE INSURANCE POLICIES

Stauffer purchased three standard-form CGL insurance policies from AMICO covering the period January 1, 1969 through March 1, 1971.[7] Each of the CGL policies contains a condition imposing a duty upon the insured to pay for the prevention of further damage once an accident or injury occurs. Condition 4(a) expressly states:

> 4. Insured's Duties in the Event of Occurrence, Claim or Suit (a) ... The named insured shall promptly take at his expense all reasonable steps to prevent other bodily injury or property damage from arising out of the same or similar conditions, but such expense shall not be recoverable under this policy.[8]

RPB argues that the failure of the drafter to include the mitigation provision in the list of policy exclusions negates any intended preclusionary effect. RPB further contends that the real purpose of the clause was to require the insured to take prompt steps to avoid a similar but different injury-producing event. The insured concludes that the reasonable steps which must be taken can never apply to remedial determinations taken after the fact because liability-avoiding measures cannot logically be taken after liability for an injury has been assessed. Rejecting RPB's reasoning, the trial court construed the mitigation provision as precluding from coverage the cost of all preventive measures. The sole issue on this appeal is the proper construction of the mitigation provision in Condition 4(a).

[1] The proper construction of any contract, including an insurance contract, is purely a question of law. *Aetna Cas. and Sur. Co. v. Kenner,* Del.Supr., 570 A.2d 1172, 1174 (1990). Accordingly, we review *de novo* for legal error the Superior Court's decision. *Rohner v. Niemann,* Del.Supr., 380 A.2d 549, 552 (1977).

[2] **[3]** Clear and unambiguous language in an insurance policy should be given its ordinary and usual meaning. *Johnston v. Tally Ho, Inc.,* Del.Super., 303 A.2d 677, 679 (1973). Absent some ambiguity, Delaware courts will not destroy or twist policy language under the guise of construing it. *Hallowell v. State Farm Mut. Auto. Ins. Co.,* Del.Super., 443 A.2d 925, 926 (1982). "[W]hen the language of an insurance contract is clear and unequivocal, a party will ***1196** be bound by its plain meaning because creating an ambiguity where none exists could, in effect, create a new contract with rights, liabilities and duties to which the parties had not assented." *Id.* To the extent that ambiguity does exist, the doctrine of *contra proferentum* requires that the language of an insurance contract be construed most strongly against the insurance company that drafted it. *Steigler v. Insurance Company of North America,* Del.Supr., 384 A.2d 398, 400 (1978).

[4] **[5]** A contract is not rendered ambiguous simply because the parties do not agree upon its proper construction. Rather, a contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings. *Hallowell,* 443 A.2d at 926. Ambiguity does not exist where the court can determine the meaning of a contract "without any other guide than a knowledge of the simple facts on which, from the nature of language in general, its meaning depends." *Holland v. Hannan,* D.C.App., 456 A.2d 807, 815 (1983). Courts will not torture contractual terms to impart ambiguity where ordinary meaning leaves no room for uncertainty. *Zullo v. Smith,* Conn.Supr., 179 Conn. 596, 427 A.2d 409, 412 (1980). The true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant. *Steigler,* 384 A.2d at 401 (contracts should be read to accord with the reasonable expectations of a reasonable purchaser); *see also, State v. Attman/Glazer,* 323 Md. 592, 594 A.2d 138, 144 (1991).

Three different federal courts have similarly construed the mitigation clause presently at issue. The consensus strongly suggests that the clause is reasonably susceptible of only one interpretation. In the case of *Chemical Applications Co., Inc. v. Home Indemnity Co.,* 425 F.Supp. 777 (D.Mass.1977), the mitigation provision was construed for the first time as "impos[ing] a duty on [the insured] to take steps to prevent further injury—to correct the fault—[but] not to repair or restore what has already occurred." *Id.* at 778. The court carefully noted that the insurance carrier remained liable for damages that had already accrued, thus ensuring that the agreement to which the parties originally assented was preserved.

The provision was next construed nearly seven years later in the case of *Mraz v. American Universal Ins. Co.,* 616 F.Supp. 1173 (D.Md.1985), *rev'd on other grounds sub nom., Mraz v. Canadian Universal Ins. Co., Ltd.,* 804 F.2d 1325 (4th Cir.1986). Galaxy Chemical, Inc. ("Galaxy") was a corporation engaged in the recycling of chemical solvents. Mraz was the founder and president of Galaxy. Soon after the plant opened, fumes began emanating from drums of unprocessed chemicals stored at the facility and the plant was declared a public nuisance. Galaxy then arranged to dispose of the controversial drums with the assistance of state and county health officials. At that time it was widely believed that "clay would form a natural barrier against any leaking of chemicals from the drums." 616 F.Supp. at 1176. Consequently, company and state officials disposed of the drums by burying them in a clay pit located on two acres of land known as the Leslie site. Although the drums were disposed of in the most technologically advanced method available at the time, the Environmental Protection Agency ("EPA") declared the site a potential health hazard to area residents several years later. The site was eventually remediated by the State of Maryland and the EPA in 1982. In an effort to recoup remediation expenditures, Mraz and Galaxy were both subsequently sued in 1983 by the state and federal governments under CERCLA. When Mraz notified his insurance carrier of the litigation, it refused to indemnify and defend him and Galaxy under the policy it issued in 1969. In an action by the insureds for declaratory judgment against the insurance company, one defense the insurer raised was that coverage was precluded because Galaxy failed to comply with Condition 4 of the policy "which required the insured to take steps to prevent further injury when an occurrence takes ***1197** place." *Id.* at 1180. The insurer argued that Galaxy should have taken steps to prevent further leakage if the company was aware of the problem when it disposed of the drums. Although the insurer correctly construed the mitigation provision, it overlooked the fact that the disposal method Galaxy used was the most technologically advanced method available in 1969. *Id.* Viewing the disposal method used by Galaxy as a measure intended to prevent future environmental damage, the court held that Mraz took sufficient steps to satisfy the mitigation provision and thereby triggered the insurer's duty to defend. *Id.* RPB's reliance on this case is misplaced because Galaxy took steps to mitigate further personal injury or property damage "from arising out

of" the same or a similar condition. Unlike Galaxy Chemicals, RPB completely disavowed its duty promptly to take any measures to mitigate further damages "from arising out of" the Tybouts Corner landfill.

The provision at issue here was most recently interpreted by the United States District Court in Delaware in an early environmental liability case involving the Tybouts Corner landfill. In the case of *New Castle County v. Hartford Acc. and Indem. Co.,* 685 F.Supp. 1321 (D.Del.1988), Senior District Judge Latchum examined an identical mitigation clause that was included in a policy New Castle County purchased from the Insurance Company of North America ("INA"). Citing *Chemical Applications* as persuasive authority, the Court held that "under the mitigation provision the insured, at its expense, would normally be required to correct any fault necessary to prevent further injury." *Id.* 804 F.2d at 1331. The Court further classified the remedies sought into three categories: (i) compensation for injuries suffered by the plaintiffs; (ii) injunctive relief compelling the County either to clean up the contaminants released by the landfill or to compensate the plaintiffs for costs incurred by the same; and/or (iii) injunctive relief forcing the County to take actions necessary to prevent future harm. *Id.* at 1332. Discriminating among the various remedies sought, the court held that INA was liable only under the first two categories. The carrier was held to be exempt from liability under the third category because it involved remedial costs required to prevent the future release of contaminants from the site. *Id.*[9]

In construing the mitigation provision, this Court cannot disregard other cases that have excluded coverage for preventive measures even in the absence of a mitigation provision in the insurance contract. *See Aerojet–General Corp. v. San Mateo County Superior Court,* Cal.Ct.App., 211 Cal.App.3d 216, 258 Cal.Rptr. 684 (1989); *Boeing Co. v. Aetna Cas. & Sur. Co.,* Wash.Supr., 784 P.2d 507, 516 (1990) (costs owing because of property damages are remedial measures taken after pollution has occurred, but preventive measures taken before pollution has occurred are not costs incurred because of property damage); *Aerojet–General Corp. v. San Mateo County Superior Court,* Cal.Ct.App., 211 Cal.App.3d 216, 257 Cal.Rptr. 621, 635 (1989) (expenditures to prevent future pollution would not be causally related to property damage and would not be covered as damages under a CGL policy). These courts reasoned that the cost of preventive measures are not "because of property damage" as is required under standard CGL policies. Rather, as the trial court found, they are costs incurred to prevent the further release of contaminants. *National Union Fire Insurance Co. of Pittsburgh v. Rhone–Poulenc Basic Chemicals Co.,* Del.Super., C.A. No. 87C–SE–11, slip op. at 37, Poppiti, J., 1992 WL 22690 (Jan. 16, 1992). Public policy clearly favors imposing upon insureds a duty to mitigate damages. In the absence of such a rule, insureds could sit back and allow environmental damage to accumulate until they are compelled to mitigate damages through litigation. The provision at issue here is consistent with that policy.

***1198** **[6]** **[7]** **[8]** The plain language of Condition 4(a), the consistency with which the three other jurisdictions noted above have construed the provision, and strong public policy concerns compel the conclusion that the mitigation clause is subject to only one reasonable interpretation. Thus, the doctrine of *contra proferentum* does not apply. In order for an insured to establish the contractual liability of an insurer for breach of an insurance contract, the insured must show that he has complied with all conditions precedent to the insurer's performance. *Casson v. Nationwide Ins. Co.,* Del.Super., 455 A.2d 361, 365 (1982). By disregarding its duty to mitigate further damage, RPB failed to satisfy an express condition precedent to performance under the policy agreement. The Superior Court properly held that the mitigation provisions in the policies issued by AMICO and Travelers preclude coverage for the cost of measures taken or to be taken in order to prevent the further release of contaminants from Tybouts Corner.

CONCLUSION

The mitigation provision in the three CGL policies RPB purchased from AMICO is properly construed as precluding coverage for the cost of measures taken or to be taken to prevent the further release of contaminants from the Tybouts Corner municipal landfill. The reasonable expectations of the purchaser can go only as far as the language of the contract will permit. *Steigler,* 384 A.2d at 401. Based upon the clear and unambiguous language of the mitigation provision, the decision of the Superior Court is AFFIRMED and the action is REMANDED for further proceedings not inconsistent with this opinion.

All Citations

616 A.2d 1192, 35 ERC 1931, 61 USLW 2375

Footnotes

1 Interlocutory appeals, pursuant to Supreme Court Rule 42, can serve a beneficial purpose in the administration of justice by advancing the termination of litigation and saving time in the trial courts if an important threshold question can be resolved, and the resolution of the question will save substantial time and expense. Certification of the present interlocutory appeal is appropriate because the orders appealed from determine a substantial legal issue, establish appellees' legal right to deny insurance coverage, and will serve the interests of justice and judicial economy. *See Rhone–Poulenc Basic Chemicals Co. v. American Motorists Insurance Co.,* Del.Supr., C.A. No. 95, 1992, Holland, J. (Mar. 11, 1992). Nevertheless, because interlocutory appeals may cause unnecessary delay and there is substantial danger of abuse, the Court cautions against the practice of a series of applications for interlocutory appeals when such a practice could delay or interrupt significantly the orderly progress of cases.

2 The January 31, 1992 order denied appellant's motion for reconsideration of the January 16, 1992 order.

3 Travelers Insurance Company is an intervenor in the present action.

4 Stauffer Chemical Company was involved in a complex series of mergers and acquisitions during the 1980s. Although the company survived, it now does business as Rhone–Poulenc Basic Chemicals Company, a Delaware corporation.

5 Stauffer used EDC, a powerful solvent, to clean its PVC reactors because it was cheaper than manual cleaning. EDC has been considered a dangerous toxic agent since 1932. *See Toxicity of EDC,* 98 J.Am.Med.Ass'n 1401 (Apr. 16, 1932).

6 The State of Delaware required New Castle County to comply with the permit requirements of both the State Water and Air Resources Committee and the Board of Health. Although the State's Certificate of Approval for the landfill prohibited the dumping of hazardous and industrial wastes without the approval of the Board of Health, there is substantial dispute as to the degree to which the County complied with the regulation.

7 The CGL policies Travelers issued provided the company with similar coverage from March 1, 1971 until July 1, 1977.

8 The Travelers policies contain a similar condition that provides:

> All expenses incurred by the insured to prevent other bodily injury or property damage from arising out of the same or similar conditions shall not be recoverable under this policy.

9 While questions concerning the extent to which preventive measures encompass remedial action may be relevant to the underlying litigation, this issue is not before the Court and will not be addressed herein.

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New York Official Reports

53 Misc.2d 402, 278 N.Y.S.2d 922

Donald Soles, on Behalf of Himself and All Other Members of the Fairport Yacht Club Similarly Situated, Plaintiff,

v.

Earl Stevenson, Defendant.

Fairport Yacht Club, Inc., Plaintiff,

v.

Earl Stevenson, Defendant.

Donald Soles, on Behalf of Himself and All Other Members of the Fairport Yacht Club Similarly Situated, et al., Plaintiffs,

v.

Wayneport Yacht Club, Inc., Defendant

Supreme Court, Wayne County
April 4, 1967

CITE TITLE AS: Soles v Stevenson

HEADNOTES

Trusts

constructive trusts--club member who took title to realty in his own name, because club had not yet incorporated, is adjudged constructive trustee for membership corporation formed by said club; membership corporation which he formed and to which he conveyed title is ordered to convey title to first membership corporation.

(1) A parcel of land was purchased for $50 by a member of a club, in his own name because the club had not yet incorporated. Then, when the club incorporated and made him a director, he refused to convey title to it unless the corporation first built a clubhouse and raised the membership dues; and finally, after an action was commenced against him, he and some other men formed their own incorporated club and he conveyed title to the latter for $200, which was said to be the amount he had spent. He is adjudged a constructive trustee; and his subsequent club corporation -- which has been made a defendant -- is ordered to convey title to the first club corporation, for $200 plus the amount of any taxes or assessments paid, by a deed containing suitable covenants against grantor's acts.

APPEARANCES OF COUNSEL

Coyle, Marks & Jordan (*David S. Jordan* of counsel), for plaintiffs. *Samuel S. Rothfield* for defendants.

OPINION OF THE COURT

Marshall E. Livingston, J.

These actions seek to impress a constructive trust upon certain real property now owned by the defendant Wayneport Yacht Club, Inc., by Donald Soles, in behalf of himself and all members of the Fairport Yacht Club prior to its incorporation on January 5, 1965, and Fairport Yacht Club, Inc., against Earl Stevenson, a former member of the yacht club, and Wayneport Yacht Club, Inc., to which club Mr. Stevenson now belongs.

On August 20, 1964, the unincorporated Fairport Yacht Club held a meeting, and the minutes reveal that approximately 30 members present voted nearly unanimously to "purchase or lease a parcel of land along the canal for a future clubhouse". The Club Commodore then appointed a land and building committee, "to find the needed land and cost for a proposed clubhouse".

George Ornt was appointed chairman of the committee. The defendant Stevenson, L. Hollis Bernard and the plaintiff Donald Soles were some of the members of this committee. ***403**

During the balance of 1964 regular monthly meetings were held, the original minutes of which are in evidence. In September a "motion was made and carried that the Land and Building Committee be given a free hand towards the leasing or purchase of the land".

On October 15 Chairman Ornt reported at the monthly meeting "on the parcel of land on the canal that is under consideration by the Club. This parcel is 1575 feet long and between 300 and 400 feet deep. He then showed the exact location on a New York State Barge Canal map and told of the excellent possibilities this land has for the Club's needs".

At another meeting on October 27, slides were shown of the parcel along the canal which the committee had located. Plans were discussed concerning the raising of funds and incorporating the club. Mr. Stevenson also spoke of a clubhouse estimated to cost $15,000 to be ready for occupancy June 1, 1965.

On November 19, 1964 Messrs. Stevenson and Bernard reported on the proposed clubhouse, and plans were shown. At this meeting six members were unanimously elected as the first Board of Directors to serve upon incorporation. Messrs. Ornt, Stevenson and Bernard were named to serve on this board.

In the meantime Chaiman Ornt and Mr. Stevenson had conferred in Syracuse with the State Public Works District Engineer in charge of the canal lands and learned from him that a half acre of land contiguous on the east end of the property to be leased by the club was owned by Wayne County. Mr. Ornt testified, in substance, that Mr. Stevenson thought *we* should buy it before *we* found a hot dog stand erected on the land. Both agreed to keep it quiet and tell no one of this development because *we* wanted to be sure of getting the land. It was agreed between them that someone should buy it so *we* could have it. Thereafter Mr. Stevenson contacted an attorney who verified the ownership of the land by Wayne County as the result of a tax sale. On October 16 Mr. Stevenson made an offer to buy the land from the Wayne County Board of Supervisors for $50. His offer was accepted November 18, and the deed to him, dated December 1, was recorded in Wayne County Clerk's office on December 15, 1964.

At the next meeting of the Fairport Yacht Club on December 17, 1964, the proposed certificate of incorporation was read, and authorization was given to pay the filing fee, after court approval of the certificate.

At this meeting Mr. Stevenson told the members he had purchased the half acre of land from Wayne County because the club was not incorporated, and an unincorporated association ***404** was not capable of holding title to real property (see *Schein v. Erasmus Realty Co.*, 194 App. Div. 38).

This position receives support by a fair preponderance of the evidence from witnesses who, in substance, testified that Mr. Stevenson in December stated to the meeting attended by more than 30 members that he would convey the land to the club after it was incorporated.

The minutes of the meeting also support this position and show: “After a friendly discussion on which should come first: the docks or the clubhouse, a motion was made and seconded that the Club dig a channel and build docks and postphone [sic] the construction of a clubhouse *until such time as the land can be purchased by the Club*. The motion was carried in a secret ballot with 26 'I's' and 8 'Noes'.” (Italics supplied.)

On January 21, 1965, after the club had been incorporated, Mr. Stevenson refused to convey the property and imposed additional conditions on the transfer, requiring that a clubhouse be built and the annual dues raised to $50. Norman Mayer testified it was at this meeting , attended by 22 members, that Mr. Stevenson said he would release the land as soon as the dues were raised. Mayer then told Stevenson, after some discussion, “We're going to have to dance to your music or you'll take your toys and go home”. Mayer offered to give Mr. Stevenson a check for his expenses in procuring the land and requested him to convey the land to the club. Mr. Stevenson refused to sell. Mr. Herron also made an offer to buy the land for the club, as did Mr. Otis Dodd, who offered to meet Mr. Stevenson at the bank and pay cash the next day. Mr. Stevenson refused all offers.

This, in effect, is conceded by Mr. Stevenson. He testified that he offered to give the land to Fairport Yacht Club if it would build. He says he offered the lot, a heating boiler, an oil tank and a fireplace.

The foregoing proof relating to the meeting of January 21, 1965 is uncontradicted and undisputed.

At the next meeting, on February 18, 1965, Mr. Stevenson was not present, and the minutes show 16 of the 20 members present agreed to annual dues of $50, provided that Mr. Stevenson donate the land he owned to the club, and a clubhouse be built in the near future.

Thus an impasse was reached, and at the March, 1965 meeting a motion to build a clubhouse was lost by one vote, and thereafter Messrs. Stevenson, Ornt, Bernard and others resigned as members of the club and from the Board of Directors of the corporation. ***405**

Mr. Bernard testified that about eight of the former Fairport Yacht Club members, including himself and Mr. Stevenson, stayed after the meeting and formed a new club, the Wayneport Yacht Club, which was subsequently incorporated on May 17, 1965.

On September 3, 1965, Mr. Stevenson conveyed the land in question to Wayneport Yacht Club, Inc., and the deed was recorded that same day in Wayne County Clerk's office.

Of interest, but of no special significance in this action, it appears that Wayneport Yacht Club then leased from the State of New York a portion of the land adjoining the leased lands of Fairport Yacht Club, Inc., at the eastern end of Fairport's premises.

The one-half acre parcel of land in question is bounded on the east by the north-south highway which leads over the Wayneport Bridge, and the leased lands of Wayneport Yacht Club, Inc., to the west of the parcel lie between the leased lands of Fairport Yacht Club and said parcel in question.

The proof shows that Wayneport Yacht Club, Inc., has materially improved its leased lands; however, the right to use these lands is not in dispute here, nor do the plaintiffs seek to obtain any benefit from the work done by Wayneport Yacht Club, Inc., on its leased adjacent land. It also appears that Fairport Yacht Club, Inc., has a right-of-way or easement across the lands of Wayneport Yacht Club, Inc., and another, so as to have access to its land, which is west of the leased land of Wayneport Yacht Club, Inc.

Defendant Earl Stevenson, a member of the land and building committee of the unincorporated Fairport Yacht Club and its successor Fairport Yacht Club, Inc., was also on its Board of Directors until his resignation in March of 1965. As such, Mr. Stevenson had a definite confidential relationship with and duty to the members of the Fairport Yacht Club and its corporate successor in acting for them to seek out a site for their activities. It matters not whether the committee was to lease or purchase land along the canal. It was incidental that Messrs. Ornt and Stevenson learned of the one- half acre of land adjoining the proposed State land to be leased and determined, as committee members, to keep it quiet in order to facilitate the purchase of the half acre parcel for the club's protection. The proof shows that the other members of the committee, although numerous special meetings were held, did not know of the parcel of land until Mr. Stevenson had made arrangements to buy it himself, as agent for the club, or so it would appear from several witnesses. At any rate, the additional conditions ***406** imposed by Mr. Stevenson gave rise to dissension within the organization culminating in the formation of the Wayneport Yacht Club, Inc., and the subsequent transfer of the property in question to it by the defendant Stevenson.

It is evident from the reported cases relating to constructive trusts imposed by the court that such an equitable device is available as a remedy for a myriad of situations. As Mr. Justice Cardozo wrote in *Beatty v. Guggenheim Exploration Co*. (225 N. Y. 380, 386): "A constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee".

A situation somewhat similar to this case arose in *Stephens v. Evans* (190 Misc. 922), wherein a presumed committee member of a church group purchased property in her own name when the expressed intention of the church was to own the property as a meeting place, and Clara Stephens, as a church member, knew this.

Here the defendant Stevenson argues that he was only instructed to lease; that no one else would buy the land; that he wanted to insure a clubhouse be built; and in effect, that he held the legal title to the land as the means whereby he could insist on his terms. In short, he took advantage of a situation, which he claims was on his own and not as a representative of the Fairport Yacht Club.

In *Stephens v. Evans* (*supra*, pp. 924-925), the court, with language particularly appropriate to this case, said: "At the most, it is said, she took advantage of a situation. This is a mere play on words and cannot be accorded the serious consideration which its proponents perhaps felt should be granted the argument. The 'situation' would not have been created if it were not for the membership of the plaintiff in the congregation and her resultant information regarding the proposed transaction. Plaintiff's relationship with the church of which she was a member was such that she should be considered, if not a positive fiduciary, in at least an implied confidential relationship. Her undisputed and admitted behavior is that unconscionable conduct which requires the court of equity to force upon her conscience the constructive trust."

Corpus Juris Secundum (vol. 89, Trusts, § 139) states in part:

"The feature which distinguishes *constructive trusts* from express trusts and resulting trusts is that the former do not arise by virtue of agreement or intention, either actual or implied, *but by operation of law, or, more accurately, by construction* ***407** *of the court*, and that result is reached in such instances regardless of, and ordinarily contrary to, any intention to create a trust. Such trusts are entirely in invitum, and are forced on the conscience of the trustee in favor of the person defrauded, for the purpose of working out right and justice and preventing fraud, or, as frequently stated, for the purpose of preventing unjust enrichment" (italics supplied), and such a rule should definitely be applied here.

The defendant Wayneport Yacht Club, Inc., is not a bona fide purchaser for value. At the time of the transfer by Mr. Stevenson to it in September of 1965, the action against Mr. Stevenson had been commenced and pending for several months. Although plaintiffs never filed a *lis pendens* against the property, it is apparent that the members of the Wayneport Yacht Club, Inc., were all aware of the controversy existing between Fairport Yacht Club, Inc., and Earl Stevenson, one of the founders of the Wayneport Yacht Club, Inc. (see *Bonham v. Coe*, 249 App. Div. 428; see, also, 90 C. J. S., Trusts, §§ 435, 441, and New York cases cited therein).

The court finds that Wayneport Yacht Club, Inc., obligated itself to pay Earl Stevenson $200 for the cost of his expenses on obtaining the land in question.

Plaintiffs may have judgment, with costs and disbursements of these actions, against the defendant Earl Stevenson, that the conveyance of the one-half acre of land to the defendant Wayneport Yacht Club, Inc., was in violation of his trust, duty and obligation as a member of the land and building committee of the Fairport Yacht Club and Fairport Yacht Club, Inc., of which he was a director.

Plaintiffs may also have judgment, with costs and disbursements, against the defendant Wayneport Yacht Club, Inc., that it be ordered and directed to convey the subject property (Liber 558 of Deeds, at p. 628, Wayne County Clerk's office) to plaintiff Fairport Yacht Club, Inc., or its assignee, with suitable covenants against grantor, upon tender of the sum of $200, within 30 days from the date of service of a copy of the judgment herein upon defendants' attorney, together with the amount of any taxes or assessments heretofore paid by said defendant.

In the event of any dispute between the parties as to the amounts to be paid in addition to the $200, any party may apply to the Special Term of the Supreme Court at the foot of the judgment herein for further directions. The parties may also make like applications for further directions regarding the enforcement of the judgment, if such instructions be necessary. ***408**

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Superior Court of Delaware.

SYCAMORE PARTNERS MANAGEMENT, L.P. (f/k/a Sycamore Partners Management, L.L.C.), Sycamore Partners, L.P., and Sycamore Partners A, L.P., Plaintiffs,

v.

ENDURANCE AMERICAN INSURANCE COMPANY, Continetal Casualty Company, Zurich American Insurance Company, XL Speciality Insurance Company, Starr Indemnity & Liability Company, Markel American Insurance Company, Argonaut Insurance Company, Great American Company, Ironshore Indemnity, Inc., and Everest National Insurance Company, Defendants.

C.A. No. N18C-09-211 AML CCLD
|
Submitted: November 19, 2020
|
Decided: February 26, 2021

Upon Plaintiffs' Motion for Partial Judgment on the Pleadings: GRANTED

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MEMORANDUM OPINION

LEGROW, J.

***1** Three investment funds acquired a company, allegedly raided its high-performing assets, and left the remainder as an overly leveraged shell. During bankruptcy proceedings, the company's bankruptcy estate sued the investment funds and their managers for fraudulent conveyance, breach of fiduciary duty, and related business torts. The investment funds ultimately settled those claims for $120 million.

To recoup some of that settlement and the costs of mounting a defense to the claims, the investment funds turned to their

insurers. The insurers, however, refused to pay. As a result, the funds filed this action seeking damages for breach of contract and a declaration that the insurers are obligated to provide coverage. In response, the insurers raise a number of affirmative defenses. Relevant to this decision is the so-called "uninsurability defense." Through that defense, the insurers contend the funds' settlement is uninsurable as a matter of public policy because it represents disgorgement of, or restitution for, ill-gotten gain. The funds move for judgment on the pleadings as to the applicability of the uninsurability defense.

Although this case is a coverage dispute, the pending motion primarily turns on a conflict-of-law analysis. Resolving the funds' instant motion requires the Court to decide which state's "public policy" serves as the reference point for the uninsurability defense: Delaware or New York. The funds assert Delaware law applies and Delaware does not have a public policy against insuring restitution or disgorgement. The insurers insist New York law applies and New York does have such a public policy.

The conflict of law question before the Court requires it to interpret a provision in the insurance policies that the investment funds contend is a choice of law provision. Under the policies, the parties agreed that the "law most favorable" to the insured would apply to coverage disputes in which the insurers challenged a loss as uninsurable. That "law most favorable" clause unambiguously is a choice of law provision, and the insurers do not meaningfully argue otherwise. Instead, the insurers contend the provision is unenforceable because it frustrates New York's interest in preventing the indemnification of wrongful gains. But the insurers have not met their burden to demonstrate that the choice of law provision should not apply. Accordingly, and because the funds validly have nominated Delaware as the jurisdiction "most favorable" to them, Delaware public policy determines the uninsurability defense's fate.

Delaware law proscribes many acts the taking of which produce relief akin to restitution and disgorgement. But any Delaware public policy against *insuring* conduct for which restitution and disgorgement is appropriate must be expressed by the legislature, not the judiciary. The General Assembly, however, has not enacted a statute proscribing insurance for restitution or disgorgement. The legislature instead has left the issue as one to be negotiated by contracting parties. Had the insurers wished to avoid exposure to settlements like the one at issue here, they could have drafted the policies in that way. Because they did not, however, their uninsurability defense fails as a matter of Delaware law. Accordingly, and for the reasons discussed below, the funds' motion for judgment on the pleadings as to the uninsurability defense is **GRANTED**.

BACKGROUND

***2** This case arises from an insurance contract dispute in which Starr Indemnity & Liability Company, Markel American Insurance Company, Argonaut Insurance Company, Great American Insurance Company, and Ironshore Indemnity, Inc., (collectively, the "Insurers"),[1] denied three Delaware-organized private equity firms, Sycamore Partners Management, L.P., Sycamore Partners, L.P., and Sycamore Partners A, L.P. (collectively, "Sycamore"), coverage for expenses incurred in a lawsuit prosecuted by the bankruptcy estate of a retail fashion holding company Sycamore acquired ("Nine West" (f/k/a the "Jones Group")).

After the Insurers denied coverage, Sycamore filed this action seeking a declaration that Sycamore's settlement with Nine West's estate (the "Nine West Settlement") is a "Loss" covered by the subject policies. In their answers, the Insurers asserted several affirmative defenses, including that the Nine West Settlement is uninsurable as a matter of public policy (the "Uninsurability Defense"). Sycamore moved for judgment on the pleadings as to the applicability of that defense.

A. The Policies

Sycamore purchased from the Insurers excess insurance coverage for a "Loss" generated by a "Claim" involving directors' and officers' ("D&O") and errors and omissions ("E&O") liability.[2] The tower of excess insurance follows form to a primary coverage policy and encompasses claims made between December 31, 2016 through June 30, 2018 (the "Policies").[3] The Policies were issued and brokered in New York, where Sycamore is headquartered, and contain scattered references to New York law.

The Policies define "Loss" generously to include "settlements," "judgments," "damages," and various litigation fees. The definition of Loss excludes, however, "amounts which are uninsurable under the law most favorable

to ... insurability."[4] Stated differently, the Policies bar coverage for expenses that are "uninsurable" in a jurisdiction that would be most likely to construe the Loss as insurable.

Relatedly, the Policies exclude coverage for unlawful gains. Under the Policies, "any personal profit or remuneration gained by [Sycamore or its managers] to which [they are] not legally entitled" is excluded from coverage.[5] This exclusion, however, is not unlimited. Unlawful gains are excludable only if they truly are "unlawful," *i.e.,* determined to be so in a "final, non-appealable adjudication."[6]

B. The Challenged Transactions and Nine West Settlement

From 2013 to 2014, Sycamore targeted the Jones Group—a holding company which owned several retail fashion brands—for acquisition and resale.[7] Sycamore engaged in a series of transactions to achieve that end. Sycamore first purchased the Jones Group's stock through a leveraged buyout.[8] Next, Sycamore caused the Jones Group to consolidate—and ultimately merge with—Jones Group affiliates and subsidiaries to centralize their most lucrative assets within a renamed firm: Nine West.[9] Nine West then sold three high-performing assets to Sycamore from which the latter extracted $160 million in dividends.[10] Finally, Sycamore sold those assets on the secondary market for a net profit of $336 million.[11]

***3** Because the deals primarily were financed with debt, Nine West's post-closing capital structure mostly was comprised of liabilities that went unserviced without the equity in the liquid assets Nine West exchanged.[12] Overly leveraged and facing insolvency, Nine West filed for Chapter 11 bankruptcy protection. In 2018, Nine West's estate sued Sycamore and its management alleging fraudulent transfers, breaches of fiduciary duty, and related business torts arising from the transactions Sycamore directed.[13] Sycamore eventually entered into the Nine West Settlement,[14] paying $120 million to Nine West's estate in exchange for dismissal of the claims.

C. The Present Coverage Dispute and Procedural History

To recoup a portion of the Nine West Settlement and the expenses incurred to defend it, Sycamore turned to the Insurers for reimbursement. The Insurers, however, refused coverage, thereby prompting this action. The Insurers removed the case to federal court, but the district court remanded for lack of subject matter jurisdiction, and alternatively, in abstention.

On September 6, 2019, Sycamore filed an amended complaint[15] in which it alleges the Insurers breached[16] the Policies by denying coverage for the Nine West Settlement and defense costs associated with the bankruptcy estate litigation.[17] In their answers to the amended complaint, the Insurers raised a series of affirmative defenses, including the Uninsurability Defense.[18] Through that Defense, the Insurers contend the Nine West Settlement is uninsurable as a matter of public policy because it represents disgorgement of, or restitution for, the ill-gotten gains Sycamore procured from the Nine West transactions.

On September 8, 2020, Sycamore moved for partial judgment on the pleadings as to the Uninsurability Defense.[19] The parties briefed the motion, and the Court took the motion under advisement after hearing oral argument.[20]

PARTIES' CONTENTIONS

In support of its motion, Sycamore argues the Policies' "law most favorable" provision, which expressly governs issues of uninsurability, is a choice of law clause.[21] Because that provision was negotiated to benefit the insured, Sycamore is free to select the jurisdiction most favorable to it, which Sycamore argues is Delaware.[22] Sycamore contends that under Delaware law losses are uninsurable as-against public policy only if the legislature expressly so provides.[23] Delaware's General Assembly has not enacted any statute making restitution or disgorgement uninsurable,[24] and Sycamore therefore argues the Nine West Settlement—even if construed to represent restitution or disgorgement—is not uninsurable as a matter of Delaware law. Accordingly, Sycamore maintains, the Uninsurability Defense fails.[25]

***4** If the Court concludes the law most favorable provision is not a choice of law clause, Sycamore alternatively argues Delaware law nevertheless applies because Delaware has the most significant relationship to the Policies because (1) Sycamore is organized in Delaware; and (2) the Policies provide D&O coverage, and Delaware has a stronger interest

in resolving claims that involve fiduciary duties, like those brought by Nine West's estate, than New York does.[26] Even if New York law applies, Sycamore contends, the Policies plainly provide that Losses are not excluded as unlawful gains unless they are adjudged unlawful in a "final, non-appealable" decision, not in a settlement like the one at issue here.[27]

In opposition, the Insurers argue the law most favorable provision is not a choice of law clause because it does not identify a particular state.[28] Even if it is a choice of law clause, the Insurers contend, it is unenforceable under Restatement (Second) Conflict of Laws § 187(2)(b).[29] Since New York law applies, the Insurers continue, the Nine West Settlement is uninsurable as a matter of public policy because it represents restitution or disgorgement.[30] But, even if Delaware law applied, the Insurers argue the Nine West Settlement would be uninsurable because Nine West's estate brought fraudulent transfer claims, and a Delaware statute prohibits fraudulent transfers.[31] Finally, in the Insurers' view, the Policies' unlawful gains exclusion is irrelevant because Sycamore has not met its burden to show the Nine West Settlement is covered.[32]

STANDARD OF REVIEW

A party may move for judgment on the pleadings under Superior Court Civil Rule 12(c).[33] In deciding a motion under that rule, the Court accepts the truth of all well-pleaded facts and draws all reasonable factual inferences in favor of the non-moving party.[34] The Court "accords the party opposing a Rule 12(c) motion the same benefits as a party defending" a motion to dismiss under Rule 12(b)(6).[35] Accordingly, this Court will grant a motion for judgment on the pleadings only if, after drawing all reasonable inferences in favor of the non-moving party, there is no material fact in dispute and the moving party is entitled to judgment as a matter of law.[36]

ANALYSIS

There are three steps to Delaware's conflict-of-law framework,[37] which this Court applies in cases pending before it.[38] First, the Court must determine whether the parties' contract contains an effective choice of law provision.[39] If it does, the analysis ends. If no choice of law provision applies, the Court next determines whether "there is an actual conflict between the laws of the different states each party believes should apply."[40] If such a conflict exists, the Court proceeds to the last step: use of the " 'most significant relationship test' to determine which state's law applies."[41]

***5** As explained below, the "law most favorable" provision is an enforceable choice of law clause that allows Sycamore to select (within reason) a forum for determining whether a Loss is uninsurable. Because Sycamore has chosen Delaware law (a reasonable choice), Delaware law and public policy govern whether the Nine West Settlement is uninsurable. In Delaware, public policies against insurability must be pronounced by statute, not by judicial fiat. The General Assembly, however, has not enacted a law rendering restitution or disgorgement uninsurable, and the Insurers' Uninsurability Defense therefore fails.

A. Delaware law governs the question of whether the Nine West Settlement is uninsurable.

1. The "law most favorable" provision is a choice of law clause.

Delaware enables sophisticated counterparties to contract as they wish, and its courts generally leave bilaterally negotiated contract terms undisturbed.[42] Indeed, Delaware courts respect voluntary agreements "as a matter of fundamental public policy."[43] That deference extends not only to the contents of a deal, but also to the governing law its makers choose.[44] As with other contractual provisions, ensuring the predictability of the dispute resolution provisions contracting parties select is important to preserving stable business arrangements.[45] The same principles of preserving certainty and justified expectations undergird the Second Restatement, which Delaware follows with respect to conflict of law.[46] As a result, "with very limited exceptions,"[47] Delaware courts enforce contractual choice of law clauses as long as the jurisdiction chosen has a "substantial relationship to the parties or the transaction" and the choice is not unenforceable under the fundamental public policy of a "default" and materially-more interested state.[48]

***6** Under the Policies, the parties agreed "the law most favorable to ... insurability" would apply to disputes in which the Insurers challenge a Loss as uninsurable.[49] This clause

unambiguously is a choice of law clause. Because Sycamore is seeking coverage, the provision grants Sycamore discretion to choose any reasonable[50] forum it believes would maximize its chances of defeating the Uninsurability Defense. Here, Sycamore chose Delaware. In this instance, then, the "law most favorable" provision is a Delaware choice of law clause.

By statute, Delaware law presumptively is valid and a "significant, material and reasonable" choice of law.[51] The same presumption for voluntary choices is embodied in Restatement § 187.[52] Moreover, Sycamore is incorporated in Delaware, giving the state a "substantial relationship" to Sycamore.[53] Sycamore's choice therefore enjoys deference unless the Insurers make "a strong showing" that rejecting Sycamore's choice "would vindicate a public policy interest even stronger" than Delaware's touchstone interest in contractual enforcement.[54] In other words, Delaware law controls unless the Insurers demonstrate clearly that the law most favorable provision is unenforceable because of a public policy in a state with an interest materially greater than Delaware's.

Before arguing unenforceability, however, the Insurers fault the wording they voluntarily accepted. They contend the law most favorable provision is not a choice of law clause because it fails to specify the "law most favorable." To support their theory, they rely on two Delaware cases that, in their view, hold as much. But the quotations the Insurers offer are taken out of context, and courts have ruled against the Insurers' theory.

Citing *Hoechst Celanese Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa*,[55] the Insurers suggest a choice of law clause that does not name a specific jurisdiction is ineffective because it permits "forum shopping."[56] The Insurers' argument would extend *Hoechst* well beyond its narrow ruling. In *Hoechst,* the court construed a "service-of-suit" clause providing that the "law and practice" of a jurisdiction selected by the insured would resolve coverage issues. After declaring the provision ambiguous,[57] the court held that it referred to procedural, rather than substantive, law.[58] The court did not conclude that an insurance provision empowering the insured to choose advantageous substantive law categorically is invalid. To the contrary, the court noted that it would have read the phrase "law and practice" to capture both procedural and substantive law if its drafters had chosen more precise wording.[59]

***7** The Insurers' reliance on *Certain Underwriters at Lloyds, London v. Chemtura Corp.*[60] similarly is misplaced. According to the Insurers, the Supreme Court in *Chemtura* rejected the insured's choice of law "because the insurance policies did not specify a particular state law."[61] But the *Chemtura* policies did not contain a choice of law provision, and the Supreme Court merely acknowledged that fact at the beginning of its review.[62] Indeed, the Supreme Court reversed the lower court on most significant relationship grounds—not on effective choice of law grounds—because there was no choice of law provision at issue in the case.[63]

With those decisions considered in their proper context, the Insurers are left without any case in which a court disregarded a choice of law clause for lack of jurisdictional specificity. And they also have not meaningfully distinguished rulings from courts outside Delaware construing "law most favorable" provisions as choice of law clauses. For example, in *Chubb Custom Ins. Co. v. Prudential Ins. Co. of Am.*,[64] the Supreme Court of New Jersey found that an insurance clause that endorsed "the law of the jurisdiction most favorable to insurability" self-evidently was a choice of law provision.[65] Similarly, in *Walters v. Am. Home Assurance*,[66] the New Jersey federal district court recognized that insurance counterparties may "implicitly ... incorporate [ ] a choice of law provision" into their agreements by negotiating a "law ... most favorable to insurability" term.[67]

In sum, the Insurers cannot explain what the law most favorable provision *is* if it is *not* a substantive choice of law clause. They next argue the provision is unenforceable under Restatement Section 187.

2. The law most favorable provision is enforceable.

Under Delaware law, when contracting parties identify a state's laws to govern the contract, a party seeking to invalidate that choice bears the burden of showing why a different state's laws should apply.[68] In doing so, that party must establish three elements under Restatement § 187(2)(b): (1) the different state would be the "default" state but for the choice of law provision; (2) enforcement of the agreement would be contrary to a fundamental public policy of that different state; and (3) that different state has a materially

greater interest than Delaware in the enforcement or non-enforcement of the agreement.

But refuge in Restatement § 187(2)(b) is reserved for rare cases. The exception "does not exist as a sword for parties to avoid their contracts when avoidance suits their personal interests."[69] Indeed, "Delaware courts will not easily invalidate"[70] a choice of law provision, and seller's remorse is not a commercially reasonable basis for avoiding a choice of law clause.[71] Instead, opponents may seek relief under Restatement § 187(2)(b) only when enforcement of a Delaware choice of law provision clearly would nullify a default state's unique public interests.[72] The Insurers advance several reasons why this is the type of rare case for which Section 187(2)(b) was intended. None of those reasons is persuasive.

a. New York would not be the "default" state.

***8** The Insurers contend that, but for the Policies' law most favorable provision, New York would be the default state because: (1) Sycamore is headquartered in New York; (2) the Nine West transactions occurred in New York; (3) the alleged misconduct that Nine West's estate litigated occurred in New York; (4) the Policies were issued and brokered in New York; and (5) the Policies contain New York endorsements.[73]

What the Insurers omit, however, is that the Policies are fiduciary liability insurance contracts written to cover Delaware entities for claims concerning the entities' management and internal affairs. This Court repeatedly has held that Delaware takes a superseding interest in the merits of disputes involving insurance coverage for fiduciary mismanagement of Delaware organizations.[74] In so ruling, this Court has deemed the state of incorporation—for Sycamore, Delaware—the default state despite the same factual circumstances the Insurers marshal here in favor of applying New York law.[75] For example, this Court in *Pfizer Inc. v. Arch Ins. Co.* held Delaware law governed a D&O policy issued to a Delaware-incorporated firm despite the fact that the firm was headquartered in New York, the policies were issued and brokered in New York, the policies were amended by New York endorsements, and the underlying claim to which coverage attached was filed in New York.[76] Similarly, even if some of the Restatement factors favor New York in this case, the presence of a D&O insurance agreement benefitting Delaware insureds balances the remaining factors in Delaware's favor.[77] Accordingly, Delaware, not New York, would be the default state if the Policies did not contain the law most favorable provision.[78]

***9** Undeterred, the Insurers seek to downplay Delaware's connection to the Policies by emphasizing that (i) the Policies provide both D&O *and* E&O coverage, and (ii) Nine West estate's claims asserted E&O-based wrongdoing.[79] But that effort overlooks two key points. First, Nine West's estate brought breach of fiduciary duty claims as well as claims under the E&O coverage.[80] In the Insurers' words, Sycamore profited from "classic self-dealing."[81] That contention challenges Sycamore's managers' loyalty—the very type of exposure D&O insurance covers.[82] Second, even after crediting the Insurers' E&O-only reading of the Nine West litigation, New York still would not be the default state. Delaware courts engaged in a conflict-of-law analysis do not focus on the specific claims asserted in the underlying litigation, but rather concentrate on the insurance scheme as a whole.[83] As a result, Delaware nevertheless would be the default state because the Policies were issued to Sycamore, a Delaware-organized group, to indemnify wrongdoing engaged by its Delaware managers. The particular misconduct Nine West identified, the theories of relief it alleged, the litigation forum in which it sued, and Sycamore's New York headquarters are not pertinent to the analysis, or at minimum, fail to outweigh Delaware's interest.[84]

Failure to satisfy the default-state element is enough to end the analysis under Restatement § 187(2)(b).[85] Nonetheless, for the sake of completeness and eventual judicial review, I briefly will address the Restatement's remaining elements.

b. The Insurers fail to satisfy the other Section 187(2)(b) elements.

In blending New York's putative public policies and material contacts, the Insurers shepherd an array of New York cases disapproving fraudulent transfers and declaring restitution or disgorgement uninsurable.[86] Although those decisions may illustrate a general common law discouragement of dubious gains, they do not establish New York's overriding enforcement priorities in these Policies.

There is no bright-line rule for measuring the weight of a sister state's policies and interests.[87] But caselaw offers some guidance. A materially greater interest surely lies when enforcement would threaten a fundamental public policy more vital than the freedom of contract.[88] And on that point, "[a] mere difference between the laws of two states" will not make enforcement "in one state contrary to the public policy of another."[89] In line with this reasoning, Delaware courts eschew recognition of "generalized" interests.[90] Conversely, and consistent with Restatement, § 187, Delaware courts often treat a public policy as "fundamental" and an interest as "materially greater" where the alternate forum clearly articulates its judgments and concerns by statute.[91] Still, the existence of a foreign statute, although significant, is not always dispositive.[92] At minimum, then, the alternate forum —especially when not the default state—must strongly and with precision disfavor the outcome likely to be derived from Delaware law on "the particular issue" for that forum's putative policies and interests to be categorized as "fundamental" and "materially greater."[93]

***10** The Insurers cite two decisions oriented by these principles in which another state's enforcement priorities supplanted a Delaware choice of law provision. Those decisions, however, are distinguishable and, in fact, undercut the Insurers' position.

In *Wind Point Partners VII-A, L.P. v. Insight Equity A.P. X Co., LLC*,[94] this Court construed a Delaware choice of law provision in a stock purchase agreement that would have stripped Texas investors of a right to sue afforded them by a Texas securities statute.[95] Importantly, the statute specifically invalidated contractual choice of law provisions that would have the effect of waiving specific, Texas-conferred remedies for fraudulently secured investments.[96] Given that Texas—the default state—had a reticulated regulatory scheme to reach Texas investors wherever harmed, this Court refused to replace it with a parallel but generalized Delaware securities law that limited recovery for harm inflicted inside Delaware only.[97] As the Court acknowledged, Delaware law is unlikely to apply where its application "would lead to [the] absurd result[ ]" of impairing a class specifically identified by a foreign statute for protection.[98]

Similarly, in *Ascension Ins. Holdings, LLC v. Underwood*,[99] the Court of Chancery confronted an equity-based compensation plan offered to a California employee by a California-based firm. The plan contained both a non-compete provision and a Delaware choice of law provision.[100] The non-compete provision, however, would have been unenforceable by California statute.[101] After determining that California was the default state, the Court of Chancery held that a covenant made illegal "unequivocally by statute" could not be enforced in Delaware, which merely had a generalized policy and interest in comparison.[102] Central to that analysis was the rationale that parties cannot "contract[ ] around the law of *a default state* ... unless the second state also has a compelling interest in enforcement" beyond its pro-contractarian regime.[103]

Wind Point and *Ascension* reflect three guiding principles about invoking Restatement § 187(2)(b) successfully. *First,* a court will accord considerable weight to a sister state's competing position that is codified by statute.[104] Here, New York has not enacted a statute prohibiting insurance of restitution or disgorgement. *Second,* and by the same token, a sister state's stance should reflect a focused initiative—not a generalized objection.[105] Here, New York's indiscriminate common law refusal to reward restitution and disgorgement reflects a generalized objection, rather than a focused initiative.[106] *Third,* if Delaware would *not* be the default state, then its enforcement priorities should not be premised entirely on freedom of contract.[107] Here, Delaware is the default state. Even if it was not, Sycamore is a Delaware-organized group of investment funds facing recoupment claims for wrongdoing attributable to Delaware fiduciaries under corporate-wide management liability insurance policies that permit Sycamore to select Delaware's courts for hearing its coverage disputes. This Court's D&O jurisprudence aside, those contacts indicate more than a generalized Delaware interest in the Policies. And, Delaware law, not New York law, would determine whether Sycamore's managers breached a fiduciary duty or are entitled to indemnification for a derivative suit.[108] Delaware's interests in those particular issues are fundamental and enshrined by statute.[109] As a result, Delaware here is concerned with more than simply the freedom of contract.[110] This being so, New York's interest in preventing a Delaware enterprise from obtaining insurance in its chartering jurisdiction for misconduct by its fiduciaries is (at best) tangential.[111]

***11** Accordingly, because the Insurers fail to satisfy all elements, the Restatement § 187(2)(b) exception is unavailable, the law most favorable provision is enforceable, and Delaware law applies in determining whether the Nine West Settlement is uninsurable.

B. Under Delaware law, the Nine West Settlement is insurable.

"A court may not enforce an insurance provision that is contrary to public policy."[112] But in Delaware, losses are uninsurable as-against public policy only if the legislature so provides.[113] As the Supreme Court has cautioned, public policy is the General Assembly's domain, and judges should avoid the temptation to legislate from the bench.[114] Following these instructions, this Court has declined invitations to apply judicially-fashioned policy limitations.[115] Consistent with that precedent, the Court will not hold that restitution or disgorgement is uninsurable as a matter of Delaware public policy unless a Delaware statute commands it to do so.[116]

There is no such Delaware statute. Recognizing this, the Insurers resort to relying on Delaware's anti-fraudulent conveyance statute,[117] from which they urge the Court to infer the General Assembly's intent to make restitution or disgorgement uninsurable. That argument fails.

As an initial matter, the Court cannot infer a public policy against certain insurance from a statute of general applicability. Indeed, the Court "will not void ... a valid insurance contract as contrary to public policy in the absence of *clear indicia* that such a policy actually exists."[118] There is a practical reason for this constraint. If courts understood every statute prohibiting conduct also to preclude insurance for any remedies associated with that conduct, there would be little or nothing left to insure.

More importantly, all the anti-fraudulent conveyance statute proves is that fraudulent conveyances are unlawful in Delaware.[119] Its enactment does not render *insuring* against clawback claims for which restitution or disgorgement might be exacted contrary to Delaware public policy.[120] Indeed, there are numerous Delaware statutory and common laws the breaching of which could offer relief akin to restitution or disgorgement. Those laws, however, do not automatically make insurance for that relief contrary to public policy. Delaware has a strong public policy against fraud,[121] but nevertheless permits insurance against fraud claims.[122] Similarly, polluting the environment is against Delaware public policy,[123] but insuring cleanup costs is not.[124] And criminal behavior is against Delaware public policy,[125] but insuring a defense of corporate fiduciaries charged with criminal conduct is not.[126] In Delaware—unless the General Assembly directs otherwise-permitting insurance of payments made to redress wrongdoing is not the same as condoning as a policy matter the wrongdoing those payments redress.[127]

***12** To be sure, insurance companies are not required to cover restitution or disgorgement. This opinion does not suggest otherwise. Insurance companies are free to sell insurance that expressly excludes coverage for cases in which restitution or disgorgement damages or settlements are obtained. In fact, that is what the Insurers tried to do in these Policies,[128] but they cabined the exclusion to cases in which a claimant obtained a "final, non-appealable" decision in the underlying litigation establishing that Sycamore gained personal profit or remuneration to which it was not entitled.[129] Faced with their own contractual limitation, the Insurers challenge Sycamore's Loss —indisputably a "settlement"[130]—as "uninsurable," not as a Policies-excluded unlawful gain. The Nine West Settlement, however, is insurable under Delaware law, and the Insurers' Uninsurability Defense therefore fails as a matter of Delaware law.[131]

CONCLUSION

For the foregoing reasons, Sycamore's motion for partial judgment on the pleadings is **GRANTED,** and judgment is entered against the Insurers only as to the Uninsurability Defense.

IT IS SO ORDERED.

All Citations

Not Reported in Atl. Rptr., 2021 WL 761639

Footnotes

1 The five other named defendants settled before this decision and have been dismissed with prejudice. *See* Dismissal Stipulation Orders (D.I. 46, 150, 158).

2 *See generally* Endurance Primary and Insurers' Excess Insurance Policies, Exhibits 1-11 (D.I. 128) (hereinafter, "Policies").

3 *See generally id.* Exhibits 2-11. Because the Insurers' excess Policies follow form to the primary agreement, the Court cites to the primary agreement when referencing the Policies.

4 *Id.* § I.O(1); *see id.* § I.O (defining Loss before providing the law most favorable clause).

5 *Id.* Exclusions, § IV.A(1)(b).

6 *Id.* § IV.A(1).

7 Exhibit A, Nine West Chapter 11 Plan at 21-25 (D.I. 134) (hereinafter, "NW Plan").

8 *Id.* at 22-23.

9 *Id.* at 23-25 & n.11.

10 *Id.* at 23-25.

11 *Id.*

12 *Id.* at 25-28.

13 *Id.* at 39-55; Amended Complaint ¶¶ 45-46 (D.I. 47) ("Compl.")

14 Compl. ¶¶ 48-50.

15 *See generally* Compl.

16 Compl. ¶¶ 57-77.

17 *Id.* Prayer for Relief. Sycamore also requests coverage declarations

18 *See* Starr Indemnity & Liability Company's Answer and Affirmative Defenses at Affirmative Defenses ¶ 31 (D.I. 63); Argonaut Insurance Company's Answer and Affirmative Defenses at Affirmative Defenses ¶¶ 9-10 (D.I. 61); Markel American Insurance Company's Answer and Affirmative Defenses at Affirmative Defenses ¶ 5 (D.I. 60); Ironshore Indemnity Inc.'s Answer and Affirmative Defenses at Affirmative Defenses ¶ 5 (D.I. 59); Great American Insurance Company's Answer and Affirmative Defenses at Affirmative Defenses ¶ 7 (D.I. 54).

19 D.I. 126.

20 Sycamore's Opening Brief (D.I. 127) ("Op. Br."); Insurers' Answering Brief (D.I. 134) ("Ans. Br."); Sycamore's Reply Brief (D.I. 136) ("Reply"); D.I. 143.

21 Op. Br. at 13-14; Reply at 3-13.

22 *Id.*

23 Op. Br. at 16-20; Reply at 16-20.

24 *Id.*

25 *Id.*

26 Op. Br. at 14-15; Reply at 13-16.

27 Op. Br. at 20-24; Reply at 20-24.

28 Ans. Br. at 14-15.

29 *Id.* at 15-23.

30 *Id.* at 24-26.

31 *Id.* at 26-27.

32 *Id.* at 27-31.

33 *See* Del. Super. Ct. Civ. R. 12(c).

34 *See Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P.,* 624 A.2d 1199, 1205 (Del. 1993); *Northrop Grumman Innovation Sys., Inc. v. Zurich Am. Ins. Co.,* 2021 WL 347015, at *6 (Del. Super. Ct. Feb. 2, 2021) (citing *Indian Harbor Ins. Co. v. SharkNinja Operating LLC,* 2020 WL 6795965, at *2 (Del. Super. Ct. Nov. 19, 2020)).

35 *Catlin Specialty Ins. Co. v. CBL & Assocs. Props., Inc.,* 2017 WL 4784432, at *6 (Del. Super. Ct. Sept. 20,2017) (citing *Desert Equities,* 624 A.2d at 1205); *see SharkNinja,* 2020 WL 6795965, at *2 ("[T]he standard for motion for judgment on the pleadings is almost identical to the standard for a motion to dismiss under Rule 12(b)(6)." (internal quotation marks omitted)); *see also Incyte Corp. v. Flexus Biosciences, Inc.,* 2017 WL 7803923, at *1-2 (Del. Super. Ct. Nov. 1, 2017) (importing same liberal construction into review of motion for "partial" judgment on the pleadings).

36 *V&M Aerospace LLC v. V&M Co.,* 2019 WL 3238920, at *3 (Del. Super. Ct. July 18, 2019) (citations omitted).

37 *Pfizer Inc. v. Arch Ins. Co.,* 2019 WL 3306043, at *6 (Del. Super. Ct. July 23, 2019).

38 *See, e.g., Shook & Fletcher Asbestos Settlement Tr. v. Safety Nat'l Cas. Corp.,* 2005 WL 2436193, at *2 (Del. Super. Ct. Sept. 29, 2005), *aff'd,* 909 A.2d 125 (Del. 2006).

39 *Pfizer,* 2019 WL 3306043, at *6 (citing *Certain Underwriters at Lloyds, London v. Chemtura Corp.,* 160 A.3d 457, 464 (Del. 2017)); *accord Travelers Indem. Co. v. CNH Indus. Am., LLC,* 2018 WL 3434562, at *3 (Del. July 16, 2018).

40 *Pfizer,* 2019 WL 3306043, at *6 (citing *Chemtura,* 160 A.3d at 464).

41 *Id.*; *but see Deuley v. DynCorp Int'l Inc.,* 8 A.3d 1156, 1161 (Del. 2010) (observing choice-of-law analyses are unnecessary when conflict is false); *but see also IDT Corp. v. U.S. Specialty Ins. Co.,* 2019 WL 413692, at *6 (Del. Super. Ct. Jan. 31, 2019) ("Delaware courts recognize that, where possible, a court should avoid a choice-of-law analysis altogether if the result would be the same under the law of either of the competing jurisdictions." (citations omitted)).

42 *See, e.g., Change Cap. Partners Fund I, LLC v. Volt Elec. Sys., LLC,* 2018 WL 1635006, at *4-9 (Del. Super. Ct. Apr. 3, 2018) (collecting and discussing authority).

43 *NACCO Indus., Inc. v. Applica Inc.,* 997 A.2d 1, 35 (Del. Ch. 2009); *accord Swipe Acquisition Corp. v. Krauss,* 2021 WL 282642, at *2 (Del. Ch. Jan. 28, 2021) ("Upholding freedom of contract is a fundamental policy of this state." (internal quotation marks omitted)).

44 *See, e.g., Swipe,* 2021 WL 282642, at *2; *Abry Partners V, L.P. v. F & W Acquisition LLC,* 891 A.2d 1032, 1048-50, 1059-61 (Del. Ch. 2006).

45 *See Change Cap.,* 2018 WL 1635006, at *4 ("[Delaware] 'courts will enforce the contractual scheme that the parties have arrived at through their own self-ordering, both in recognition of a right to self-order and to promote certainty of

obligations.' " (quoting *Ascension Ins. Holdings, LLC v. Underwood,* 2015 WL 356002, at *4 (Del. Ch. Jan. 28, 2015))); *see NACCO,* 997 A.2d at 35 ("Delaware law generally elevates contract law ... to allow parties to order their affairs and bargain for specific results....").

46 *See Chemtura,* 160 A.3d at 464; *Focus Fin. Partners, LLC v. Holsopple,* 241 A.3d 784, 805 (Del. Ch. 2020) (citing *Restatement (Second) of Conflict of Laws* § 188 (1971)) (hereinafter, "*Restatement*") (observing that "justified expectations" are central to a contractual choice-of-law analysis); *Abry Partners,* 891 A.2d at 1048 ("Parties operating in interstate ... commerce seek, by a choice of law provision, certainty as to the rules that govern their relationship." Frustrating that choice "would create uncertainty of precisely the kind that the parties' choice of law provision sought to avoid." (citation omitted)).

47 *Change Cap.,* 2018 WL 1635006, at *4 (internal quotation marks omitted).

48 *Restatement* §§ 187(2)(a)-(b).

49 Policies, General Definitions § I.O(1).

50 *See Restatement* § 187(2)(a) (requiring a "reasonable basis" for the choice); *accord Holsopple,* 241 A.3d at 803-04.

51 6 *Del. C.* § 2708(a); *Change Cap.,* 2018 WL 1635006, at *4 ("Title 6, section 2708(a) of the Delaware code recognizes that a choice of law clause is a significant, material and reasonable relationship with this State and shall be enforced whether or not there are other relationships with this State." (internal quotation marks omitted)); *see FdG Logistics LLC v. A&R Logistics Holdings, Inc.,* 131 A.3d 842, 855 (Del. Ch. 2016) ("At its core, Section 2708 is intended to provide certainty to parties who are subject to jurisdiction in Delaware that their choice of Delaware law regarding the construction and enforceability of their contracts will be respected."), *aff'd,* 148 A.3d 1171 (Del. 2016).

52 *Restatement* § 187(2) ("The law of the state chosen by the parties to govern their contractual rights and duties will be applied" unless shown that the choice is not reasonable or is unenforceable).

53 *See Holsopple,* 241 A.3d at 804 (citing *Restatement* § 187 cmt. f); *see also Change Cap.,* 2018 WL 1635006, at *8 (observing that when an entity is chartered in Delaware, that entity's choice of Delaware law confirms a substantial relationship).

54 *Change Cap.,* 2018 WL 1635006, at *4 (internal quotation marks omitted).

55 1994 WL 721651 (Del. Super. Ct. Mar. 28, 1994).

56 Ans. Br. at 14-15.

57 *Hoechst,* 1994 WL 721651, at *1. Unlike that clause, however, the law most favorable provision is unambiguous. *Hoechst,* then, is doubly inapposite.

58 *Id.* ("[T]he phrase refers to the entire law of the forum, including the forum's choice of law principles."). The court also approached the issue at a time when Delaware courts "recently held that a [service-of-suit] clause is not a choice of law provision." *Id.* at *2.

59 *Id.* at *1 ("If the drafters ... had intended the local law of the forum chosen by the insured to apply ... they would have included the terms 'local law' or 'substantive law' in the ... clause."). Contrary to the Insurers' position, the court's reference to "forum shopping" came only after it held the provision did not cover substantive law. *See id.* ("*To hold otherwise,* [*i.e.*, that the insured had a right not provided in the agreement], would allow ... forum shopping." (emphasis added)). Here, in contrast, the law most favorable provision plainly means "substantive law most favorable." *See* Policies, General Definitions § I.O(1) (providing that the law most favorable should determine any uninsurable exceptions to the Loss definition).

60 160 A.3d 457.

61 Ans. Br. at 15 (emphasis omitted).

62 *See Chemtura,* 160 A.3d at 464 ("The Superior Court correctly observed that the insurance policies did not specify a particular state law." (citation omitted)).

63 *See id.* at 464-69.

64 948 A.2d 1285 (N.J. 2008).

65 *Id.* at 1289, 1293.

66 2011 WL 4409170 (D.N.J. Sept. 21, 2011).

67 *Id.* at *5 (internal quotation marks and citations omitted).

68 *Change Cap.,* 2018 WL 1635006, at *6 (citing *Ascension,* 2015 WL 356002, at *3); *accord Wind Point Partners VII-A, L.P. v. Insight Equity A.P. X Co., LLC,* 2020 WL 5054791, at *19 (Del. Super. Ct. Aug. 17, 2020).

69 *Change Cap.,* 2018 WL 1635006, at *9 (citing *Libeau v. Fox,* 880 A.2d 1049, 1058 (Del. Ch. 2005)) (internal quotation marks omitted), *rev'd on other grounds,* 892 A.2d 1068 (Del. 2006).

70 *Change Cap.,* 2018 WL 1635006, at *8 (internal quotation marks omitted).

71 *See Abry Partners,* 891 A.2d at 1049-50; *accord Lyons Ins. Agency Inc., v. Work,* 2020 WL 429114, at *1 (Del. Ch. Jan. 28, 2020) ("Delaware law in general recognizes that the value of contracts is maximized by enforcing them as written [and that] little value can come of a promise that can be avoided upon the remorse of the maker thereof.").

72 *Change Cap.,* 2018 WL 1635006, at *9 (citing *Libeau,* 880 A.2d at 1058) (internal quotation marks omitted).

73 *See* Ans. Br. at 15-17; *Restatement* § 187(2)(b) (directing courts to consider § 188 factors in determining which state's laws would apply absent an effective choice of law provision).

74 *See, e.g., Northrop,* 2021 WL 347015, at *16-17; *Ferrellgas Partners L.P. v. Zurich Am. Ins. Co.,* 2020 WL 363677, at *4 & n.42 (Del. Super. Ct. Jan. 21, 2020), *appeal refused sub nom., Beazley Ins. Co. Inc. v. Ferrellgas Partners L.P.,* 249 A.3d 408 (Del. 2020); *Pfizer,* 2019 WL 3306043, at *8; *IDT Corp.,* 2019 WL 413692, at *6-7; *Arch Ins. Co. v. Murdock,* 2018 WL 1129110, at *10-11 (Del. Super. Ct. Mar. 1, 2018); *Mills Ltd. P'ship v. Liberty Mut. Ins. Co.*, 2010 WL 8250837, at *5-6 (Del. Super. Ct. Nov. 5, 2010).

75 *Pfizer,* 2019 WL 3306043, at *7-8; *see Murdock,* 2018 WL 1129110, at *10-11 (state of incorporation is the default state in D&O insurance context); *see also Mills,* 2010 WL 8250837, at *6 ("In a case [where a Delaware firm purchases D&O policies for the benefit of its managers,] what difference does headquarters' location make to the company or people involved?").

76 *See Pfizer,* 2019 WL 3306043, at *7-8.

77 *Cf. id.* at *6-8 (evaluating *Restatement* § 188 factors in the absence of a choice of law provision and concluding the presence of a D&O insurance policy and the insured's Delaware incorporation status diminished New York's—but strengthened Delaware's—contacts to the litigation).

78 *See Northrop,* 2021 WL 347015, at *16-17; *IDT Corp.,* 2019 WL 413692, at *6-7; *Murdock,* 2018 WL 1129110, at *10-11; *Mills,* 2010 WL 8250837, at *6. For this reason, even if the law most favorable provision were not a choice of law clause, Delaware law would have the most significant relationship to the policies. *See Northrop,* 2021 WL 347015, at *16-17; *Pfizer,* 2019 WL 3306043, at *6-8.

79 Ans. Br. at 18-19.

80 NW Plan at 39-55.

81 Ans. Br. at 8.

82 *Murdock,* 2018 WL 1129110, at *9 (observing that D&O insurance is implicated whenever "the directors' and officers' 'honesty and fidelity' " to a Delaware corporation has been challenged (quoting *Mills,* 2010 WL 8250837, at *6)); *accord Northrop,* 2021 WL 347015, at *16 ("[P]redictability for and the justified expectations of Delaware firms are vindicated when their state of incorporation resolves questions about the 'honesty and fidelity' of their Delaware officials[.]" (citations omitted)); *IDT Corp.,* 2019 WL 413692, at *6; *see* 8 *Del. C.* § 145 (enabling Delaware entities to purchase insurance for their fiduciaries and making indemnification mandatory in certain cases).

83 *See Pfizer,* 2019 WL 3306043, at *8 ("[W]hen applying the ... *Restatement* to a corporate-wide insurance program, 'the inquiry should center on the insurance contracts and not the underlying claims.' " (quoting *CNH Indus.,* 2018 WL 3434562, at *1)).

84 *See Northrop,* 2021 WL 347015, at *17; *see also Pfizer,* 2019 WL 3306043, at *8 ("Where D&O coverage is at issue 'and the choice of law is between the headquarters and state of incorporation, the state of incorporation has the most significant relationship.' " (quoting *Murdock,* 2018 WL 1129110, at *9)).

85 *See, e.g., Wind Point,* 2020 WL 5054791, at *19 (Party must demonstrate clearly default state, fundamental public policy, and materially greater interest elements "in order to invoke the [*Restatement*] § 187(2)(b) exception." (citation omitted)).

86 Ans. Br. at 19-26.

87 *See, e.g., Holsopple,* 241 A.3d at 820 ("Whether a policy is 'fundamental' involves a case-specific analysis." (citing *Restatement* § 187 cmt. g)); *cf. Restatement* § 188(2) (listing factors for determining the default state but not for determining whether a policy is fundamental, or an interest is materially greater under § 187(2)(b)).

88 *See Change Cap.,* 2018 WL 1635006, at *4, *9; *see also Geo-Tech. Assocs., Inc. v. Cap. Station Dover, LLC,* 2020 WL 2557139, at *3 (Del. Super. Ct. May 15, 2020) ("[Delaware] courts will not interfere unless ... a public policy interest [is] even stronger than the freedom of contract." (internal quotation marks omitted)).

89 *Change Cap.,* 2018 WL 1635006, at *5 (citing *J.S. Alberici Constr. Co., Inc., v. Mid-W. Conveyor Co., Inc.,* 750 A.2d 518, 520 (Del. 2000)) (internal quotation marks omitted).

90 *See Holsopple,* 241 A.3d at 812, 821; *Ascension,* 2015 WL 356002, at *5.

91 *See Holsopple,* 241 A.3d at 820 (citing *Restatement* § 187 cmt. g); *Swipe,* 2021 WL 282642, at *3-7 (finding California materially more interested where a California statute prohibited contractual waivers of rights afforded investors); *Wind Point,* 2020 WL 5054791, at *19-20 (finding Texas materially more interested where a Texas statute prohibited contractual waivers of rights afforded investors); *Ascension,* 2015 WL 356002, at *2 (finding California materially more interested where California statute invalidated the specific non-compete provision at issue).

92 *See Change Cap.*, 2018 WL 1635006, at *7 (applying Delaware law although the outcome would have been usurious under a Texas statute).

93 *Restatement* § 187(2)(b).

94 2020 WL 5054791.

95 *Id.* at *18-21.

96 *Id.* at *19-20 (quoting statutory language and characterizing it as a "fundamental policy").

97 *Id.*

98 *Id.* at *20. The Court of Chancery, following *Wind Point*, recently reached the same conclusion. In *Swipe Acquisition Corp. v. Krauss,* the same Delaware securities statute at issue in *Wind Point* was pitted against a California securities statute that invalidated any choice of law provision that effectively would eliminate California investors' statutory rights. As a result, the Court declined to enforce the Delaware choice of law provision at issue, which would have worked a waiver of the very type California specifically disapproved. *See Swipe*, 2021 WL 282642, at *5-7.

99 2015 WL 356002.

100 *Id.* at *1-2.

101 *Id.* at *2-3.

102 *Id.* at *5.

103 *Id.* (emphasis added).

104 *See Wind Point,* 2020 WL 5054791, at *19 (citing the Texas securities statute and Texas caselaw interpreting it in concluding Texas's investor-protection policy was fundamental); *Ascension,* 2015 WL 356002, at *2 (finding it critical that California employment policy was "not a common-law" development but was "enshrined in statute").

105 *See Wind Point,* 2020 WL 5054791, at *19-20 (contrasting negatively Delaware's general disdain for securities fraud with Texas's specialized statutory interest in "protect[ing] Texas residents" from illegal "interstate securities transactions" "emanating from Texas" (internal quotation marks and citations omitted)); *Ascension,* 2015 WL 356002, at *5 ("The performance of a covenant not to compete is against a clear public policy of California stated unequivocally by statute. Against this is a general [though, to the Court, "significant"] interest of Delaware in freedom of contract.").

106 *Cf. Wind Point,* 2020 WL 5054791, at *19-20 (reviewing focused anti-contractual waiver statute); *Ascension,* 2015 WL 356002, at *2-5 (reviewing focused anti-non-compete statute); *Change Cap.,* 2018 WL 1635006, at *5 ("A mere difference between the laws of two states will not necessarily render the enforcement of a cause of action arising in one state contrary to the public policy of another." (citing *J.S. Alberici,* 750 A.2d at 520) (internal quotation marks omitted)).

107 *See Wind Point,* 2020 WL 5054791, at *18-19 (citing Delaware's pro-contractarian interests but nevertheless finding Texas's clear statutory prohibition on remedial waivers to be more fundamental); *Ascension,* 2015 WL 356002, at *5 (When the "formation and enforcement of the contract relate overwhelmingly *to the default state,* a general interest in the freedom of contract is unlikely to be the equal of that public policy...." (emphasis added)) *see also Wind Point,* 2020 WL 5054791, at * 19 (holding Texas was the default state before diminishing weight of Delaware's pro-contractarian interests); *Ascension,* 2015 WL 356002, at *3 (holding California was the default state before diminishing weight of Delaware's pro-contractarian interests).

108 *See IDT Corp.,* 2019 WL 413692, at *6-7 ("Delaware law ultimately determines whether a director or officer of a Delaware corporation breaches his or her fiduciary duties." (internal quotation marks and citations omitted)); *Murdock,* 2018 WL 1129110, at *11 (same).

109 *See* 8 *Del. C.* § 144(a) (enumerating standards of review for self-dealing claims); 8 *Del. C.* § 145(g) (authorizing corporations to purchase insurance for fiduciaries "against any liability asserted ... in any ... capacity, or ... status ... whether or not the corporation would have the power to indemnify" the fiduciary otherwise); *see also Murdock,* 2018 WL 1129110, at * 11 (citing 8 *Del. C.* § 145(g)); *Mills,* 2010 WL 8250837, at *6 (citing 8 *Del. C.* § 145(g)).

110 *Cf. Ascension,* 2015 WL 356002, at *5 (finding no non-contractarian Delaware interest).

111 *See Mills,* 2010 WL 8250837, at *6 (observing that a sister state's interest "in whether Delaware corporations insure their directors and officers" is "indirect" and not overriding).

112 *Murdock,* 2018 WL 1129110, at *11 (citation omitted).

113 *See Jones v. State Farm Mut. Auto. Ins. Co.,* 610 A.2d 1352, 1354 (Del. 1992); *Whalen v. On-Deck, Inc.,* 514 A.2d 1072, 1074 (Del. 1986).

114 *See Jones,* 610 A.2d at 1354 (noting that "the General Assembly is the proper forum to seek a change" if insurance covers unsavory acts not excluded bilaterally (citation omitted)); '*Whalen,* 514 A.2d at 1074 (holding punitive damages were not uninsurable because the legislature did not "formulate[ ]" a "public policy ... against such insurance").

115 *See, e.g., Murdock,* 2018 WL 1129110, at *11 (holding fraud damages were not uninsurable in the absence of legislation rendering them uninsurable); *Wilson v. Chem-Solv, Inc.,* 1988 WL 109375, at *1 (Del. Super. Ct. Oct. 14, 1988) (holding environmental pollution damages were not uninsurable in the absence of legislation rendering them uninsurable).

116 Because the Insurers are entitled to favorable inferences, the Court assumes for purposes of this review that the Nine West Settlement constitutes restitution or disgorgement. *See, e.g., CBL & Assocs.,* 2017 WL 4784432, at *6 (affording party opposing 12(c) motion the same benefits afforded parties opposing 12(b)(6) motions).

117 *See, e.g.,* 6 *Del. C.* § 1304.

118 *Whalen,* 514 A.2d at 1074 (emphasis added).

119 *See* 6 *Del. C.* §§ 1307(a)-(b) (outlining creditor remedies for fraudulent transfers).

120 *See Wilson,* 1988 WL 109375, at *1 (Delaware's anti-pollution statutes "impose[ ] civil penalties with regard to hazardous waste disposal. [They] do not prohibit insurance coverage for [those] civil penalties.") (citing 7 *Del. C.* §§ 6309(b), 6005(b)).

121 *See, e.g., Surf's Up Legacy Partners, LLC v. Virgin Fest, LLC,* 2021 WL 117036, at *11 & n.142 (Del. Super. Ct. Jan. 13, 2021) (collecting cases in which Delaware courts have refused to enforce contracts immunizing intentional fraud).

122 *See Murdock,* 2018 WL 1129110, at *11.

123 *See* 7 *Del. C.* §§ 6309(b), 6005(b) (providing strict liability for environmental torts).

124 *See Wilson,* 1988 WL 109375, at *1.

125 *See generally* 11 *Del. C.* §§ 101 *et seq.*

126 *See, e.g.,* 8 *Del. C.* § 145(a) (authorizing Delaware corporations to indemnify fiduciaries who are convicted of a crime as long as the fiduciary "had no reasonable cause to believe [the] conduct was unlawful"); *see also Hermelin v. K-V Pharm. Co.,* 54 A.3d 1093, 1108 (Del. Ch. 2012) (explaining that a corporation is required to indemnify a fiduciary's defense fees when the fiduciary obtains "anything less than a conviction") (citing 8 *Del. C.* § 145(c)).

127 *See Murdock,* 2018 WL 1129110, at *12 ("Although it may strain public policy [against fraud] to allow a [tortfeasor] to collect insurance on a fraud, it does not appear to [be] explicitly prohibited by Delaware statutory law.").

128 Policies, Exclusions, § IV.A(1)(b) (excluding coverage for unlawful gains).

129 *Id.* § IV.A(1).

130 *See* Ans. Br. at 10 (conceding that Sycamore "settled for $120 million"); Policies, General Definitions § I.O (defining "Loss" to include "settlements" and carving out "amounts" that are "uninsurable under the law most favorable to ... insurability"); Compl. ¶¶ 48-50; *see also Desert Equities,* 624 A.2d at 1205 (Court treats "well-pleaded facts alleged in the complaint as admitted" on Rule 12(c) review).

131 Because the Court has concluded that the Nine West Settlement is insurable under Delaware law, it is unnecessary to address Sycamore's argument that the Policies would not exclude the Nine West Settlement's coverage even if Delaware law prohibited the Settlement's coverage.

End of Document

22

840 A.2d 624
Supreme Court of Delaware.

TWIN CITY FIRE INSURANCE COMPANY, Defendant Below, Appellant,
v.
DELAWARE RACING ASSOCIATION and Delaware Park LLC, Plaintiffs Below, Appellees.

No. 373,2003.
|
Submitted: Nov. 18, 2003.
|
Decided: Dec. 29, 2003.

Synopsis

Background: Horse track owners brought action against excess liability insurer that had applied athletic activity exclusion to claim arising out of riders' injuries during a "breeze" to exercise racehorses and accustom them to running in close proximity to one another. The Superior Court, New Castle County, entered summary judgment in favor of owners. Insurer appealed.

[Holding:] The Supreme Court, Jacobs, J., held as a matter of first impression that the riders were not practicing or participating in horseracing, and, thus, the exclusion did not apply.

Affirmed.

West Headnotes (11)

[1] Appeal and Error Construction, interpretation, and application in general

The Supreme Court reviews, de novo, rulings that involve the interpretation of contract language, including policies of insurance.

8 Cases that cite this headnote

[2] Appeal and Error De novo review

The Supreme Court reviews de novo a decision granting summary judgment.

[3] Contracts Language of contract

Under standard rules of contract interpretation, a court must determine the intent of the parties from the language of the contract.

36 Cases that cite this headnote

[4] Contracts Existence of ambiguity

Contract language is ambiguous if it is reasonably susceptible of two or more interpretations or may have two or more different meanings.

29 Cases that cite this headnote

[5] Contracts Language of Instrument

Where no ambiguity exists, the contract will be interpreted according to the ordinary and usual meaning of its terms.

20 Cases that cite this headnote

[6] Insurance Common Exclusions

Horse riders were not "participating in horseracing" during a "breeze" to exercise racehorses, and, thus, athletic activity exclusion in track owners' excess liability policy for injury while participating in horseracing did not apply to riders' injuries caused by stray horse; the purpose of the breeze ride was to exercise the horses and accustom them to running in close proximity to one another without being frightened, and the object was to keep them together, not win a prize.

[7] Insurance Common Exclusions

Horse riders were not "practicing horseracing" during a "breeze" to exercise racehorses and accustom them to running in close proximity to one another without being frightened, and,

thus, athletic activity exclusion in track owners' excess liability policy for injury while practicing horseracing did not apply to riders' injuries caused by stray horse; the term "practicing" was ambiguous as referring to an exercise designed to acclimate horses to actual racing conditions or practice for a race sponsored by the insured track owner, and construing the term against the insurer was thus warranted.

[8] **Contracts** Construction against party using words

Under the "contra proferentem principle of construction," ambiguities in a contract should be construed against the drafter.

26 Cases that cite this headnote

[9] **Insurance** Common Exclusions

Applying the contra proferentem rule to construe athletic activity exclusion of excess liability policy against insurer was appropriate with regard to whether horse riders were practicing horseracing during a "breeze" to exercise racehorses and accustom them to running in close proximity to one another without being frightened; the insurer could have defined "practicing" to include any person riding or driving a horse.

3 Cases that cite this headnote

[10] **Insurance** Common Exclusions

The term "practicing" in athletic activity exclusion in track owners' excess liability policy for injury while practicing horseracing referred to practice activities directly related to a scheduled race sponsored by owner.

2 Cases that cite this headnote

[11] **Insurance** Common Exclusions

The term "participating in," as used in athletic activity exclusion in track owners' excess liability policy for injury while participating in horseracing, covers cases where the rider is injured while actually participating (as a rider) in a race officially scheduled and sponsored by the owner.

***625** Court Below: Superior Court of the State of Delaware in and for New Castle County, C.A. No. 01C–12–051.
Upon appeal from Superior Court. AFFIRMED.

Attorneys and Law Firms

Joseph S. Naylor, Esquire, of Pepper Hamilton LLP, Wilmington, Delaware, for the Appellant.

James F. Burnett, Esquire, of Potter Anderson & Corroon LLP, Wilmington, Delaware, for the Appellees.

Before VEASEY, Chief Justice, BERGER and JACOBS, Justices.

Opinion

JACOBS, Justice.

Twin City Fire Insurance Company ("Twin City") appeals from an order of the Superior Court granting summary judgment in favor of Twin City's insureds, Delaware Park Racing Association and Delaware Park, LLC,[1] and denying Twin City's cross motion for summary judgment. In ruling for Delaware Park, the trial court held that the exclusion in Twin City's general liability excess policy for "Athletic Activity" did not encompass (and, therefore, that the Twin City policy covered) claims against Delaware Park for personal injuries sustained by three persons who were riding and/or exercising racehorses at Delaware Park.[2] We conclude, for the reasons next discussed, that the Superior Court ruling is correct in all respects and accordingly, we affirm.

Facts

On November 5, 1999, three "breeze riders," Eric L. Jones, Roberto Montiel, and ***626** Leah Waldman were injured during a "breeze" when a stray horse that had gotten loose collided with them, causing all horses and riders to fall. A "breeze" is a training exercise in which a horse is run out of a starting gate, usually timed at a speed to the horse's potential. The purpose of the breeze ride was to exercise the horses' muscles and to accustom the horses to running in close proximity to one another without being frightened. The riders

were not racing the horses, but, rather, were exercising them as part of a morning workout.

Jones and Montiel had been trained and employed as both exercise riders and jockeys. The third rider, Waldman, was employed only as an exercise rider. As a result of the collision, each of these three riders suffered personal injury and filed an action for damages against Delaware Park and others. The Waldman lawsuit was settled for $1.2 million, and the Jones and Montiel lawsuits remain pending. Twin City refused coverage of all these claims based on an exclusion in the excess policy that it had issued to Delaware Park.

By way of background, Delaware Park obtained its statutorily-required liability insurance coverage through Lowe–Tillson, an insurance broker that had represented Delaware Park for several years. Through Lowe–Tillson, Delaware Park renewed a two-tiered insurance plan in which CNA Insurance Company ("CNA") provided the primary coverage with limits of $1 million per occurrence, and Twin City provided the excess coverage in a secondary, umbrella policy having limit of $10 million per occurrence. Given those coverages, after the $1.2 million settlement was reached in the Waldman lawsuit, CNA contributed to that settlement its policy limits of $1 million, and Delaware Park then looked to Twin City to pay the $200,000 excess. Twin City denied coverage, based on an exclusion contained in its policy. The language of the exclusion upon which Twin Cities relied in denying coverage reads as follows:

> Description of Designated "Athletic Activity": HORSERACING.
>
> The policy does not apply to "bodily injury" to any person while practicing or participating in any "Athletic Activity" shown in the above Schedule. For the purposes of this endorsement, "Athletic Activity" means physical fitness activity including gym classes or similar activities; or a sports or athletic contest or exhibition that you [the insured] sponsor.[3]

Delaware Park then filed this coverage action in the Superior Court. After discovery, both sides filed cross motions for summary judgment. After finding that the Twin Cities policy covered the three underlying claims, the Superior Court granted Delaware Park's motion for summary judgment, and denied Twin Cities' cross motion. Twin Cities appealed from the order implementing those rulings.

Analysis

[1] **[2]** The issue presented on the summary judgment motions in the trial court was one of law: was the activity in which the breeze riders were engaged "horseracing" within the meaning of the above-quoted policy exclusion? The trial court answered that question in the negative. Twin City's appeal presents the identical issue. This Court reviews, *de novo,* rulings that involve the interpretation of contract language, including policies of insurance.[4] This Court also reviews *de novo* a ***627** decision granting summary judgment.[5] Because in this case all parties agreed that no material issue of fact precluded the entry of summary judgment, this Court's sole task is to determine and apply the principles of law that govern the interpretation of the parties' contract.[6]

In the trial court, Twin Cities claimed that coverage was excluded because the activity in which the breeze riders were engaged when they sustained their injuries (November 5, 1999) was "practicing or participating" in horse racing. The Court concluded that the breeze riders were clearly not "participating" in horse racing, because:

> No races were scheduled or took place on that date. At best, there was a conditioning or exercising, and learning to "ride in company." There was no evidence that the breeze riders ever rode the horses in question, in a race or otherwise, prior to that date. Indeed, Ms. Waldman was not considered to be a jockey and presumably couldn't participate in the formal horseracing presented at Delaware Park.[7]

That ruling was not dispositive, however, because there remained the question of whether the breeze riders were "practicing" horse racing. On that issue the trial court found the policy language to be "poorly drafted" and ambiguous. Because of the ambiguity, the trial court applied both the *contra preferentem* rule of construction, which requires that the ambiguity be resolved against the drafter (here, Twin Cities), and also the rule of construction requiring that exclusions in statutorily required insurance policies be construed narrowly. Applying those rules of construction, the trial court interpreted the exclusion for "practicing" horse racing as encompassing "activities directly related to the presentation of a scheduled or ongoing race." Because the conditioning or general training activity in which the breeze riders were engaged did not fall within that category, the

breeze riders' personal injury claims were found to be covered under the Twin City policy.[8]

On appeal, Twin City claims that the trial court erred in three separate respects. First, Twin City argues that the court erroneously determined that the exclusion was ambiguous because under the exclusion's clear language, the breeze riders were "participating in" or "practicing" horseracing as a matter of law. Second, Twin Cities argues that even if the exclusion was ambiguous, the court nonetheless improperly construed the policy against Twin Cities under both the *contra preferentem* rule and the rule requiring narrow construction of insurance policy exclusions. Third, Twin Cities argues that even under a narrow construction of the exclusion, the result reached by the trial court was erroneous, because the court's interpretation of the policy effectively read the term "practicing" out of the exclusion.

These claims generate three issues: (1) Is the policy exclusion ambiguous? (2) If so, was the *contra preferentem* rule of construction and/or the rule requiring a narrow construction of the exclusion properly applicable in these circumstances? (3) If so, did the trial court nonetheless erroneously adopt an interpretation that effectively read the term "practicing" out of the exclusion? We address these issues in that order.

***628 1. Is the Exclusion Ambiguous?**

[3] **[4]** **[5]** Under standard rules of contract interpretation, a court must determine the intent of the parties from the language of the contract.[9] A determination of that kind will sometimes require the court to decide whether or not the disputed contract language is ambiguous. Contract language is ambiguous if it is "reasonably susceptible of two or more interpretations or may have two or more different meanings."[10] Where no ambiguity exists, the contract will be interpreted according to the "ordinary and usual meaning" of its terms.[11]

The analysis starts with the language of the policy exclusion, which relevantly states that "[t]his policy does not apply to 'bodily injury' to any person while *practicing or participating* in any "Athletic Activity" shown in the above Schedule."[12] The only "Athletic Activity" shown in the schedule is "HORSERACING." In fine print, "Athletic Activity" is also defined, *inter alia,* as a "sports or athletic contest or exhibition that you [the insured] sponsor." Because the policy excludes coverage both for "participating in" and for "practicing" horseracing, the question of whether or not the exclusion is ambiguous must be answered separately for each excluded activity.

[6] The trial court first held as a matter of law that the breeze riders were not participating in horseracing. That holding amounted to an implicit ruling that the term "participating in" horseracing was not ambiguous. We agree with both rulings. The Delaware Thoroughbred Racing Commission's *Rules of Racing for Delaware* define "racing" as a "running contest between horses, ridden by Jockeys, over a prescribed course, at a recognized meeting, during regular racing hours, for a prize."[13] It is undisputed that the "breeze" in which the breeze riders were engaged was not a contest, was not conducted during regular racing hours, and did not involve a prize. Nor was any ongoing race scheduled by Delaware Park taking place during the time that the breeze was occurring. The uncontroverted testimony of the breeze riders was that the activity in which they were engaged was not a race but a "morning workout" or "exercise."[14] The testimony also confirms that when a horse is breezed or exercised in company with other horses, the object is not to pull away from other horses and get to the finish line first, but instead to try to keep the horses close together.[15]

For these reasons, the trial court was correct in determining, as a matter of law, that the "breeze activity" in which the breeze riders were engaged at the time of their injury did not constitute "participating" in horseracing. That leads us to the second threshold issue, which is whether ***629** the exclusion term "practicing" to participate in horse racing was ambiguous.

[7] Regarding that issue, the trial court held—this time explicitly—that the term "practicing" was ambiguous. That conclusion was correct, because the disputed term is reasonably susceptible to two or more interpretations. One interpretation, advocated by Twin City, is that "practicing" refers to an exercise designed to acclimate *horses* to actual racing conditions. That interpretation is reasonable, because it can be argued that is what (*inter alia*) the "breeze" workout is intended to accomplish.

A second, but also reasonable, interpretation, advocated by Delaware Park, is that for the injury to be excluded from coverage, the *injured person* must be either (i) actually participating in a specific horse race sponsored by the insured (Delaware Park) or (ii) more pertinent to the issue here, *practicing* to participate in a horse race sponsored

by Delaware Park. That interpretation flows from Delaware Park's premise that the activity must be viewed from the perspective of the "*injured person,"* i.e., the rider, and not the horse, because the exclusion refers to bodily injury to a "*person* while practicing or participating in" horse racing. It also is based on the fine print definition of "Athletic Activity" as a "sports...contest or exhibition that you [the insured] sponsor."

Although the issue is one of first impression in Delaware, the trial court's conclusion that the exclusion language ("practicing" horse racing) is ambiguous, is supported by case law from other jurisdictions. In *Mountain States Mutual Casualty Co. v. Northeastern New Mexico Fair Ass'n,*[16] a jockey was injured by being thrown while galloping his horse around the track, when dogs that had strayed onto the track attacked the horse. Based on a policy exclusion that was virtually identical to the exclusion at issue here, the racetrack's liability insurer refused to defend or indemnify the racetrack owners against liability arising out of an underlying personal injury action filed by the jockey. The New Mexico Supreme Court found the exclusion ambiguous, and held that the jockey had not been "practicing" for the race merely by galloping the horse around the track, because trainers who were not jockeys often performed the same activity to exercise horses.

Similarly, in *Tropical Park, Inc. v. United States Fidelity and Guaranty Co.,*[17] a freelance jockey was injured while galloping a horse around the track. The insurer refused to indemnify or defend the racetrack owners in a resulting personal injury action by the jockey against the racetrack, again relying on a policy exclusion almost identical to the clause at issue here. Holding for the track owners, the court found that the horse was only being exercised, because it had not been run, nor was it scheduled to run, in any race at the time of the accident. Reasoning that the exclusion had to be interpreted from the perspective of the rider rather than the horse, the court found the jockey's activity comparable to that of a groomer whose job was to brush the horses.

The ambiguity of the exclusion in the present policy is perhaps best underscored by comparing its language to the exclusion language interpreted by the Louisiana Court of Appeal in *Colson v. Louisiana State Racing Commission.*[18] There, the court held that the policy endorsement ***630** excluded from coverage a claim by a jockey who had been injured in a practice race for horses that had never raced on a track. The disputed policy language in *Colson*, like the disputed language here, excluded "practicing for or participating in" horseracing; but the exclusion then went on to say:

> For the purposes of this endorsement any person 'practicing for or participating in' shall include any person riding or driving a horse for the purpose of warm-up, exercise, practice or race.[19]

Had the Twin City exclusion contained that language, that exclusion would have unambiguously covered the activities of the injured breeze riders in this case. The absence of that language underscores the correctness of the trial court's determination that the policy language excluding coverage for "practicing" horseracing, is ambiguous.

2. Did The Trial Court Correctly Apply The *Contra Preferentem* Rule of Construction?

[8] **[9]** Having found as a threshold matter an ambiguity in the policy exclusion, the trial court then applied the well-accepted *contra preferentem* principle of construction, which is that ambiguities in a contract should be construed against the drafter.[20] The second issue presented to us, which is one of law, is whether the trial court erred in applying that rule of construction to the Twin City policy exclusion. We conclude that the trial court did not err by interpreting the exclusion in accordance with that principle.

It is undisputed that neither Delaware Park nor its broker had any role in drafting the exclusion. Twin City was "the entity in control of the process of articulating the terms,"[21] and it was therefore the "obligation of the insurer to state clearly the terms of the policy."[22] This Court has held that "if the contract in such a setting is ambiguous, the principle of *contra preferentem* dictates that the contract must be construed against the drafter," and that "[c]onvoluted or confusing terms are the problem of the insurer...not the insured."[23]

Twin Cities rests its contrary argument upon our statement in *Kaiser Alum. Corp. v. Matheson* that the rule of *contra preferentem* should be a tool of last resort where the disputed language is "hopelessly ambiguous,"[24] i.e., cannot be resolved by resort to extrinsic evidence. This argument, based upon supposed evidence that was never placed before the trial court, is fatally inconsistent with Twin Cities' concession at the trial court level, that there were no material facts in dispute.

In addition, the argument ignores our statement in *Kaiser Aluminum* that application of the *contra preferentem* rule is particularly appropriate in cases where "alternative formulations indicate that these provisions could easily have been made clear."[25] As indicated in our discussion of *Colson* above, this is such a case. Indeed, in its Opinion, the trial court noted ***631** that Twin City, a member of the insurance industry, was presumably aware of the case law relating to athletic activity exclusions and could have chosen to use language that would have defined the phrase "any person while practicing or participating" to include "any person riding or driving a horse."[26]

We conclude, for these reasons, that the trial court's application of the *contra preferentem* rule to the exclusionary clause, resulting in the rejection of Twin City's interpretation and the acceptance of Delaware Park's, was legally correct.[27]

3. Did the Trial Court's Interpretation Of The Exclusion Language Render The Term "Practicing" Nugatory?

[10] Twin City's third, and final claim of error is that even if the exclusion is construed against the drafter, the interpretation adopted by the trial court was incorrect because it effectively reads the term "practicing" out of the contract. The trial court held that the term "practicing" referred to practice activities that were "directly related" to a scheduled race. That construction, Twin City argues, conflates the terms "participating in" and "practicing," and makes them redundant, in violation of the principle that where possible, a court should give effect to all contract terms.

[11] We disagree. The trial court's interpretation of the term "practicing [for] horseracing" was a reasonable construction of the policy language, which included in the definition of "Athletic Activity" a "sports or athletic contest or exhibition that you [the insured] sponsor." That definition envisions a horserace officially scheduled by Delaware Park, consistent with the definition of "racing" in the *Rules of Racing*. It therefore was reasonable for the trial court (1) to interpret the exclusion term "participating in" horseracing as covering cases where the rider is injured while actually participating (as a rider) in a race officially scheduled and sponsored by Delaware Park, and (2) to interpret the term "practicing" to encompass situations where a rider is injured while practicing to participate in an officially sponsored, scheduled horse race —in advance of that race.

Twin City has not attempted to explain in any reasoned way how or why that interpretation collapses the distinction between "participating" and "practicing," or otherwise renders those two terms redundant. We find Twin City's challenge on this ground lacking in merit.

Conclusion

For the foregoing reasons, the judgment of the Superior Court is affirmed.

All Citations

840 A.2d 624

Footnotes

1 Delaware Park Racing Association and Delaware Park, LLC are referred to collectively in this Opinion as "Delaware Park."

2 *Delaware Racing Association and Delaware Park, LLC,* C.A. No. 01C–12–051, 2003 WL 1605764 (Del.Super., Mar. 26, 2003) ("Opinion")

3 "Umbrella Liability Insurance Policy" effective April 1, 1999, Endorsement 3.

4 *ABB Flakt, Inc. v. Nat'l Union Fire Ins. Co.,* 731 A.2d 811, 816 (Del.1999).

5 *Id.*

6 *Pike Creek Chiropractic Center, P.A. v. Robinson,* 637 A.2d 418, 420 (Del.1994).

7 Opinion, at 2003 WL 1605764 *3 (footnotes omitted).

8 Opinion, at 2003 WL 1605764 *4.

9 *Kaiser Alum. Corp. v. Matheson,* 681 A.2d 392, 395 (Del.1996).

10 *Id. (citing Rhone–Poulenc Basic Chems. Co. v. American Motorists Ins. Co.,* 616 A.2d 1192, 1196 (Del.1992)).

11 *Rhone–Poulenc,* 616 A.2d at 1195.

12 A–41 (italics added).

13 Delaware Thoroughbred Racing Commission, *Rules of Racing for Delaware* ("*Rules of Racing* "), Rule 1.42.

14 A–66 (Waldman Dep. at 28); B–32 (Jones Dep. at 8); B–7 (Montiel Dep. at 7). Rule 1.63 of the *Rules of Racing* defines "workout" as a "training exercise of a horse on the training or main track of a [racetrack] during which such horse is timed for speed over a specified distance".

15 A–76–A77 (Waldman Dep. at 60–62); A–93 (Jones Dep. at 69).

16 84 N.M. 779, 508 P.2d 588 (1973).

17 357 So.2d 253 (Fla.Dist.Ct.App.1978).

18 726 So.2d 432 (La.Ct.App.1999).

19 *Id.* at 433–434.

20 *Kaiser Alum. Corp. v. Matheson,* 681 A.2d at 398 (*citing* Restatement (Second) of Contracts § 206 (1981); Arthur L. Corbin, *et al., Corbin on Contracts,* § 559, supp. at 337 (1960 & Supp.1996).

21 *Penn Mutual Life Ins. Co. v. Oglesby,* 695 A.2d 1146, 1150 (Del.1997)

22 *Id.* at 1149.

23 *Id.* at 1150.

24 681 A.2d at 398–399.

25 *Id.* at 399.

26 Opinion at 2003 WL 1605764 *3 and n. 20.

27 Given that disposition, we do not reach Twin City's alternative argument that the trial court erred in applying the rule requiring a narrow construction of exclusions from statutorily-mandated policy coverage.

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2019 WL 4668350
Only the Westlaw citation is currently available.

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

WILLIAMS FIELD SERVICES GROUP, LLC, Plaintiff,

v.

CAIMAN ENERGY II, LLC; Encap Flatrock Midstream Fund II, L.P.; Encap Energy Infrastructure Fund, L.P.; TT-EEIF Co-Investments, LLC; UT EEIF Side Car, LLC; LIC-EEIF Sidecar, LLC; Oaktree Capital Management, L.P.; Highstar IV Caiman II Holdings, LLC; FR BB Holdings L.L.C.; Jack M. Lafield; Richard D. Moncrief; Stephen L. Arata; William R. Lemmons, JR.; Dennis F. Jaggi; Steven Gudovic; and Blue Racer Midstream, LLC, Defendants.

C.A. No. 2019-0350-JTL
|
Date Submitted: July 29, 2019
|
Date Decided: September 25, 2019

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MEMORANDUM OPINION

LASTER, V.C.

***1** This post-trial decision addresses the parties' competing requests for declaratory judgments that interpret the currently operative limited liability company agreement of Caiman Energy II, LLC ("Caiman II"). The parties agree that the LLC agreement gives EnCap Capital Management ("EnCap") the sole and exclusive right to cause Caiman II to approve an initial public offering that meets the definition of a "Qualified IPO." They further agree that the LLC agreement gives EnCap the sole and exclusive right to take any action that is "required or necessary to facilitate" a Qualified IPO. Their superficial agreement on these realities masks a fundamental disagreement on the scope of authority that these provisions confer.

The defendants read the provisions as granting plenary authority to EnCap in connection with a Qualified IPO, including the power to modify the definition of a Qualified IPO and to alter steps that the LLC agreement otherwise would require in connection with a Qualified IPO. Using the expansive authority that the defendants contend it possesses,

EnCap has proposed an intricate, multi-step reorganization that will culminate in what the parties describe as an "Up-C IPO." EnCap's proposed transaction, however, is far more complex than a standard Up-C IPO. Among other things, it will invert the Caiman II entity structure, transforming Caiman II from its current status as the top-tier entity into a post-IPO role as the lowest-tier subsidiary. The defendants contend that EnCap has the authority to implement its Up-C IPO.

The plaintiff reads the same provisions narrowly as granting, at best, limited authority to EnCap to approve what the LLC agreement defines as a Qualified IPO, and then to take actions that are necessary to achieve an IPO that meets the contractual definition. As the plaintiff sees it, EnCap cannot amend the definition of a Qualified IPO or evade otherwise mandatory steps for pursuing a Qualified IPO. More broadly, the plaintiff contends that EnCap cannot take action that would conflict with veto rights that the plaintiff possesses under other sections in the LLC agreement. The plaintiff concludes that EnCap lacks the authority to implement its Up-C IPO.

This decision interprets the plain language of the LLC agreement differently than either of the extreme positions taken by the parties. This decision concludes that EnCap has the power to implement certain steps in its proposed Up-C IPO, but lacks the power to implement others. This decision further concludes that EnCap cannot rely on a cooperation clause in the LLC agreement to compel the plaintiff to give up its contractual rights.

I. FACTUAL BACKGROUND

The parties reached agreement on fifty-four stipulations of fact. During two days of trial, the parties introduced 250 exhibits and lodged fourteen depositions in evidence. Seven fact witnesses testified live. What follows are the court's findings based on a preponderance of the evidence.[1]

A. Caiman I

***2** In 2009, defendants Jack M. Lafield and Richard D. Moncrief formed Caiman Energy, LLC ("Caiman I"). Defendant Stephen L. Arata later joined the Caiman I management team. This decision refers to Lafield, Moncrief, and Arata as "Caiman Management."

Between 2009 and 2012, Caiman I acquired and developed midstream assets in the Marcellus Shale in West Virginia. In March 2012, Caiman I sold its assets to The Williams Companies, Inc. for $2.5 billion (the "Caiman I Sale"). As part of that transaction, Caiman Management entered into non-competition agreements that prohibited them from competing with their former business in its area of operations for a period of two years (the "Non-Compete Agreements").

B. Caiman II

In June 2012, three months after the Caiman I Sale, Caiman Management formed Caiman II. Through Caiman II, they planned to pursue the same midstream business model that Caiman I had used, this time in the Utica Shale in Ohio and Pennsylvania.

Caiman II obtained funding from many of the same investors who had backed Caiman I. EnCap committed $285 million.[2] Oaktree Capital Management ("Oaktree") committed $95 million.[3] Caiman Management committed approximately $29 million, and a smattering of other individuals invested. *See* JX 1, sched. I.

During the negotiations over the Caiman I Sale, Caiman Management had expressed interest in pursuing a follow-on venture, and Williams had expressed interest in investing. As a result, when Caiman Management formed Caiman II, they sought and obtained capital from Williams.[4] Williams committed $380 million, making it the largest investor in Caiman II.

Williams did not want Caiman Management to use Williams' capital to compete with the business that Williams had only recently purchased in the Caiman I Sale. *See* Armstrong Dep. 146–48; Scheel Dep. 175. Williams had protection for the first two years in the form of the Non-Compete Agreements, but once they expired, Williams could find itself in the position of having funded a competitor. To address this risk, Williams insisted on a geographic limitation that would restrict Caiman II to the Utica Shale.[5] Without the geographic limitation, Williams would not have invested in Caiman II.[6]

***3** The geographic limitation was memorialized in Caiman II's original limited liability company agreement, dated as of July 9, 2012 (the "Original LLC Agreement"). In the initial draft, Caiman Management proposed that Caiman II could "acquire, own, hold, maintain, develop and operate

Midstream Assets in the continental United States and the state and federal waters offshore thereto." JX 13 at '217. Williams struck the reference to the continental United States and its offshore waters, substituting "Utica Shale in Ohio and northwestern Pennsylvania." *Id.* at '217 to '218. Caiman Management accepted this change but added the language "and such other areas as determined by the Board with the approval required for a Special Voting Item." JX 14 at '550 to '551. In the final version of the Original LLC Agreement, Section 1.3 provided as follows:

> **Purpose**. The purposes for which [Caiman II] is organized are:
>
> (a) to acquire, own, hold, maintain, develop and operate Midstream Assets in the Utica Shale in Ohio and northwestern Pennsylvania and such other areas as determined by the Board with the approval required for a Special Voting Item;
>
> (b) to sell, abandon and otherwise Dispose of Midstream Assets; and
>
> (c) to engage in or perform any and all activities that are related to or incident to the foregoing or otherwise authorized by the Board in accordance with the terms of this Agreement, and that may be lawfully conducted by a limited liability company under the Act.
>
> In carrying out the business and purposes of [Caiman II], [Caiman II] may act directly or indirectly through one or more entities.

See JX 17, § 1.3 (formatting altered). This decision refers to this language as the "Original Purpose Clause."

Clause (a) of the Original Purpose Clause limited Caiman II's operations to "the Utica Shale in Ohio and northwestern Pennsylvania *and such other areas as determined by the Board with the approval required for a Special Voting Item*." *See id.* (emphasis added). The concept of a "Special Voting Item" referenced an aspect of Caiman II's governance regime. Under the Original LLC Agreement, Caiman II was a manager-managed LLC with a nine-member board of managers (the "Board"). Williams received the right to designate three of the members of the Board; it designated Curt Carmichael, David Keylor, and T.J. Rinke (the "Williams Managers"). EnCap received the right to designate two of the members of the Board; it designated William R. Lemmons, Jr. and Dennis F. Jaggi (the "EnCap Managers"). Oaktree received the right to designate one member of the Board; it designated Steven Gudovic (the "Oaktree Manager"). Caiman Management held the remaining three seats. *See* PTO ¶ 37.

The Original LLC Agreement provided that as a general matter, valid Board action required a number of votes equal to or exceeding a majority of the managers then entitled to be designated to the Board. *See* JX 17, §§ 6.1, 6.8(a). In other words, with nine managers entitled to be designated to the Board, valid Board action required five votes. But the Original LLC Agreement then identified a list of eleven additional matters, each defined as a "Special Voting Item," for which valid Board action also required "the affirmative vote of at least one EnCap Manager and at least one [Williams] Manager." *See id.* § 6.8(b). If either EnCap or Williams opposed a Special Voting Item, their representatives could block it by withholding support, even if a majority of the Board otherwise approved.

By providing that Caiman II could only operate outside of the Utica Shale "as determined by the Board with the approval required for a Special Voting Item," Clause (a) of the Original Purpose Clause required approval from at least one EnCap Manager and at least one Williams Manager. As a result, Caiman II would not be able to operate outside the Utica Shale without both EnCap's and Williams' consent. Making this agreement doubly clear, the list of Special Voting Items included taking "any action that is inconsistent with [Caiman II's] purpose, as set forth in Section 1.3." *Id.* § 6.8(b)(x).

***4** Other pertinent Special Voting Items included:

> (iii) unless such matter is a Major Special Voting Item, to merge, combine, or consolidate [Caiman II] with any other entity, convert [Caiman II] into another form of entity, or exchange interests in [Caiman II] with any other person (except as part of a Drag-Along Sale effected pursuant to Section 9.3);
>
> * * *
>
> (xi) to approve a Qualified IPO; or
>
> (xii) to take any action, authorize or approve, or enter into any binding agreement with respect to or otherwise omit to any of the foregoing.

Id. § 6.8(b).

As indicated by item (iii) in this list, the Original LLC Agreement identified an additional category of Board actions known as "Major Special Voting Items." *See id.* § 6.8(c).

For these items, Board approval required the affirmative vote of one EnCap Manager. *Id.* A Major Special Voting Item could *not* be approved by any other means, meaning that a single EnCap Manager could determine unilaterally whether to approve a Major Special Voting Item. *Id.* The list of Major Special Voting Items in the Original LLC Agreement identified only one substantive item, followed by a general catchall for actions related to that item:

> (i) subject to the applicable requirements of Section 9.7, to enter into or consummate any transaction that will constitute an Exit Event, including
>
> the Disposition of all or substantially all of the assets of [Caiman II] (including by way of Disposition of all or any portion of any equity interests held by [Caiman II] or its subsidiaries),
>
> the Disposition of all of the Membership Interests as a Drag-Along Sale effected pursuant to Section 9.3, or
>
> a merger of [Caiman II] with and into another entity or pursuant to which [Caiman II] is not the surviving entity (any such transaction approved pursuant to this Section 6.8(c), a "Company Sale"), or
>
> (ii) to take any action, authorize or approve, or enter into any binding agreement with respect to or otherwise commit to do any of the foregoing.

Id. (formatting altered). The possibility of effectuating an Exit Event through a "Drag-Along Sale" referred to Section 9.3 of the Original LLC Agreement, which gave EnCap the right to cause the Board to approve and Caiman II to engage in "a sale of [Caiman II] that will be an Exit Event ... structured as a sale of the Membership Interests." *Id.* § 9.3(a).

By making the effectuation of an Exit Event a Major Special Voting Item, Section 6.8(c)(i) gave EnCap the unilateral ability to cause the Board to approve and Caiman II to consummate an Exit Event. Consistent with the examples included in Section 6.8(c)(i), the Original LLC Agreement defined "Exit Event" as

> the sale of [Caiman II], in one transaction or a series of related transactions, whether structured as
>
> (i) a sale or other transfer of all or substantially all of the Equity Securities (including by way of merger, consolidation, share exchange, or similar transaction),
>
> (ii) the sale or other transfer of all or substantially all of the assets of [Caiman II], promptly followed by a dissolution and liquidation of [Caiman II],
>
> ***5** (iii) any other dissolution or liquidation of [Caiman II], or
>
> (iv) a combination of any of the foregoing.

Id. § 2.1 (formatting altered).

Although EnCap had the unilateral ability to cause the Board to approve and Caiman II to consummate an Exit Event, the exercise and implementation of that right was not unfettered. EnCap's rights under Section 6.8(c)(i) were "subject to the applicable requirements of Section 9.7." In that section, Williams had a right of first offer under which EnCap had to provide Williams with written notice of the proposed Exit Event, then negotiate in good faith with Williams

> with respect to a transaction pursuant to which [Williams] would consummate an Exit Event pursuant to which [Williams] would acquire all of the Equity Interests (if a Drag-Along Sale), all of the assets of [Caiman II] (if a Company Sale) or all of the assets of [Caiman II] to be sold (if a Material Asset Sale) ....

Id. § 9.7(b). EnCap's right to effectuate a Drag-Along Sale under Section 9.3 was likewise subject to Williams' right of first offer in Section 9.7. *Id.* § 9.3(b).

Through its right of first offer, Williams had the opportunity to consummate the Exit Sale itself. By doing so, Williams could avoid the prospect of a new owner buying Caiman II, eliminating the Original Purpose Clause, and using Caiman II to compete with the business that Williams had purchased from Caiman I.

C. The Dominion Transaction

In fall 2012, Caiman II identified an opportunity to partner with Dominion Energy, Inc. ("Dominion") to form a joint venture that Caiman Management would manage (the "Dominion Transaction"). In November, Caiman II and Dominion negotiated a letter of intent, and Caiman II formed a wholly owned subsidiary called Blue Racer Midstream LLC ("Blue Racer") to serve as the vehicle for the Dominion Transaction. *See* JX 20; JX 21; JX 34 at 1. Blue Racer became and remains Caiman II's only revenue producing asset. It is also the only entity through which Caiman II does business.

In December 2012, Dominion effectuated the first step of the Dominion Transaction by causing its wholly owned subsidiary, Dominion Natrium Holdings, Inc., to contribute certain midstream assets to Blue Racer in exchange for cash at closing. Dominion also committed to cause Dominion Natrium to contribute additional assets over time in return for additional cash payments to be funded by Caiman II. As part of the Dominion Transaction, Dominion received equity interests reflecting a 50% ownership interest in Blue Racer, leaving Caiman II with the remaining 50% ownership interest. *See generally* JX 31; JX 33.

In connection with the Dominion Transaction, Caiman II and Dominion entered into a new limited liability company agreement for Blue Racer. *See* JX 34 (the "Blue Racer LLC Agreement"). At around the same time, the members of Caiman II entered into an amended and restated limited liability company agreement for Caiman II. *See* JX 1. This agreement is still the operative agreement that governs Caiman II, so this decision refers to it as the "Caiman LLC Agreement."

***6** When entering into the Blue Racer LLC Agreement and the Caiman LLC Agreement, the parties addressed a variety of issues. Two are pertinent to the current dispute: (i) a modification to the geographic area in which Caiman II and Blue Racer would operate, and (ii) a restructuring of EnCap's exit rights.

1. Geographic Scope

Dominion contributed assets to Blue Racer that included certain assets located in West Virginia, near the assets that Williams had purchased in the Caiman I Sale. Under the Original Purpose Clause, Caiman II could not operate in West Virginia, and Caiman II would have violated the Original Purpose Clause by engaging in business in West Virginia through Blue Racer. The parties addressed this problem by including a modified geographic limitation in the Blue Racer LLC Agreement, then using that modified scope to frame a revised purpose provision in the Caiman LLC Agreement.

The Blue Racer LLC Agreement addressed the geographic situation by defining the "Purposes of the Company" as follows:

> [Blue Racer] is formed for the purposes of developing the business of wet gas, lean gas, crude and condensate gathering, processing, and fractionation and NGL transportation within the AMI Area and, to the extent necessary for owning, operating and expanding the TL-404 Gathering Line, the Natrium Facility and G-150 Pipeline, within West Virginia (collectively, the "**Company Business**"). Each of the Members agrees to cause [Blue Racer] to conduct, directly and through its subsidiaries, the Company Business in accordance with the provisions of this Agreement and the Act.

JX 34, § 3.1 (the "Blue Racer Purpose Clause"). The Blue Racer LLC Agreement defined "AMI Area" as "the area of the Utica Shale formation, specifically the counties in the State of Ohio and the Commonwealth of Pennsylvania set forth in Schedule 3, as may be modified pursuant to Section 10.4."[7] The Blue Racer Purpose Clause thus limited Blue Racer to operating in this area, except that Blue Racer could operate within West Virginia "to the extent necessary for owning, operating and expanding the TL-404 Gathering Line, the Natrium Facility and G-150 Pipeline." *Id.* § 3.1. These were specific assets that Dominion Natrium contributed to Blue Racer as part of the Dominion Transaction.

The Caiman LLC Agreement addressed the geographic situation with a new purpose clause. Section 1.3 of the Caiman LLC Agreement provided as follows:

> **Purpose**. The purposes for which [Caiman II] is organized are:
>
> (a) to acquire, own, hold, maintain, develop and operate Midstream Assets in the Utica Shale in Ohio and northwestern Pennsylvania, including all those areas covered by the AMI Area and, to the extent necessary for owning, operating and expanding the Natrium Facility, the G-150 Pipeline and the TL-404 Gathering Line, within West Virginia (provided that, except for the Replacement Natrium Processing Contracts (as such term is defined in the Blue Racer Investment Agreement), neither [Caiman II] nor its subsidiaries may enter into, or cause Blue Racer or its subsidiaries to enter into, new gathering, processing or fractionation agreements for hydrocarbons produced in West Virginia prior to April 27, 2014), and such other areas as determined by the Board with the approval required for a Special Voting Item;
>
> ***7** (b) to sell, abandon and otherwise Dispose of Midstream Assets; and
>
> (c) to engage in or perform any and all activities that are related to or incident to the foregoing or otherwise authorized by the Board in accordance with the terms of

> this Agreement, and that may be lawfully conducted by a limited liability company under the Act.
>
> In carrying out the business and purposes of [Caiman II], [Caiman II] may act directly or indirectly through one or more entities. Notwithstanding the foregoing, prior to the Equalization Date, [Caiman II] shall not pursue any Operation and Enhancement Plans except through Blue Racer and its subsidiaries.

JX 1, § 1.3 (formatting altered; the "Caiman Purpose Clause").

To ensure that the Blue Racer Purpose Clause and the Caiman Purpose Clause (together, the "Purpose Clauses") tracked each other, the Caiman LLC Agreement defined the term "AMI Area" to have "the meaning set forth in the Blue Racer LLC Agreement." *Id.* § 2.1. Recognizing that the scope of the Caiman Purpose Clause now turned on a definition in the Blue Racer LLC Agreement, the Caiman LLC Agreement expanded the list of Special Voting Items to include any action "to amend, modify or otherwise change (including by waiver or consent ...) in any material respect any Blue Racer Agreement, including but not limited to an amendment of the definition of 'AMI Area' or 'ROFO Development Opportunity' under the Blue Racer Agreements ...." JX 1, § 6.8(b)(xii).[8]

As a result of these changes, both before and after the Dominion Transaction, Caiman II could not compete with the business that Williams had purchased in the Caiman I Sale. The Caiman Purpose Clause only permitted Caiman II to operate in West Virginia to the extent necessary to own, operate, or expand the specific assets it received in the Dominion Transaction. Otherwise, Caiman II could not operate outside of the Utica Shale. Before Caiman II could operate anywhere else, it had to receive the approval of *both* one EnCap Manager *and* one Williams Manager. Caiman II could not violate this limitation directly or indirectly, whether through Blue Racer or otherwise. Blue Racer also could not operate outside of that same designated area, and Caiman II could not authorize any change in this aspect of the Blue Racer LLC Agreement without the approvals necessary for a Special Voting Item. As a result, neither Caiman II nor Blue Racer could operate outside of their designated area without Williams' consent.

2. Exit Rights

A more significant set of changes to the Original LLC Agreement involved the members' exit rights. This issue arose because the Blue Racer LLC Agreement contemplated that Dominion Natrium would contribute additional assets to Blue Racer in exchange for cash, and it obligated Caiman II to provide the capital necessary for Blue Racer to finance those transactions. *See* JX 22. During the lead up to the Dominion Transaction, Williams submitted a proposal to Caiman Management under which Williams would fund 100% of the required capital in return for additional member interests in Caiman II, which would result in Williams holding up to a 66% ownership interest in Caiman II. JX 24. In exchange for this commitment, Williams' proposal contemplated that an Exit Event would no longer be a Major Special Voting Item that EnCap could control unilaterally. *See id.*; *see also* JX 23.

***8** Knowing that EnCap would be focused on its need to exit as its funds entered their harvesting stage, Caiman Management questioned whether EnCap would be willing to give up its control over an Exit Event. But Caiman Management believed a compromise was possible, because they foresaw that the most likely outcome for Caiman II was either a sale to Williams or an IPO, and Caiman Management believed an IPO would likely generate greater value for EnCap. Caiman Management therefore thought that EnCap might be willing to give up its control over an Exit Right in return for greater control over an IPO. *See* JX 23.

In crafting a counteroffer that would be acceptable to both Williams and EnCap, Caiman Management proposed swapping the approvals required for an Exit Event and a Qualified IPO. Under the Caiman Management proposal, an Exit Event would become a Special Voting Item, and a Qualified IPO would become a Major Special Voting Item only requiring the approval of an EnCap Manager. JX 25. Caiman Management also proposed that in the event of a Qualified IPO that was structured through a master limited partnership ("MLP"), the other investors in Caiman II "will sell their GP interest for cash to [Williams] using a defined valuation mechanism." *Id.* at '146. At the time, publicly traded midstream businesses were invariably organized as MLPs, and the parties expected Caiman II to go public as an MLP. Under this proposal, Williams would have the right to purchase all of the general partner interests in the MLP and control the post-IPO entity. The Caiman Management proposal also reduced Williams' maximum capital contribution and resulting equity stake from 66% to 62.5%. *See id.* In addition, Caiman Management proposed that the geographic restrictions in the Caiman LLC Agreement and the Blue Racer LLC Agreement would

fall away once Caiman II had satisfied all of its funding commitments to Blue Racer. *See id.* at '147; JX 34 at A-6.

Caiman Management ran its proposal by EnCap. *See* JX 26. EnCap struck the language eliminating its right to force an Exit Event, but kept the language that would let it unilaterally approve a Qualified IPO. Caiman Management sent the amended proposal to Williams. *See* JX 28. Williams restored the language eliminating EnCap's right to force an Exit Event and struck the point about the geographic restrictions falling away. *See* JX 30.

The parties reached an agreement in principle based on Williams' counterproposal. Looking back on the negotiations from May 2014, Arata summarized the basic deal as follows:

> When [Blue Racer] was formed, [Williams] negotiated for the option to increase its interest in Caiman II to 62.5%. An additional element of this change was [Williams'] request to not be able to be dragged into a sale of Caiman II (as they would now most likely be a majority owner of Caiman II). This was agreed to on the condition of [EnCap] being allowed to drag [Williams] into an IPO of either [Blue Racer] or Caiman II. The final element of the change of control adjustments was that, in the event of an IPO of either [Blue Racer] or Caiman II, [Williams] would have the right to buy out the other Caiman II owners' interest in the GP of Caiman II for fair market value in cash at the closing of the IPO (with an agreed upon process for resolving a valuation dispute).

JX 46 at '757 to '758.

The lawyers implemented the business deal in the Caiman LLC Agreement. To document the agreement regarding an Exit Event, the Caiman LLC Agreement (i) struck Section 9.3 of the Original LLC Agreement in its entirety, thereby eliminating the concept of a Drag-Along Sale, and (ii) moved the approval of an Exit Event from Section 6.8(c)(i), where it was a Major Special Voting Item, to Section 6.8(b)(xi), where it became a Special Voting Item. In a related change, the parties revised Section 6.8(b)(iii), which made it a Special Voting Item "to merge, combine, or consolidate [Caiman II] with any other entity, convert [Caiman II] into another form of entity, or exchange interests in [Caiman II] with any other person." Previously, this provision included an exception that recognized EnCap's right to authorize a merger or similar transaction as a Major Special Voting Item when it was part of an Exit Event. JX 17, § 6.8(b)(iii). The Caiman LLC Agreement eliminated that exception.

***9** To document the agreement regarding a Qualified IPO, the Caiman LLC Agreement moved the approval of a Qualified IPO from Section 6.8(b)(xi), where it had been a Special Voting Item, to Section 6.8(c)(i), where became a Major Special Voting Item. As a result, the list of Major Special Voting Items in the Caiman LLC Agreement consisted of the following:

> (i) to approve a Qualified IPO, or
>
> (ii) to take any action, authorize or approve, or enter into any binding agreement with respect to or otherwise commit to do any of the foregoing.

Id. § 6.8(c).

The Caiman LLC Agreement did not make any changes to the definition of a Qualified IPO. Both in the Original LLC Agreement and in the Caiman LLC Agreement, a "Qualified IPO" was defined as

> any underwritten initial public offering by the IPO Issuer of equity securities pursuant to an effective registration statement under the Securities Act for which aggregate cash proceeds to be received by the IPO Issuer from such offering (without deducting underwriting discounts, expenses and commissions) are at least $75,000,000; provided that a Qualified IPO shall not include an offering made in connection with a business acquisition or combination pursuant to a registration statement on Form S-4 or any similar form, or an employee benefit plan pursuant to a registration statement on Form S-8 or any similar form.

Id. § 2.1(a); JX 17, § 2.1(a).

The definition of "Qualified IPO" referred to the concept of the "IPO Issuer," and the Caiman LLC Agreement changed that definition. It now stated:

> "IPO Issuer" means (i) [Caiman II] or (ii) an Affiliate of [Caiman II] that will be the issuer in a Qualified IPO. For the avoidance of doubt, and without limiting the definition of Affiliate, Blue Racer and its subsidiaries will be considered Affiliates of [Caiman II] for purposes of this definition.

JX 1, § 2.1(a). The qualification "[f]or the avoidance of doubt" was an addition. It made clear that Blue Racer or one of its subsidiaries could be the IPO Issuer.

In the Original LLC Agreement, Section 9.5 governed the implementation of a Qualified IPO, and in the Caiman LLC

Agreement, the parties made relatively limited changes to this set of provisions. *See* JX 1, § 9.5 (the "Qualified IPO Section"). To implement the agreement regarding who could control a Qualified IPO, the parties added language to Section 9.5(a) to make clear that (i) the decision to effectuate a Qualified IPO was a Major Special Voting Item and (ii) any references to approvals by the Board in Section 9.5 meant the approval necessary for a Major Special Voting Item, *i.e.*, EnCap's sole approval. *See* JX 1, § 9.5(a).

The only other significant modification to the Qualified IPO Section addressed Williams' right to acquire 100% of the general partner interest in the event of a Qualified IPO involving an MLP, which the Caiman LLC Agreement defined as an "MLP Conversion." To implement this agreement, the parties added a new Section 9.5(e) which granted Williams "the sole and exclusive right to purchase each other Investor's Equity Interests in the general partner, including any incentive distribution rights and similar incentive securities" for cash in an amount equal to "fair market value." *See* JX 1, § 9.5(e). The new section included a mechanism for determining fair market value, including for the appointment of an appraiser. *See id.*

***10** In January 2013, weeks after executing the Caiman LLC Agreement, Williams prepared a summary of its terms. The summary of the Qualified IPO Section stated: "Actions requiring Board approval in connection with a Qualified IPO are considered Major Special Voting Items (as defined below), which require the affirmative vote of one EnCap Manager and no other." JX 35 at '448.

D. The Contemplated MLP Conversion In 2015

Beginning in early 2014, Caiman Management explored the possibility of conducting a Qualified IPO, believing initially that it "would optimally be timed in early Q2 of 2015." JX 46 at '757; *see* PTO ¶ 38; JX 55. Publicly traded midstream companies continued to be organized as MLPs, and Caiman Management expected that a Qualified IPO would take place through an MLP Conversion.

Caiman Management did not want the MLP to face geographic restrictions and asked their outside counsel whether the restrictions would apply. In an email sent in May 2014, counsel expressed the view that

> the restrictions in the Caiman II purpose clause would naturally fall away at a Caiman II level at IPO b/c we will have a new partnership agreement, however, absent amending the Blue Racer LLC Agreement, Caiman II would still be limited by the purpose clause in Blue Racer to the extent it is pursuing activities through Blue Racer.

JX 43 at '328. After receiving this advice, Caiman Management and EnCap discussed how to negotiate with Williams over removing the Blue Racer Purpose Clause. *See* JX 46 at '758. Their discussions assumed that the amendment would require Williams' consent. *See id.*

When EnCap engaged with Williams about the Qualified IPO, Williams suggested the possibility of buying Caiman II. *See* JX 50 at '021. For a time, the discussions focused on a sale of Caiman II to Williams. *See* JX 59.

In November 2014, with the discussions over a sale bogging down, Caiman Management resumed their preparations for an MLP Conversion. Caiman Management anticipated that Williams would exercise its right to acquire 100% of the general partner and asked Williams to confirm that fact. Notwithstanding the advice they had received six months earlier about the Caiman Purpose Clause "fall[ing] away," Caiman Management asked Williams to agree that the Purpose Clauses would be removed post-IPO "as they would be unduly restrictive for marketing purposes." JX 70. Caiman Management argued this should be an easy concession for Williams because if Williams exercised its right to acquire 100% of the general partner, then Williams "will be in joint control of [Blue Racer] at that point" and could ensure that the MLP and Blue Racer did not expand into the Marcellus Shale. *Id.*

In January 2015, counsel for Caiman II prepared a draft Form S-1. It disclosed as a risk factor that both the MLP's limited partnership agreement and the Blue Racer LLC Agreement would "limit[ ] our ability to expand [our or] Blue Racer's operations beyond the Utica Shale and certain portions of the Marcellus Shale." JX 71 at '139 (bracketed text in original). A drafting note from counsel called for confirming with Williams whether this disclosure needed to be retained, or whether Williams would agree to eliminate the geographic restrictions: "***NTD: confirm [Williams] intent to leave purpose limitation in place***." *Id.* Williams "held to the position that we did want to maintain [the business purpose limitation], and that it should be in the [S-1] disclosures." Carmichael Tr. 124.

***11** Caiman II subsequently filed a preliminary Form S-1 on a confidential basis with the SEC on May 13, 2015. JX 77 at '710. The as-filed Form S-1 included the same risk factor

language and contained additional disclosures regarding how the business purpose provisions would limit the operations of the post-IPO entities. It stated that the "sole purpose" of Caiman II and Blue Racer was "pursuing midstream energy opportunities in the Utica Shale." *Id.* at '716. It later stated that "Blue Racer's assets are exclusively located in ... the Utica Shale and certain adjacent areas in the Marcellus Shale, and the Blue Racer LLC Agreement restricts it from engaging in operations outside of this area." *Id.* at 749. The as-filed version added that "entry into any business other than the company's stated purposes" would require approval of members holding 100% of Blue Racer's member interests. *Id.* at '763 to '764. *See generally* PTO ¶¶ 38–43.

E. The Contemplated MLP Conversion In 2017

Because of adverse market conditions, Caiman II did not proceed with the MLP Conversion in 2015. Caiman Management revisited the prospect of an MLP Conversion in 2017. This time, Caiman Management did not assume that Williams would exercise its right to acquire 100% of the MLP's general partner and proceeded with the expectation that the Form S-1 would have to disclose both the possibility that Williams would exercise its option and the possibility that the general partner would have multiple members. As before, Caiman Management wanted to remove the business purpose limitations, but did not believe it could be done without Williams' consent. *See* Juban Dep. 111; *see also* JX 137 at '828. When Caiman II filed a new Form S-1 confidentially in 2017, it disclosed that the business purpose provisions would limit the ability of IPO Issuer and Blue Racer to operate and discussed the resulting implications for investors.[9]

While Caiman Management was preparing for the 2017 MLP Conversion, Williams supported the Qualified IPO, but proceeded slowly and deliberately. Williams had a contractual obligation to support a Qualified IPO, and it took care to comply with that obligation, but it also sought to limit its support to what was contractually required. At the same time, Williams continued to dangle the possibility of a purchase of Caiman II. By February 2017, little progress had been made, and Caiman Management and EnCap had grown frustrated with Williams. *See* JX 112 at '132, JX 113 at '193. Those dynamics persisted through the balance of 2017. *See, e.g.*, JX 140; JX 141; JX 142; JX 149; JX 154.

Unfavorable market conditions in late 2017 put an end to the prospect of the MLP Conversion. In June 2018, when Caiman Management tried to re-start the IPO process. EnCap did not support the idea, believing it was "a waste of time unless Williams is on board." JX 162.

F. First Reserve Buys Out Dominion.

In September 2018, a private equity firm named First Reserve Corporation contacted EnCap. First Reserve was exploring a purchase of Dominion's interest in Blue Racer but did not want to buy in without a path to liquidity. First Reserve proposed that the two private equity firms work together to achieve an Up-C IPO of Blue Racer in 2019 or 2020 to open the door to secondary offerings that would enable them to exit from their positions. *See* JX 163.

***12** By agreement dated October 31, 2018, a subsidiary of First Reserve committed to purchase Dominion's interest in Blue Racer. The acquisition closed on December 14, 2018. PTO ¶ 44. Through this transaction, First Reserve replaced Dominion as the other 50% member in Blue Racer. *Id.* Under an agreement also dated October 31, 2018, the same subsidiary of First Reserve and EnCap committed to work together to achieve an IPO of Blue Racer. *See* JX 167.

G. The Up-C IPO

After hearing from First Reserve, Caiman Management and EnCap began exploring the possibility of an Up-C IPO. *See* JX 165. In this structure, an existing limited liability company that is taxed as a pass-through entity undertakes a public offering through a newly formed corporation ("NewCo"), which is structured as a holding company that owns an interest in the LLC. The basic steps in a typical Up-C are as follows:

- NewCo issues Class A common stock to the public in an IPO, with the Class A stock carrying both economic rights and voting rights.
- NewCo uses the proceeds from the IPO to purchase member interests in the LLC, giving NewCo an ownership interest in the LLC and diluting the ownership interest of the pre-IPO owners (the "Sponsors").
- The Sponsors retain their pre-IPO member interests in the LLC, for which they continue to receive pass-through tax treatment.
- The Sponsors receive Class B common stock in NewCo, with the Class B stock carrying voting rights but no economic rights. The voting rights allocated to the Class B shares track the equity interest reflected by the Sponsor's member interests in the LLC.

- NewCo is designated as the managing member of the LLC and is governed by a board of directors elected by the Class A and Class B stockholders of NewCo.

- Each Sponsor can exchange a member interest in the LLC and the corresponding shares of Class B stock for an equivalent amount of Class A stock.

See JX 184 at '716. Although EnCap and Caiman Management ultimately sought to move forward with what they have called an Up-C IPO, their version is far more complex and involves many more steps than the typical Up-C transaction. *See* JX 225.

During their initial exploration of an Up-C IPO, Caiman Management and EnCap did not perceive it as a means of eliminating the Purpose Clauses. Instead, during March 2019, Caiman Management explored whether they could induce Williams to agree to change the Purpose Clauses, either by invoking their ability to exclude Williams from decisions about "competitive activities" or by withholding consent to a transaction that Williams wanted to pursue. *See* JX 180; JX 182; Arata Tr. 413–14, 419–20.

Around the same time, Arata suggested that maybe Williams would "lose[ ] the right to vote regarding changes to the business purpose clause in connection with the IPO." JX 181. The general counsel of Caiman II shot down that idea. After citing some points that might support Arata's argument, he asked outside counsel, "[W]e can't use the IPO reorg to strip Williams of rights it currently has, correct? Or have I missed something somewhere?" JX 181. Although the same counsel had expressed the view in an email five years earlier that the Caiman Purpose Clause would fall away in an IPO if there was a new entity, no one gave that advice at this point. Arata also texted with First Reserve about his idea of using an Up-C IPO to eliminate the Purpose Clauses. This was the first time First Reserve had heard of the idea. *See* JX 182.

***13** Later in March 2019, EnCap informed Williams that it was once again considering a Qualified IPO. Caiman Management and EnCap subsequently called a special meeting of the Board to consider moving forward with a Qualified IPO of Blue Racer "or an entity formed for such purpose" and to

> [a]uthorize management ... to hire advisors, form, merge or consolidate entities, draft and file registration statements, file documents with such regulatory authorities as management deems necessary or appropriate and to take or cause to be taken any and all actions as and to the extent necessary to effectuate a Qualified IPO of Blue Racer.

JX 185. Williams recognized that "EnCap has a right to take Caiman or [Blue Racer] public" and told Caiman Management that Williams would support the IPO "if our agreement rights are maintained." JX 186; *see* JX 188. During a meeting on April 5, 2019, the Board unanimously approved the proposed resolutions. PTO ¶ 46.

On April 17, 2019, the Board held an organizational meeting to discuss the Qualified IPO. PTO ¶ 49. The Up-C structure as presented involved at least the following steps.

- Step One: Form three new entities.
  - Caiman Ohio Midstream, LLC ("Ohio Midstream"), an existing holding company through which Caiman II holds its 50% interest in Blue Racer, forms a wholly owned subsidiary called Blue Racer Midstream Inc. ("PubCo").
  - PubCo forms a wholly owned subsidiary called Blue Racer Midstream Holdings, LLC ("HoldCo").
  - HoldCo forms a wholly owned subsidiary called BR Holdco Merger Sub, LLC ("Holdco Merger Sub").
- Step Two: Caiman II and Dominion amend and restate the Blue Racer LLC Agreement to convert Blue Racer's member units into a single class.
- Step Three: Caiman II contributes its retained assets to Ohio Midstream, except for its ownership interest in Ohio Midstream.
- Step Four: Ohio Midstream distributes all of its Blue Racer units to Caiman II.
- Step Five: Caiman II distributes all of its newly received Blue Racer units to its members.
- Step Six: Caiman II distributes its ownership interest in Ohio Midstream to Caiman Management.
- Step Seven: Blue Racer forms a wholly owned subsidiary called BRM Merger Sub LLC.
- Step Eight: Caiman II merges with and into BRM Merger Sub LLC, with Caiman II surviving as a new entity named Blue Racer Midstream Management LLC.
- Step Nine: PubCo issues (i) Class A shares to the public in exchange for cash, contributing the cash to HoldCo,

(ii) contributes Class B shares to Holdco, and (iii) agrees with Ohio Midstream to cancel Ohio Midstream's interest in PubCo.

- Step Ten: HoldCo Merger Sub merges with and into Blue Racer, with Blue Racer surviving as a wholly owned subsidiary of HoldCo and former unitholders of Blue Racer receiving a combination of cash raised in the IPO, Class B stock in PubCo, and units of HoldCo.

See JX 184 at '722 to '728.

At the meeting, Caiman Management asked Williams to consent to the removal of the Purpose Provisions. *See* JX 194 at '109. The lead Williams representatives said that Williams would not consent. Carmichael Tr. 147.

H. The Defendants Develop Their Strategy.

Toward the end of April 2019, the defendants focused on using the Up-C IPO to eliminate the Purpose Clauses. On April 30, 2019, Caiman Management informed Williams that the Board would meet on May 7 to consider whether to remove the Purpose Clauses from the Caiman LLC Agreement and the Blue Racer LLC Agreement. During this call, Caiman Management mentioned that "maybe" Williams' consent would not be required to remove the provisions in an IPO. Carmichael Tr. 151–52. This was the first time anyone had expressed that view to Williams. *Id.* at 152.

***14** On May 2, 2019, two EnCap representatives had a discussion with EnCap's outside counsel about the "BRM purpose clause." JX 241; Lemmons Tr. 543–44. The next day, Caiman Management, EnCap, and First Reserve had a call about "strategy wrt [W]illiams and [the] purpose clause." JX 213; *see* Reaves Tr. 612–13. After the meeting, Caiman II's Chief Financial Officer exchanged text messages with an EnCap representative about using a new entity to circumvent the Purpose Clauses. They decided that the idea would not work *See* JX 212.

Three days later, on May 6, 2019, the board of managers of Blue Racer voted to amend the Blue Racer Purpose Clause to eliminate any geographic restrictions, subject to approval from the board of Caiman II. PTO ¶ 50. On May 7, 2019, the Board met to consider changing the Purpose Clauses. Caiman Management formally proposed to amend the Caiman Purpose Clause to eliminate any geographic restriction and to approve the conditional amendment to the Blue Racer Purpose Clause that the Blue Racer board had approved. *See* JX 222; JX 223. The lead Williams representative stated that Williams would not consent to the proposed changes. The Williams Managers did not vote in favor of the proposal, causing it to fail. *See* JX 220; PTO ¶ 51.

On May 8, 2019, Caiman Management advised Williams that although the Purpose Clauses could not be changed without Williams' consent outside of an IPO, Caiman II could amend the Purpose Clauses as part of a Qualified IPO. PTO ¶ 52; Lafield Dep. 163–64. Before May 8, no one had taken this positon.

Later in May 2019, Blue Racer filed a confidential Form S-1 for its IPO. In it, Blue Racer described the Up-C IPO somewhat differently, characterizing it as having the following steps:

- "Blue Racer LLC's limited liability company agreement will be amended and restated to, among other things, create a single class of units in Blue Racer LLC, referred to herein as 'Blue Racer Units,' held by First Reserve, and following a distribution by Caiman of the Blue Racer Units to its members, the Legacy Caiman Owners[.]"

- "Holdco's limited liability company agreement will be amended and restated to, among other things and as described further under 'Certain Relationships and Related Party Transactions—Limited Liability Company Agreement of Holdco,' create a single class of units in Holdco, referred to herein as 'Holdco Units[.]' "

- "[W]e will issue Class A shares to the public in this offering, representing 100% of the economic rights in Blue Racer Inc., at an initial offering price of $ per share (the midpoint of the price range set forth on the cover page of this prospectus)[.]"

- "[W]e will issue and contribute Class B shares and a portion of the net proceeds received in the offering to Holdco in exchange for Holdco Units[.]"

- "Holdco will form a merger subsidiary, which will merge with and into Blue Racer LLC, with Blue Racer LLC surviving the merger as a wholly-owned subsidiary of Holdco and the Existing Owners receiving, as merger consideration, their allocable amounts of Holdco Units and a number of Class B shares equal to the number of Holdco Units received by such Existing Owner[.]"

- "[T]he remaining proceeds will be used to (i) pay down $ million in borrowings under the Blue Racer credit facility and (ii) purchase $ million of Holdco Units

(along with a corresponding number of Class B shares, which will be cancelled) from the Existing Owners, with the total number of Holdco Units acquired by us from Holdco and the Existing Owners equaling the number of Class A shares sold by us in the offering."

***15** JX 225 at '436.

I. This Litigation

On May 13, 2019, Williams filed this lawsuit, naming as defendants Caiman II, Blue Racer, EnCap, Oaktree, Caiman Management, the EnCap Managers, and the Oaktree Manager. Count I asserted a claim for anticipatory breach of the Caiman LLC Agreement based on the defendants plan to amend the Caiman Purpose Clause and the Blue Racer Purpose Clause without Williams' consent. Count II sought a declaratory judgment that the defendants could not amend the Caiman Purpose Clause or the Blue Racer Purpose Clause without Williams' consent.

On June 13, 2019, the defendants filed counterclaims and asserted affirmative defenses. The sole count in the counterclaims sought the following declaratory judgments:

- "Williams is not entitled to dictate the terms of the Qualified IPO (including, among other things, insisting that the [Caiman Purpose Clause] be included in the IPO charter documents and remain in place forever unless Williams consents otherwise)[.]"
- "In connection with the IPO, Williams is limited to the protections set forth in Section 9.5 of the LLC Agreement[.]"
- "Williams is not entitled to consent rights regarding amendments to the charter of the IPO Issuer[.]"
- "Williams is not entitled to unilaterally block the Proposed Amendments under 12.2(a)(v)."

Dkt. 99 at 26–27. The parties agreed to litigate on an expedited basis.

J. Post-Litigation Developments

While the litigation was proceeding, the parties continued to negotiate aspects of the Up-C IPO. *See, e.g.*, JX 231; JX 233; JX 236. Williams advised Caiman II that Williams would view "as adverse" any amendments to the Caiman LLC Agreement that would "facilitate an Up-C Structure" or "make the economic waterfall provisions more advantageous to other parties in connection with an Up-C Structure ...." JX 244 at 1.

In June 2019, Caiman Management met with financial advisors who were vying to lead the IPO. Barclays recommended an IPO size of approximately $650 million. JX 237 at '709. Wells Fargo recommended an IPO of between $500 million and $750 million. JX 238 at '022.

II. LEGAL ANALYSIS

The dispute between the parties reduces to disagreements over their respective rights under the Caiman LLC Agreement. Each side seeks declaratory judgments establishing its preferred interpretations. To the extent that each side seeks further relief, such as the issuance of an injunction, that relief is premised on its interpretations being correct.

The party seeking a declaratory judgment assumes the burden of proving its position. *See* *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 316 n.38 (Del. Ch.), *aff'd*, 981 A.2d 1173 (Del. 2009). Because both sides have sought declaratory judgments, each theoretically bears the burden of proving its position by a preponderance of the evidence. As a practical matter, the allocation of the burden of proof "becomes relevant only when a judge is rooted on the fence post and thus in equipoise." *In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761, 791–92 (Del. Ch. 2011), *aff'd sub nom. Ams. Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012).

***16** In this case, the competing burdens of proof are not at issue because this decision interprets the relevant provisions as a matter of law. For purposes of the factual findings set forth in this decision, the evidence was not in equipoise, and the preponderance-of-the-evidence standard would result in the same determinations, regardless of which party bore the burden of proof.

A. Principles of Contract Interpretation

To resolve the parties' disagreements requires interpretation of the Caiman LLC Agreement. When interpreting an LLC agreement, "a court applies the same principles that are used when construing and interpreting other contracts." *Godden v. Franco*, 2018 WL 3998431, at *8 (Del. Ch. Aug. 21, 2018). "When interpreting a contract, the role of a court

is to effectuate the parties' intent." *Lorillard Tobacco Co. v. Am. Legacy Found.*, 903 A.2d 728, 739 (Del. 2006). Absent ambiguity, the court "will give priority to the parties' intentions as reflected in the four corners of the agreement, construing the agreement as a whole and giving effect to all its provisions." *In re Viking Pump, Inc.*, 148 A.3d 633, 648 (Del. 2016) (internal quotation marks omitted).

"Unless there is ambiguity, Delaware courts interpret contract terms according to their plain, ordinary meaning." *Alta Berkeley VI C.V. v. Omneon, Inc.*, 41 A.3d 381, 385 (Del. 2012). The "contract's construction should be that which would be understood by an objective, reasonable third party." *Salamone v. Gorman*, 106 A.3d 354, 367–68 (Del. 2014) (internal quotation marks omitted). "Absent some ambiguity, Delaware courts will not destroy or twist [contract] language under the guise of construing it." *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1195 (Del. 1992). "If a writing is plain and clear on its face, *i.e.*, its language conveys an unmistakable meaning, the writing itself is the sole source for gaining an understanding of intent." *City Investing Co. Liquidating Tr. v. Cont'l Cas. Co.*, 624 A.2d 1191, 1198 (Del. 1993).

"In upholding the intentions of the parties, a court must construe the agreement as a whole, giving effect to all provisions therein." *E.I. du Pont de Nemours & Co. v. Shell Oil Co.*, 498 A.2d 1108, 1113 (Del. 1985). "[T]he meaning which arises from a particular portion of an agreement cannot control the meaning of the entire agreement where such inference runs counter to the agreement's overall scheme or plan." *Id.* "[A] court interpreting any contractual provision ... must give effect to all terms of the instrument, must read the instrument as a whole, and, if possible, reconcile all the provisions of the instrument." *Elliott Assocs. v. Avatex Corp.*, 715 A.2d 843, 854 (Del. 1998).

"Contract language is not ambiguous merely because the parties dispute what it means. To be ambiguous, a disputed contract term must be fairly or reasonably susceptible to more than one meaning." *Alta Berkeley*, 41 A.3d at 385 (footnote omitted). If the language of an agreement is ambiguous, then the court "may consider extrinsic evidence to resolve the ambiguity." *Salamone*, 106 A.3d at 374. Permissible sources of extrinsic evidence may include "overt statements and acts of the parties, the business context, prior dealings between the parties, [and] business custom and usage in the industry." *Id.* at 374 (quoting *In re Mobilactive Media, LLC*, 2013 WL 297950, at *15 (Del. Ch. Jan. 25, 2013) (alteration in original)). A court may consider "evidence of prior agreements and communications of the parties as well as trade usage or course of dealing." *Eagle Indus., Inc. v. DeVilbiss Health Care, Inc.*, 702 A.2d 1228, 1233 (Del. 1997). "When the terms of an agreement are ambiguous, 'any course of performance accepted or acquiesced in without objection is given great weight in the interpretation of the agreement.' " *Sun-Times Media Gp. v. Black*, 954 A.2d 380, 398 (Del. Ch. 2008) (quoting Restatement (Second) of Contracts § 202). "[T]he private, subjective feelings" of contract "negotiators are irrelevant and unhelpful to the Court's consideration of a contract's meaning, because the meaning of a properly formed contract must be shared or common." *United Rentals, Inc. v. RAM Hldgs., Inc.*, 937 A.2d 810, 835 (Del. Ch. 2007) (footnote omitted).

B. EnCap's Authority Under Section 6.8(c)

***17** As described in Blue Racer's confidential Form S-1, and as presented at trial, the defendants' proposed Up-C IPO has many steps. As authority for EnCap's ability to implement these steps, the defendants rely in the first instance on Section 6.8(c) of the Caiman LLC Agreement. This section does not provide EnCap with the expansive authority that the defendants' claim.

Sections 6.8(a), (b), and (c) of the Caiman LLC Agreement identify different approvals that Caiman II must obtain before it can engage in identified actions. Section 6.8(a) states:

> In addition to any other matters under Applicable Law or pursuant to the provisions of this Agreement that require the approval of or a determination by the Board ..., [Caiman II] (or the officers and agents acting on its behalf), on its own behalf or on behalf of any of its subsidiaries, shall not take any of the following actions without having first received Majority Board Approval, unless such matter is a Special Voting Item (in which event the approval set forth in Section 6.8(b) and no other shall be required) or a Major Special Voting Item (in which event the approval set forth in Section 6.8(c) and no other shall be required), and unless such actions were previously and expressly approved by the Board in connection with, or as a part of, approving the most recently approved Overhead Budget, Capital Budget, or Operation and Enhancement Plan ....

JX 1, § 6.8(a) (formatting altered). Section 6.8(a) then lists the "actions" that Caiman II cannot engage in "without first having received Majority Board Approval." *Id.* The list of twenty-one actions includes item (xvii), which is "to make a distribution by [Caiman II] to the Members." It also includes a catchall item (xxi), which is "to take any action, authorize or approve, or enter into any binding agreement with respect to or otherwise commit to do any of the foregoing." *Id.* § 6.8(a).

The Caiman LLC Agreement defines "Majority Board Approval" as "the approval of those Managers having the Majority of the Voting Power." *Id.* at 10. It defines "Majority of the Voting Power" to mean "those Managers whose aggregate votes equal or exceed, [sic] a majority of the votes then entitled to be exercised by Managers then entitled to be designated to the Board." *Id.* § 6.2(b). Because the Board consists of nine seats, before Caiman II can take any of the twenty-one identified actions, it must receive approval from at least five of the managers serving on the Board.

As indicated by Section 6.8(a), Section 6.8(b) identifies a list of Special Voting Items, which are actions that Caiman II cannot engage in without *both* receiving Majority Board Approval *and* the approval of at least one EnCap Manager and one Williams Manager. In pertinent part, Section 6.8(b) states:

> Notwithstanding Section 6.8(a) ... [Caiman II] (or the officers and agents acting on its behalf), on its own behalf or on behalf of any of its subsidiaries (and for the purposes of this Section 6.8(b), Blue Racer shall be deemed to be a "subsidiary" of [Caiman II]), shall not take any of the following actions (each a "Special Voting Item") without having first received Majority Board Approval, which majority must include the affirmative vote of at least one EnCap Manager and at least one [Williams Manager] ....

Id. § 6.8(b). The list of fourteen Special Voting Items includes item (xii), "to amend, modify or otherwise change ... in any material respect any Blue Racer Agreement ...." *Id.* It also includes a catchall item (xiv), which is "to take any action, authorize or approve, or enter into any binding agreement with respect to or otherwise commit to do any of the foregoing." *Id.*

***18** As further indicated by Section 6.8(a), Section 6.8(c) identifies a list of Major Special Voting Items, which are actions that a single EnCap Manager has the sole and exclusive ability to approve. In its entirety, Section 6.8(c) states:

> Notwithstanding Section 6.8(a) and Section 6.8(b) the following actions (each a "Major Special Voting Item") shall only require the affirmative vote of one EnCap Manager, and upon such affirmative vote shall be deemed approved as an act of the Board (and, for the avoidance of doubt, such actions may not be taken by any other vote or approval of the Board):
>
> (i) to approve a Qualified IPO, or
>
> (ii) to take any action, authorize or approve, or enter into any binding agreement with respect to or otherwise commit to do any of the foregoing.

Id. § 6.8(c). Although this provision empowers "a single EnCap Manager" with this authority, for simplicity, this decision refers to the authority as being vested in EnCap.

The parties agree that Section 6.8(c) applies "[n]otwithstanding Section 6.8(a) and Section 6.8(b)," and they agree that Section 6.8(c)(i) gives EnCap the sole and exclusive authority to approve a Qualified IPO. They disagree about the implications of Section 6.8(c)(ii). The defendants contend that Section 6.8(c)(ii) gives EnCap sole and exclusive authority to take any action with respect to a Qualified IPO. They read the authority "to take any action ... with respect to ... the foregoing" as meaning "to take any action with respect to a Qualified IPO." They conclude that if the Caiman LLC Agreement requires or empowers the Board to take action on a particular item, and if Section 6.8(a) or (b) would require a different vote for Board action, then Section 6.8(c) vests EnCap with the sole and exclusive authority to take action on behalf of the Board if a Qualified IPO is involved.

Williams reads Section 6.8(c)(ii) more narrowly. As Williams sees it, the grant of authority in Section 6.8(c)(ii) "to take any action ... with respect to ... the foregoing" means "to take any action with respect *the approval of* a Qualified IPO." Williams does not read the resulting authority as extending to any action in connection with a Qualified IPO, only the steps necessary to approve a Qualified IPO.

To bolster its reading, Williams points out that the Caiman LLC Agreement contains the Qualified IPO Section, which contains twelve single-spaced paragraphs identifying actions that the Board can take in connection with a Qualified IPO and the rights that certain members have. *See id.* § 9.5. In particular, Section 9.5(b) states:

> Notwithstanding anything to the contrary in this Agreement, at any time after the approval of a Qualified IPO in accordance with this Agreement, the Board shall be entitled
>
> [1] to approve the transaction or transactions to effect the IPO Exchange and
>
> [2] to take all such other actions as are required or necessary to facilitate the Qualified IPO including
>
> forming any entities required or necessary in connection with the Qualified IPO without the consent or approval of any other person (including any Member).

Id. § 9.5(b) (formatting altered) (enumeration added). This decision refers to subpart [1] as the "IPO Exchange Clause," subpart [2] as the "IPO Facilitation Clause," and subpart [2]'s subsidiary right to form entities as the "Entity Formation Clause."

***19** Williams correctly observes that under the defendants' reading of Section 6.8(c)(ii), the Qualified IPO Section largely becomes surplusage. The IPO Facilitation Clause, for example, empowers EnCap "to take all such ... actions as are required or necessary to facilitate the Qualified IPO ...." *Id.* § 9.5(b). If the defendants were correct that Section 6.8(c)(ii) vested EnCap with the sole and exclusive authority "to take any action ... with respect to ... [a Qualified IPO]," then Section 9.5(b) would not serve any purpose, because Section 6.8(c)(ii) already would have covered the waterfront.

The defendants' interpretation of Section 6.8(c) is also unreasonable because it has no natural limiting principle. As long as EnCap was acting with respect to a Qualified IPO, the defendants' interpretation would give a single EnCap Manager the ability to take any action whatsoever, notwithstanding any requirement in Section 9.5 or any other section of the Caiman LLC Agreement. For example:

- Section 9.5(a) establishes requirements for proceeding with a Qualified IPO, and Sections 9.5(d) and (e) specify requirements for proceeding with an MLP Conversion. Under the defendants' reading of Section 6.8(c)(ii), EnCap could override those provisions and effectuate a different transaction that failed to comply with those requirements.

- Sections 3.2, 3.7, 3.8 and 9.2 limit the situations under which new members can be admitted to Caiman II. Under the defendants' reading, EnCap could admit new members in connection with a Qualified IPO.

- Section 4.3 precludes the payment of interest on capital contributions and forecloses a member from requiring the return of its capital contribution. Under the defendants' reading, EnCap could recover its capital contribution, with interest, in connection with a Qualified IPO.

- Section 6.3(a) empowers the member that appointed a particular manager to remove the manager. Under the defendants' reading, EnCap could remove a Williams Manager or the Oaktree Manager in connection with a Qualified IPO.

- Sections 6.3(b) and (c) grant protections against removal to Caiman Management in their capacities as members of the Board. Under the defendants' reading, EnCap could override these protections in connection with a Qualified IPO.

- Section 6.4(a) empowers Williams and Oaktree to designate a successor manager to fill any vacancy created by the death, disability, retirement, resignation, or removal of a designated manager. Under the defendants' reading, EnCap could fill these vacancies in connection with a Qualified IPO.

- Section 6.4(b) empowers certain "Management Investors" to fill any vacancy created by the death, disability, retirement, resignation, or removal of a "Management Manager." Under the defendants' reading, EnCap could fill these vacancies in connection with a Qualified IPO.

- Section 6.5(d) requires a quorum for a valid meeting of the Board, and the same quorum requirement exists under Section 6.5(g) for action by written consent. Section 6.8(c) only addresses the voting standard, not the quorum requirement. Under the defendants' reading, EnCap could ignore the quorum requirement for any meeting of the Board, or any action by written consent, in connection with a Qualified IPO.

- Section 6.5(f) entitles Lafield to serve as chairman of any meeting of the Board as long as he is a member and empowers the chairman to determine the order of business and the procedure, including the manner of voting and conduct of discussion. Under the defendants'

reading, EnCap could take over meetings of the Board in connection with a Qualified IPO.

***20** • Section 6.6 prohibits managers from receiving compensation for serving on the Board. Under the defendants' reading, EnCap could pay managers for their service in connection with a Qualified IPO.

To be clear, EnCap is not claiming that Section 6.8(c)(ii) gives it these rights. Nevertheless, a necessary implication of EnCap's argument would be that its rights under Section 6.8(c)(ii) would sweep so broadly that they would override these aspects of the Caiman LLC Agreement. *See Sun-Times*, 954 A.2d at 400–01 (describing the importance of considering "the practical implications" of a party's interpretive position).

Williams' reading harmonizes Section 6.8(c)(i) with the Qualified IPO Section and gives meaning to both sections. Section 6.8(c)(i) gives EnCap the unilateral authority to approve a Qualified IPO. If EnCap exercises its authority, then the Qualified IPO Section governs what EnCap can do to structure and carry out the IPO.

Williams' reading also gives meaning to Section 6.8(c)(ii), which provides EnCap with unilateral authority to "to take any action, authorize or approve, or enter into any binding agreement with respect to or otherwise commit to [the approval of a Qualified IPO]." Absent this additional authority, the quorum requirements in the Caiman LLC Agreement could interfere with the ability of a single EnCap Manager to act validly at a meeting or by written consent to approve a Qualified IPO, as could the power of the chairman of the Board to control the order of business and procedure at a meeting. *See id.* §§ 6.5(d)–(g).

Finally, Williams' reading explains why Section 9.5(a) takes pains to specify that references in the Qualified IPO Section to the "Board" refer to "the Board with the approval required for a Major Special Voting Item." *Id.* § 9.5(a). Under the defendants' reading of Section 6.8(c)(ii), there would have been no need to include this language because Section 6.8(c)(ii) would have already provided EnCap with sole and exclusive authority "to take any action ... with respect to ... [a Qualified IPO]." Without this language, the references to "the Board" in the Qualified IPO Section would indicate that although EnCap could *approve* the Qualified IPO, only the Board as a whole had the authority *to effectuate* the Qualified IPO. The plain language of Section 9.5(a) addresses this problem by providing EnCap with the authority to effectuate a Qualified IPO. The inclusion of this language similarly indicates that Section 6.8(c) only grants EnCap authority with respect to the *approval* of a Qualified IPO, after which EnCap must look to the Qualified IPO Section to determine the scope of its authority to carry it out.

Read in conjunction with other sections in the Caiman LLC Agreement, Section 6.8(c) does not give EnCap expansive authority to take any conceivable action with respect to a Qualified IPO. Section 6.8(c)(i) grants EnCap sole and exclusive authority to approve or reject a Qualified IPO, and Section 6.8(c)(ii) ensures that EnCap has the power to take all actions with respect to the approval of a Qualified IPO, notwithstanding potential procedural impediments in the Caiman LLC Agreement. Once EnCap has approved a Qualified IPO, the Qualified IPO Section determines what steps EnCap can take to effectuate the Qualified IPO.

C. EnCap's Authority Under The Qualified IPO Section

***21** The defendants separately argue that EnCap has the unilateral power to carry out the multiple steps involved in the Up-C IPO under the Qualified IPO Section. Within the Qualified IPO Section, Section 9.5(b) grants EnCap the authority "to approve the transaction or transactions to effect the IPO Exchange and to take all such other actions as are required or necessary to facilitate the Qualified IPO ...." *Id.* § 9.5(b). Within this provision, the IPO Exchange Clause authorizes EnCap "to approve the transaction or transactions to effect the IPO Exchange," and the IPO Facilitation Clause authorizes EnCap "to take all such other actions as are required or necessary to facilitate the Qualified IPO." Providing an example of the latter grant of authority, the Entity Formation Clause authorizes the "forming any entities required or necessary in connection with the Qualified IPO."

1. EnCap's Authority Under The IPO Exchange Clause

The defendants contend that in carrying out the Up-C IPO, EnCap can rely on the IPO Exchange Clause. Section 9.5(a) describes the requirements for an "IPO Exchange" as follows:

> [1] In connection with any proposed Qualified IPO approved in accordance with this Agreement, the outstanding Membership Interests will be converted or exchanged in accordance with this Section 9.5 into equity securities of the IPO Issuer ("IPO Securities") of the same class or series as the securities of the IPO Issuer proposed to be offered to the public in the Qualified IPO (the "Publicly Offered Securities").

> [2] Each outstanding Membership Interest will be converted into or exchanged for IPO Securities at such time as determined by the Board with the approval required for a Major Special Voting Item in a transaction or series of transactions that give effect to the provisions of Section 5.4 (the "IPO Exchange") such that each holder of Membership Interests will either
>
> (i) receive IPO Securities having a Fair Market Value equal to the same proportion of the aggregate Pre-IPO Value, if any, that such holder would have received if all of [Caiman II's] cash and other property had been distributed by [Caiman II] in complete liquidation pursuant to the rights and preferences set forth in Section 10.2(h) as in effect immediately prior to such distribution assuming that the value of the IPO Issuer immediately prior to such liquidation distribution was equal to the Pre-IPO Value or
>
> (ii) have such Membership Interests cancelled for no consideration, if the application of the foregoing clause (i) would result in a holder of Membership Interests receiving no IPO Securities.

Id. § 9.5(a) (formatting altered) (bracketed numbering added). The defendants contend that sentence [2] gives EnCap further (and, in their view redundant) authority to determine the "time" at which "[e]ach outstanding Membership Interest will be converted into or changed for IPO Securities."

The primary purpose achieved by the plain language of Section 9.5(a) is not to empower EnCap, but rather to establish the requirements for carrying out a Qualified IPO. Sentence [1] provides that in connection with any Qualified IPO, "the outstanding Membership Interests" must be exchanged for or converted into equity securities of the IPO Issuer "of the same class or series as the securities of the IPO Issuer proposed to be offered to the public in the Qualified IPO." The Caiman LLC Agreement defines the term "Membership Interests" to mean "the interest of a Member in [Caiman II] ...." *Id.* at 11. Sentence [1] thus imposes two requirements for carrying out a Qualified IPO: (i) the membership interests *in Caiman II* must be converted into the securities of the IPO Issuer (the "Caiman Interests Requirement"), and (ii) the securities that the members receive must be "of the same class or series as the securities of the IPO Issuer proposed to be offered to the public" (the "Same Securities Requirement").

***22** Sentence [2] starts with language to make clear that EnCap is empowered to act on behalf of the Board when taking the actions contemplated by the Qualified IPO Section, but the bulk of that provision imposes additional requirements for the IPO Exchange. Under sentence [2], "[e]ach outstanding Membership Interest"—a reiteration of the Caiman Interest Requirement—must be converted into or exchanged for IPO Securities "in a transaction or series of transactions that give effect to the provisions of Section 5.4." Section 5.4 establishes a contractual waterfall for payouts "to the holders of Class A Units, Class B Units, Class C Units, Cass D Units and Class E Units" based on their respective "Sharing Percentages." *Id.* § 5.4. To calculate the amount of IPO Securities that each member is entitled to receive, EnCap must determine "the aggregate Pre-IPO Value, if any, that such holder would have received if all of [Caiman II's] cash and other property had been distributed by [Caiman II] in complete liquidation pursuant to the rights and preferences set forth in Section 10.2(h) ...." *See id.* § 9.5(a). The Caiman LLC Agreement defines Pre-IPO Value as

> the product of (a) the quotient obtained by dividing (i) the net proceeds to the IPO Issuer from a Qualified IPO (less the reasonably estimated expenses of such Qualified IPO to the IPO Issuer) by (ii) a fraction (expressed as a percentage), the numerator of which is the number of Publicly Offered Securities to be sold to the public in the Qualified IPO and the denominator of which is the total number of securities of the same class or series as the Publicly Offered Securities (including the Publicly Offered Securities) that will be outstanding immediately after the Qualified IPO and (b) the difference between 100% and the percentage described in clause (a)(ii) of this definition.

Id. at 13. The "rights and preferences set forth in Section 10.2(h)" incorporate the members' contractually defined "Sharing Percentages" from Section 5.4(c) and also take into account their capital account balances. *See id.* §§ 10.2(d), (h).

In substance, these calculations require that EnCap determine how much each Caiman II member would receive under the dissolution waterfall in a hypothetical sale of Caiman II for an amount equal to the anticipated IPO proceeds, and then use the resulting amounts to determine the members' relative ownership stakes in Caiman II. In the IPO Exchange, the membership interests of each member in Caiman II must either be (i) converted or exchanged into IPO Securities "having a Fair Market Value equal to the same proportion of the pre-IPO Value," or (ii) cancelled for no consideration if the member would not receive anything in the distribution (the "Waterfall Distribution Requirement").

The plain language of the IPO Exchange Clause authorizes EnCap "to approve the transaction or transactions to effect the IPO Exchange." *Id.* § 9.5(b). The IPO Exchange, however, must comply with the requirements of Section 9.5(a), including the Caiman Interests Requirement, the Same Securities Requirement, and the Waterfall Distribution Requirement.

In this case, the defendants cannot rely on the IPO Exchange Clause as a source of authority for the Up-C IPO because EnCap is not using its authority "to effect the IPO Exchange" as defined in Section 9.5(a). In the proposed Up-C IPO, the membership interests of Caiman II would not be converted into the same IPO Securities that the public would receive, which would violate both the Caiman Interests Requirement and the Same Securities Requirement. The package of securities that the defendants have proposed to provide to the members of Caiman II appears to satisfy the allocative component of the Waterfall Distribution Requirement, but the defendants' proposal does not contemplate providing that value in the form of IPO Securities, as called for by the Waterfall Distribution Requirement.

The Qualified IPO Section does not recognize any situations in which the Qualified IPO can depart from the Caiman Interests Requirement or the Waterfall Distribution Requirement. The Qualified IPO Section only recognizes one situation in which the parties can depart from the Same Securities Requirement. Section 9.5(d) states that in the event of an MLP Conversion, the securities of the master limited partnership would be valued in accordance with the Waterfall Distribution Requirement "and distributed in two sequential, contemporaneous distributions ...." *Id.* § 9.5(d). The first distribution would consist of "any cash, the common units and subordinated units of the master limited partnership," and the second would consist of "any incentive distribution rights or similar incentive securities," recognizing that the distributions made in the first tranche could result in changes in the amounts that holders would receive under the second tranche. *Id.* Here, EnCap is not pursuing an MLP Conversion.

***23** Demonstrating that the Up-C IPO will not comply with the Caiman Interests Requirement, the Same Securities Requirement, or the Waterfall Distribution Requirement, EnCap proposes to amend Section 9.5(a) so that it authorizes the type of transaction that EnCap wants to implement through the Up-C IPO. The defendants claim that EnCap can make those amendments, and then invoke the IPO Exchange Clause to carry out the IPO Exchange once EnCap has rewritten that clause. As discussed below, EnCap does not have the power to amend the Caiman LLC Agreement in pursuit of a Qualified IPO. *See infra*, Part II.D.2. EnCap can exercise the authority it possesses under the Caiman LLC Agreement to approve and effectuate a Qualified IPO, but EnCap does not have the power to change what constitutes a Qualified IPO or its component parts and thereby grant itself different and greater rights.

In sum, the IPO Exchange Clause is not a meaningful source of authority for EnCap in pursuing the Up-C IPO. The IPO Exchange Clause authorizes EnCap to implement the IPO Exchange, but the contractual parameters of the IPO Exchange impose limitations on what EnCap can accomplish. The IPO Exchange Clause restricts what EnCap can do; it does not expand what EnCap can do.

2. EnCap's Authority Under The IPO Facilitation Clause

To support their position that EnCap can effectuate the proposed Up-C IPO, the defendants rely most heavily on the IPO Facilitation Clause. To reiterate, that clause states:

> Notwithstanding anything to the contrary in this Agreement, at any time after the approval of a Qualified IPO in accordance with this Agreement, [EnCap] shall be entitled ... to take all such other actions as are required or necessary to facilitate the Qualified IPO ... without the consent or approval of any other person (including any Member).

JX 1, § 9.5(b).

Under the plain language of the IPO Facilitation Clause, EnCap is entitled to take all such actions as are "required or necessary to facilitate the Qualified IPO." "Something required is necessary or essential, and a requirement is something that must take place." *CompoSecure, L.L.C. v. CardUX, LLC*, 2019 WL 2371954, at *2 (Del. Ch. June 5, 2019), *aff'd*, 213 A.3d 1204, 2019 WL 3311949 (Del. July 24, 2019). The term "necessary" is thus a synonym for "required." Its inclusion is an example of "the law's hoary tradition of deploying joint terms, such as 'indemnify and hold harmless,' where technically one term would suffice." *See Quadrant Structured Prods. Co. v. Vertin*, 106 A.3d 992, 1024 (Del. 2014).[10] The word "facilitate" means "to make easier" or "help bring about."[11]

***24** Here, the object of facilitation is a "Qualified IPO." The Caiman LLC Agreement defines that term as

> any [1] underwritten initial public offering by the IPO Issuer of equity securities
>
> [2] pursuant to an effective registration statement under the Securities Act
>
> [3] for which aggregate cash proceeds to be received by the IPO Issuer from such offering (without deducting underwriting discounts, expenses and commissions) are at least $75,000,000;
>
> [4] provided that a Qualified IPO shall not include an offering made in connection with a business acquisition or combination pursuant to a registration statement on Form S-4 or any similar form, or an employee benefit plan pursuant to a registration statement on Form S-8 or any similar form.

JX 1 at 14 (formatting altered) (enumeration added).

Under the plain meaning of the IPO Facilitation Clause, EnCap is entitled to take actions that are "necessary or required to facilitate a Qualified IPO." In other words, EnCap is entitled to take actions that are necessary or required to facilitate an IPO having the characteristics of a Qualified IPO as described in the Caiman LLC Agreement. Most obviously, EnCap can hire an underwriter, retain securities counsel, and take other actions required or necessary to facilitate an unwritten offering of equity securities pursuant to an effective registration statement, such as conducting due diligence and making filings with the SEC. More broadly, EnCap is empowered to take actions required or necessary to facilitate an offering that raises cash proceeds of at least $75 million, which is the amount targeted in the definition of a Qualified IPO. EnCap is not empowered to take actions to facilitate an IPO that would raise less than $75 million.

A more difficult question is whether the IPO Facilitation Provision gives EnCap the power to disregard otherwise mandatory provisions of the Caiman LLC Agreement, such as the Caiman Interest Requirement, the Same Securities Requirement, and the Waterfall Distribution Requirement. This question can be answered by recognizing that when EnCap takes action under the IPO Facilitation Provision, EnCap is acting on behalf of the Board. That provision therefore only gives EnCap the power to take action that the Board otherwise would have authority to take. Put differently, EnCap cannot take actions that the Caiman LLC Agreement does not empower the Board to take.[12] For similar reasons, EnCap cannot take actions that the Caiman LLC Agreement has empowered specific members to take, such as designating or removing particular managers. *See* Part II.B, *supra* (listing examples of mandatory provisions and members' rights).

***25** The fact that EnCap is acting on behalf of the Board also means that the IPO Facilitation Provision does not empower EnCap to act unilaterally to amend the terms of the Caiman LLC Agreement. The scope of the Board's authority over various matters and the votes required for the Board to take valid action are set forth in Sections 6.8(a), (b), and (c). Under Section 6.8(e), the Board's exercise of authority under Sections 6.8(a), (b), and (c) is subject to Section 12.2, which governs amendments to the Caiman LLC Agreement. The Board cannot amend the Caiman LLC Agreement by invoking its authority under Section 6.8(a), (b), or (c); the Board must comply with the requirements of Section 12.2.

By the same token, EnCap does not have the power under the IPO Facilitation Provision to amend the Caiman LLC Agreement. The IPO Facilitation Clause gives EnCap the power to carry out a Qualified IPO that the Board (through EnCap) has approved under Section 6.8(c). The fact that the Board (through EnCap) cannot amend the Caiman LLC Agreement under Section 6.8(c) when approving the Qualified IPO means that EnCap cannot amend the Caiman LLC Agreement when effectuating the Qualified IPO. Otherwise, EnCap would be able to approve a Qualified IPO, and then use the ensuing authority to amend the very sections that specify what a Qualified IPO means and entails, such as the definition of a Qualified IPO and the parameters for the IPO Exchange.

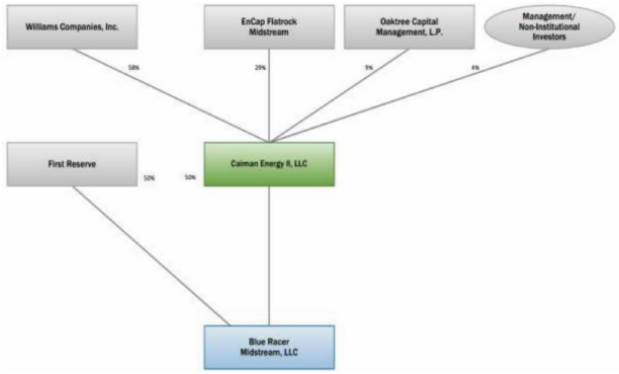
The defendants argue that because the IPO Facilitation Clause begins with the phrase "[n]otwithstanding anything to the contrary in this Agreement," EnCap can ignore mandatory provisions in the Caiman LLC Agreement and act unilaterally to amend those provisions. Although that reading might be plausible when the IPO Facilitation Clause is read in isolation, it does not take into account the Caiman LLC Agreement as a whole, which contemplates EnCap effectuating a Qualified IPO that has been approved under Section 6.8(c) and is carried out in compliance with the Qualified IPO Section. The limitations in Section 6.8(e) and EnCap's role in exercising the Board's authority for purposes of the Qualified IPO Section mean that EnCap can take action that the Board otherwise could take, but cannot disregard mandatory requirements or amend them such that they are no longer meaningful.

The IPO Facilitation Clause empowers EnCap to make all discretionary decisions "[n]otwithstanding anything to the contrary in this Agreement." It does not empower EnCap to override or amend the Caiman LLC Agreement.

D. The Application Of The Provisions To Six Disputed Steps In The Up-C IPO

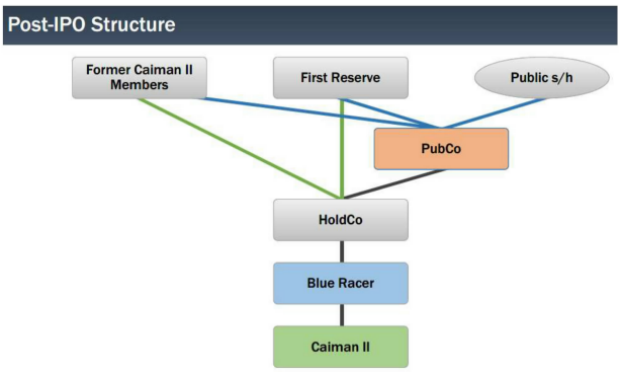
Having construed the plain meaning of the various provisions in the Caiman LLC Agreement, the next task is to apply those provisions to six disputed steps in the proposed Up-C IPO. Williams contends that EnCap lacks the authority to implement the disputed steps.

Before the Up-C IPO, in simplified form, the ownership structure for Caiman II and Blue Racer can be depicted as follows:



This diagram does not reflect the fact that Caiman II holds its 50% interest in Blue Racer through Ohio Midstream.

After the Up-C IPO that EnCap intends to carry out, the same business will have the following ownership structure:



To get from point A to point B, EnCap will take numerous actions, which can be grouped together in varying combinations. Williams has disputes EnCap's ability to implement six of the steps:

- Disputed Step One: Form PubCo and HoldCo.
- Disputed Step Two: Amend the Caiman LLC Agreement.
- Disputed Step Three: Amend the Blue Racer LLC Agreement.
- Disputed Step Four: Distribute the Blue Racer units held by Caiman II to Caiman II's members.

*26 • Disputed Step Five: Form a subsidiary of HoldCo, merge it into Blue Racer, and convert the Blue Racer units into HoldCo units and Class B shares of PubCo.

- Disputed Step Six: Form a subsidiary of Blue Racer and merge it with Caiman II.

1. Disputed Step One: Form PubCo And HoldCo.

EnCap has already completed the first disputed step in the Up-C IPO, which involved creating the entities that it regards as necessary to facilitate the Up-C IPO. EnCap did not include provisions analogous to the Purpose Clauses in the governing documents of those entities. Williams claims that EnCap could not form entities that lacked analogous provisions, but under the IPO Facilitation Clause and the Entity Formation Clause, EnCap had the authority to omit those provisions from the new entities' governing documents.

On April 24, 2019, EnCap formed PubCo, the Delaware corporation that EnCap intends to use as the IPO Issuer. EnCap also formed HoldCo, the Delaware limited liability company that will serve as a pivotal intermediate entity in the post-Up-C IPO structure. If the Up-C IPO is completed, then PubCo's only material asset will be membership interests in HoldCo, and HoldCo will own 100% of Blue Racer. JX 184 at '729.

To effectuate the Up-C IPO, PubCo will issue two classes of shares. Class A shares will have one vote per share and carry economic rights, including the right to dividends. Class B shares will also have one vote, but will not have any economic rights. Public investors will purchase Class A shares in the Up-C IPO. Legacy members of Caiman II will receive Class B shares and member interests in HoldCo as a result of a merger between an acquisition subsidiary of HoldCo and Blue Racer. Each Class B share will be paired on a one-for-one basis with a member interest in HoldCo, with the latter carrying the economic rights that the former lacks. *See id.* at '716–17.

As noted, the governing documents of PubCo and HoldCo do not contain provisions analogous to the Purpose Clauses. The defendants seek a declaration that EnCap has the authority under the Entity Formation Clause to form entities to effectuate the Qualified IPO whose governing documents do not contain provisions analogous to the Purpose Clauses. At times, Williams does not seem to contend otherwise, arguing only that other steps in the Up-C IPO require Williams' consent, and that "Williams will not consent to these steps" unless PubCo's certificate of incorporation contains a clause analogous to the Purpose Clauses. Dkt. 159 at 5. At other times, Williams appears to contend that PubCo's certificate of incorporation must contain such a clause.

The IPO Facilitation Clause gives EnCap the power to form entities that are required or necessary to facilitate the Qualified IPO. The Entity Formation Clause expressly grants that power by providing that the authority conferred by the IPO Facilitation Clause "includ[es] forming any entities required or necessary in connection with the Qualified IPO." JX 1, § 9.5(b). Nothing in the IPO Facilitation Clause or the Entity Formation Clause establishes any requirements for the contents of the governing documents of the entities that EnCap forms.

***27** Although the Caiman LLC Agreement contemplates that either Caiman II or Blue Racer could serve as the IPO Issuer, in which case the IPO Issuer's governing documents would contain a Purpose Clause, the IPO Issuer can be another entity that is an "Affiliate" of Caiman II. The Caiman LLC Agreement defines an "Affiliate" as "any person directly or indirectly Controlling, Controlled By, or Under Common Control with such person." *Id.* at 3. The Caiman LLC Agreement defines "Controlling, Controlled By, or Under Common Control" as "the possession, directly or indirectly, of the power to direct or cause the direction of management or policies (whether through ownership of securities or any partnership or other ownership interest, by contract or otherwise) of a person." *Id.* at 6. The Caiman LLC Agreement thus recognizes that the IPO Issuer could be any entity that controls, is controlled by, or is under common control with Caiman II. When the definition of "Affiliate" is read together with the Entity Formation Clause, the IPO Issuer could be a newly formed entity that controls, is controlled by, or is under common control with Caiman II. There is nothing in the Caiman LLC Agreement that requires the governing documents of the Affiliate to have a provision analogous to the Purpose Clauses.

Williams argues that because the IPO Issuer must be either Caiman II or an Affiliate of Caiman II, the governing documents of the IPO Issuer must contain a Purpose Clause. In support of this argument, Williams cites Section 12.8 of the Caiman LLC Agreement, which states that "[w]here any provision of this Agreement refers to action to be taken by any person, or which such person is prohibited from taking, such provision shall be applicable whether such action is taken directly or indirectly by such person, including actions taken by or on behalf of any Affiliate of such person." This provision does not say that the governing document of an Affiliate must contain a Purpose Clause. It rather implies the opposite by saying that if Caiman II is required to act or prohibited from acting under the Caiman LLC Agreement, then Caiman II cannot achieve the same result by acting through an Affiliate. This suggests that the Affiliate is not under the same restriction because if it were, it already would be unable to take the specified action, and Section 12.8 would not add anything.

EnCap thus had the authority under the IPO Facilitation Clause and the Entity Formation Clause to form PubCo to serve as the IPO Issuer without including a Purpose Clause in its certificate of incorporation. That does not mean that the formation of PubCo is without difficulties. The IPO Facilitation Clause and the Entity Formation Clause authorize EnCap to take actions required or necessary to facilitate a Qualified IPO, and as discussed in later sections, the Up-C IPO does not meet the requirements for a Qualified IPO because it does not comply with the Caiman Interests Requirement or the Same Securities Requirement. Because of these problems, the defendants failed to prove that forming PubCo was required or necessary to facilitate a Qualified IPO. But the defendants did prove that EnCap had the authority not to include a Purpose Clause in PubCo's certificate of incorporation.

The same is true for HoldCo. That entity's role in the Up-C structure depends on the viability of PubCo issuing two different classes of stock and the legacy members of Caiman II initially owning different securities than the public holders will receive. Because these features do not conform to the requirements for a Qualified IPO, the defendants failed to prove that forming HoldCo was required or necessary to facilitate a Qualified IPO. But the defendants did prove EnCap had the authority not to include a Purpose Clause in HoldCo's limited liability company agreement.

2. Disputed Step Two: Amend The Caiman LLC Agreement.

Williams next disputes EnCap ability to amend and restate the Caiman LLC Agreement. Williams is correct that EnCap lacks the authority to effectuate these amendments unilaterally.

EnCap proposes to make extensive changes to the Caiman LLC Agreement to enable the Up-C IPO to take place. The changes include, but are not limited to:

- Altering the definition of "Available Cash" to include cash generated "with respect to any operations of [Caiman II] other than those conducted by Blue Racer ...." JX 232 at '896.

***28** • Altering the definition of "Qualified IPO" so that proceeds generated in secondary public offerings can be credited against the $75 million threshold. *Id.* at '908.

- Adding new defined terms including "Blue Racer Members," "BRM Additional Capital Contribution," "Class A Common Stock," "Class B Common Stock," "Company Level Taxes," "Company Representative," "Covered Audit Adjustment," "Holdco," "Holdco Units," "Incentive Award," "IPO Value," "LTIP," "Partnership Tax Audit Rules," "Secondary Public Offering," "Up-C," "Allocated Securities," "Approved BRM Expenditure," "Excess Tax Amount," "Existing Agreement," "Final Launch Notice," "Final Participation Notice," "Participation Notice," "Preliminary Launch Notice," "Preliminary Participation Notice," "Retained Available Cash," "Tax Contribution Obligation," and "Tax Offset." *See id.* at '895 to '912.

- Deleting the term "Pre-IPO Value." *Id.* at '907.

- Altering the provisions of Section 5.1, which govern Capital Account Allocations. *See id.* at '918 to '921.

- Altering the provisions of Section 5.4, which specifies the waterfall for distributions to unitholders, to treat Incentive Awards under the newly defined LTIP as advances of distributions to holders of Class D Units. *See id.* at '922 to '923.

- Altering the provisions of Section 5.4(c) and introducing a new Section 5.4(d) to alter the requirement to distribute Available Cash and provide for the automatic retention of cash under particular circumstances. *See id.* at '923 to '924.

- Altering the provisions governing payment of distributions (Section 5.5) and tax distributions (Section 5.6). *See id.* at '924 to '927.

- Adding two new items requiring Majority Board Approval: the determination of the amount of Available Cash to be distributed (Section 6.8(a)(xvii)) and the determination of the amount of Available Cash to be reinvested (Section 6.8(a)(xxi)). *See id.* at '934 to '935.

- Altering a Special Voting Item addressing a limitation on funding for Blue Racer (Section 6.8(b)(ii)). *See id.* at '935 to '936.

- Amending the Qualified IPO Section to eliminate the Same Securities Requirement in Section 9.5(a) and add language to authorize the Up-C IPO. *Id.* at '952 to '953.

- Amending the Qualified IPO Section to provide that if EnCap determines to engage in an Up-C IPO and pursue an exchange in the manner EnCap contemplates, then "each holder of Units agrees to participate in such an exchange." *Id.* at '953.

- Amending the Qualified IPO Section to add an entirely new subsection with five lengthy subparts addressing the ability of members to participate in a secondary public offering. *Id.* at '954 to '955.

The only contractual basis for EnCap to effectuate these amendments unilaterally is through the IPO Facilitation Clause. For the reasons discussed previously, EnCap's power under that provision, like its approval power under Section 6.8(c), is subject to Section 12.2, which governs amendments to the Caiman LLC Agreement. Assuming for the sake of argument that the defendants could satisfy the general requirements to amend the Caiman LLC Agreement, they still must confront Section 12.2(a)(v), which provides that the terms of the Caiman LLC Agreement "may not be amended in a way that adversely affects the rights or obligations of [Williams] without the approval of [Williams]." JX 1, § 12.2(a)(v).

***29** The extensive changes that EnCap intends to make to the Caiman LLC Agreement are adverse to Williams. Without those changes, EnCap cannot implement the Up-C IPO because the structure of the Up-C IPO would contravene mandatory provisions in the Caiman LLC Agreement, such

as the Caiman Interest Requirement, the Same Securities Requirement, and the Waterfall Distribution Requirement. As a result, without the amendments, EnCap cannot force Williams out of the current Caiman II structure and into the post-Up-C IPO structure. At present, Williams is a majority investor in a privately held entity that operates within a governance arrangement that provides Williams with significant rights and protections. Through the Up-C IPO, EnCap wishes to transform Williams into a holder of two different securities: (i) units in a newly formed, privately held entity, plus (ii) Class B common stock in a publicly traded entity. In those new entities, Williams would be a minority investor without significant governance rights. The amendments would also alter the distribution waterfall under Section 5.4 of the Caiman LLC Agreement, which would change Williams' financial rights. By amending the Caiman LLC Agreement, EnCap would make the Up-C IPO possible. By doing so, EnCap would radically alter Williams' position, thereby affecting Williams adversely.

To argue that the amendments are not adverse, the defendants compare Williams' position under the Up-C IPO with Williams' position under a non-Up-C IPO. They claim, but have not established, that there would be no difference between the two for Williams except that the Up-C IPO would carry tax advantages. Even assuming that the defendants had proven that this was the only difference, it is still the wrong comparison. Section 12.2(a)(v) calls for comparing the situation Williams currently enjoys with its situation under the proposed amendments. *See id.* § 12.2(a)(v) (requiring Williams' approval for "amendments to *this Agreement*" that adversely affect Williams' rights and obligations) (emphasis added)). Section 12.2(a)(v) does not call for comparing Williams' situation under one set of amendments with Williams' situation under another set of amendments. Compared to the situation that Williams currently enjoys under the Caiman LLC Agreement, the amendments are adverse.

The defendants also argue that if the amendments are viewed in isolation, nothing about them is adverse to Williams. According to the defendants, any adversity results from the follow-on Up-C IPO rather than from the amendments themselves. The defendants' overly simplified approach ignores the fact that the amendments are designed to authorize and clear the path for the Up-C IPO, a transaction that adversely affects Williams. Without the amendments, EnCap lacks the ability to implement the Up-C IPO. With the amendments, EnCap has the ability to implement the Up-C IPO. The amendments load the gun, which adversely affects the target of the gun. They adversely affect Williams by eliminating the provisions that foreclose the Up-C IPO and exposing Williams to the threat of the Up-C IPO.

Regardless, the amendments are sufficiently intertwined with the other steps in the Up-C IPO that they must be analyzed together for purposes of assessing adversity. "The [step transaction] doctrine treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan." *Noddings Inv. Gp., Inc. v. Capstar Commc'ns, Inc.*, 1999 WL 182568, at *6 (Del. Ch. Mar. 24, 1999) (alteration in original) (quoting *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994)). "The purpose of the step transaction doctrine is to ensure the fulfillment of parties' expectations notwithstanding the technical formalities with which a transaction is accomplished." *Coughlan v. NXP B.V.*, 2011 WL 5299491, at *7 (Del. Ch. Nov. 4, 2011).

The step-transaction doctrine applies if the component transactions meet one of three tests. *See id.* First, under the "end result test," the doctrine will be invoked "if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result." *Noddings*, 1999 WL 182568, at *6 (internal quotation marks omitted). Second, under the "interdependence test," transactions will be treated as one if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Id.* (internal quotation marks omitted). The third and "most restrictive alternative is the binding-commitment test under which a series of transactions are combined only if, at the time the first step is entered into, there was a binding commitment to undertake the later steps." *Id.* (internal quotation omitted).

***30** The end result test and the interdependence test are both met here. EnCap designed the amendments to clear the path for the intricate steps necessary to effectuate the Up-C IPO, intending to achieve the end result contemplated of the post-Up-C IPO structure. But for the Up-C IPO, EnCap would have had no reason to propose the amendments and no basis on which to claim the power to implement them. Although EnCap has not bound itself contractually to carry out the Up-C IPO, a series of transactions need only meet one of the three tests to be treated as a single transaction. The satisfaction

of the first two tests provides a sufficient basis to treat the amendments to the Caiman LLC Agreement as an integral part of the Up-C IPO for purposes of determining whether they are adverse to Williams. They are, and so they cannot be implemented without Williams' consent.

The nature of the amendments that EnCap seeks to implement further underscores how incongruous it would be to permit EnCap to rely on the IPO Facilitation Provision to implement them. The IPO Facilitation Provision authorizes EnCap to take action required or necessary to facilitate a Qualified IPO. Yet as part of that authority, EnCap claims the ability to amend the definition of a Qualified IPO such that EnCap can use that authority to implement a different type of transaction.

In this case, EnCap might claim that it is making a relatively minor change to the definition of Qualified IPO by aggregating the primary and secondary offerings to determine whether the threshold of $75 million is met. The effect of that change, however, is not minor, as it would enable EnCap to invoke its authority to implement a Qualified IPO, but to then redefine "Qualified IPO" to refer to a different type of transaction. Nor is the change in this case actually minor. Under the original definition of "Qualified IPO," the IPO Issuer is entitled to receive proceeds of at least $75 million. The amendment would enable EnCap to sell its own shares as part of the Qualified IPO, in effect allowing EnCap to divert the proceeds of that sale to itself and yet credit those same proceeds against the $75 million requirement. The IPO Facilitation Clause authorizes EnCap to facilitate a Qualified IPO. It does not authorize EnCap to redefine Qualified IPO to refer to a different transaction and then implement that different transaction.

Absent Williams' consent, EnCap lacks the authority to amend the Caiman LLC Agreement in the manner contemplated for purposes of the Up-C IPO. EnCap therefore cannot carry out what this decision has described as step two of that transaction.

3. Disputed Step Three: Amend The Blue Racer LLC Agreement.

In the third disputed step of the Up-C IPO, EnCap intends to amend and restate the Blue Racer LLC Agreement. In connection with a Qualified IPO, EnCap can act unilaterally on behalf of Caiman II to amend the Blue Racer LLC Agreement. But because the defendants have not shown that the Up-C IPO is a Qualified IPO, they have not established that EnCap could properly exercise this power.

Under the IPO Facilitation Provision, EnCap has the power to take actions that the Board could take to the extent that those actions are required or necessary to facilitate a Qualified IPO. Section 6.8(b)(xii) gives the Board the power to amend the Blue Racer LLC Agreement with the vote required for a Special Voting Item. In connection with a Qualified IPO, EnCap can take action that the Board otherwise could take.

Although EnCap has the authority to amend the Blue Racer LLC Agreement in connection with a Qualified IPO, EnCap has failed to show that the Up-C IPO is a Qualified IPO. Instead, Williams has shown that the Up-C IPO depends on amendments to the Caiman LLC Agreement that EnCap lacks the power to make. Accordingly, in the context of the Up-C IPO, EnCap lacks authority to amend the Blue Racer LLC Agreement.

4. Disputed Step Four: Distribute The Blue Racer Units To Caiman II's Members.

***31** In the fourth disputed step of the Up-C IPO, EnCap intends to cause Caiman II to distribute all of its Blue Racer units to Caiman II's members. Under the IPO Facilitation Clause, EnCap possesses the power to take this step if it is required or necessary to facilitate a Qualified IPO. But because the defendants have not shown that the Up-C IPO is a Qualified IPO, they have not established that EnCap could properly exercise this power.

If EnCap could properly amend the Blue Racer LLC Agreement to create a single class of units, then EnCap could effectuate a distribution of Caiman II's Blue Racer units in connection with a Qualified IPO. Section 6.8(a)(xvii) of the Caiman LLC Agreement gives the Board the authority "to make a distribution by [Caiman II] to [its] Members" with a majority vote of the Board. To the extent that the distribution was necessary or required to facilitate a Qualified IPO, EnCap would have the power under the IPO Facilitation Clause to exercise that authority.

Williams argues that because the distribution would involve Caiman II's entire ownership interest in its only operating asset, it amounts to an Exit Event over which Williams would have a veto. To reiterate, an Exit Event is defined as

> the sale of [Caiman II], in one transaction or a series of related transactions, whether structured as

(i) a sale or other transfer of all or substantially all of the Equity Securities (including by way of merger, consolidation, share exchange, or similar transaction),

(ii) the sale or other transfer of all or substantially all of the assets of [Caiman II] promptly followed by a dissolution and liquidation of [Caiman II],

(iii) any other dissolution or liquidation of [Caiman II], or

(iv) a combination of any of the foregoing.

JX 1 at 8 (formatting altered). Williams reasons that by distributing the Blue Racer units, Caiman II would be transferring substantially all of its assets to its members, resulting in Caiman II's members, rather than Caiman II itself, directly owning Blue Racer.

Under Section 6.8(b)(xi), the Board can approve an Exit Event with the vote required for a Special Voting Item. Characterizing the distribution as an Exit Event thus changes the vote required for the Board to approve it outside of the context of a Qualified IPO. Within the context of a Qualified IPO, EnCap would have the power to exercise the Board's authority as long as the distribution was necessary or required to facilitate a Qualified IPO.

EnCap alternatively relies on the IPO Exchange Clause to provide it with the authority to distribute Caiman II's entire ownership interest in Blue Racer. The IPO Exchange Clause contemplates that the members' interests in Caiman II will be exchanged for or converted into equity of the IPO Issuer. Under the Same Security Requirement, the members must receive the same type of equity that the IPO Issuer's public investors receive. Although EnCap can achieve this outcome through one more or transactions, the distribution of Caiman II's entire ownership interest in Blue Racer is not a step toward that end. After the distribution, the members of Caiman II would continue to hold their membership interests in Caiman II, and they also would hold membership interests in Blue Racer. Each type of interests would be converted subsequently into a different security, neither of which would be the same security that the IPO Issuer's public investors would receive. EnCap is thus not relying on the requirements of the IPO Exchange Clause as written; EnCap is relying on the amended requirements that it has sought to effectuate. Because this decision has held that EnCap cannot effectuate those amendments, those amendments cannot provide EnCap with the authority to cause Caiman II to distribute its entire ownership interest in Blue Racer.

***32** Consequently, although EnCap has the authority to make the distribution in connection with a Qualified IPO, EnCap has failed to show that the Up-C IPO is a Qualified IPO that would give it the power to take this step. In the context of the Up-C IPO, EnCap lacks the authority to cause Caiman II to distribute its entire ownership interest in Blue Racer to its members.

5. Disputed Step Five: Form An Acquisition Subsidiary Of HoldCo And Merge It With Blue Racer.

In the fifth disputed step of the Up-C IPO, EnCap intends to form an acquisition subsidiary of HoldCo and merge it with and into Blue Racer. As a result of the merger, the membership interests in Blue Racer will be converted into a combination of HoldCo units and Class B shares of PubCo. EnCap lacks the authority to effectuate this step of the Up-C IPO.

Under the Blue Racer LLC Agreement, the act of "commencing, initiating or participating in any amalgamation, merger, or consolidation of [Blue Racer], or any reconstruction, conversion, liquidation, dissolution, bankruptcy or similar proceedings," requires the "prior approval of Members who in the aggregate hold one hundred percent (100%)" of its member interests. JX 34, § 7.11(b)(iv). At this point in the Up-C IPO, the member interests in Blue Racer would have been distributed to the current members of Caiman II, all of whom would have to vote in favor of the merger for it to be approved. Under the terms of the Blue Racer LLC Agreement, EnCap cannot accomplish this step unilaterally.

EnCap contends that the IPO Facilitation Clause gives it the power to take this step because the Up-C IPO must be viewed as a unitary transaction. As discussed previously, the Up-C IPO is correctly viewed as a unitary transaction for certain purposes, such as when determining whether it has an adverse effect on Williams. That fact does not relieve EnCap of its obligation to establish that it can validly carry out each step of the Up-C IPO.

The IPO Facilitation Clause gives EnCap the authority to exercise power on behalf of Caiman II that the Board otherwise could exercise. As long as Caiman II owned units in Blue Racer and had corresponding rights under the Blue Racer LLC Agreement, EnCap (rather than the Board) could cause Caiman II to exercise those rights to the extent required or necessary to facilitate a Qualified IPO. The IPO Facilitation

Clause does not give EnCap the authority to exercise rights or powers that the Board could not exercise.

Under the structure of the Up-C IPO that EnCap has proposed, at the point when it would become necessary to approve the merger of the HoldCo merger subsidiary with and into Blue Racer, Caiman II would no longer own Blue Racer units and would be unable to vote those units in favor of the merger. At that point, Blue Racer would be a separate entity under common ownership with Caiman II, rather than an entity partially owned by Caiman II. Under the structure of the Up-C IPO that EnCap has proposed, EnCap would lack the ability to approve the merger without the unanimous consent of the other members of Blue Racer, including Williams.

6. Disputed Step Six: Form An Acquisition Subsidiary Of Blue Racer And Merge It With Caiman II

In the last disputed step of the Up-C IPO, EnCap intends to form an acquisition subsidiary of Blue Racer and merge it with and into Caiman II. The Up-C IPO cannot reach this stage because of earlier problems. Assuming it did, then under the IPO Facilitation Clause, EnCap would possess the power cause Caiman II to merge if it was required or necessary to facilitate a Qualified IPO. In connection with the Up-C IPO, however, EnCap has not made the showing necessary to exercise this authority.

***33** Under the IPO Facilitation Provision, EnCap has the power to take actions that the Board could take to the extent that those actions are required or necessary to facilitate a Qualified IPO. Section 6.8(b)(iii) gave the Board the power "to merge, combine, or consolidate [Caiman II] with any other entity" with the vote required for a Special Voting Item. JX 1, § 6.8(b)(iii). If required or necessary to facilitate a Qualified IPO, then EnCap can take the action that the Board otherwise could take, including merging Caiman II with another entity.

Although EnCap would have the authority to cause Caiman II to merge if required or necessary to facilitate a Qualified IPO, EnCap has failed to show that the Up-C IPO is a Qualified IPO that would give it the power to take this step. Instead, Williams has shown that the Up-C IPO depends on steps that EnCap lacks the power to take. Accordingly, in the context of the Up-C IPO, EnCap does not have authority to cause Caiman II to merge with the Blue Racer acquisition subsidiary.

E. The Post-IPO Application Of Section 12.8

Williams argues that because Caiman II will survive the Qualified IPO, albeit as the lowest-tier subsidiary in the entity stack, the Caiman Purpose Clause will continue to bind PubCo, HoldCo, and Blue Racer under Section 12.8 of the Caiman LLC Agreement because they will be Affiliates of Caiman II.

To reiterate, Section 12.8 states: "Where any provision of this Agreement refers to action to be taken by any person, or which such person is prohibited from taking, such provision shall be applicable whether such action is taken directly or indirectly by such person, including actions taken by or on behalf of any Affiliate of such person." *Id.* § 12.8. This provision seems most clearly applicable to a parent entity that acts through a subsidiary, or a sibling entity that acts on behalf of another sibling entity when both entities are wholly owned by the same parent. It seems unlikely that a lower-tier, wholly owned subsidiary would be acting indirectly through a higher-tier entity, as opposed to the other way around, but it would be premature to rule out a possible factual scenario in which that might occur. Whether Caiman II could be found to be acting "indirectly" through PubCo, HoldCo, Blue Racer, or any other Affiliate would be a fact-dependent question that cannot be answered on the current record.

The defendants have argued that because Williams will no longer own any membership interest in Caiman II after the Up-C IPO, it will not have standing to assert a claim under Section 12.8. It is premature to address questions of Williams' standing, which could involve a multi-level derivative action or the novel question of a Williams Manager seeking to sue derivatively.

F. The IPO Cooperation Clause

The defendants contend that even if there are steps in the Up-C IPO that require Williams' consent, Williams is required to consent under the second sentence of Section 9.5(b). That provision states that if EnCap approves a Qualified IPO, then each of Caiman II's members shall:

> (i) take such actions as may be reasonably requested by [EnCap] in connection with consummating the IPO Exchange, including
>
> (x) such actions as are required to transfer all of the issued and outstanding Membership Interests or the assets of [Caiman II] to an IPO Issuer or its general partner (including a Blocker Corporation) and

(y) such actions as are required in order to merge or consolidate [Caiman II] into or with an IPO Issuer or its general partner and

(ii) use commercially reasonable efforts to

***34** (x) cooperate with the other Members so that the IPO Exchange is undertaken in a tax-efficient manner and

(y) if any Institutional Investor or its limited partners or investors has a structure involving ownership of all or a portion of its interests in [Caiman II], directly or indirectly, through one or more Blocker Corporations, at the request of such Institutional Investor, merge its Blocker Corporation into the IPO Issuer in a tax-free reorganization, utilize such Blocker Corporation as the IPO Issuer or otherwise structure the transaction so that the Blocker Corporation is not subject to a level of corporate tax on the Qualified IPO or subsequent dividend payments or sales of stock.

Id. § 9.5(b). This decision refers to this sentence as the "IPO Cooperation Clause."

Part (i) of the IPO Cooperation Clause obligates Williams to take such actions as may be reasonably requested by EnCap in connection with consummating the IPO Exchange. As discussed previously, EnCap is not carrying out the IPO Exchange. EnCap instead proposes to amend the Caiman LLC Agreement to authorize a different type of transaction. In the Up-C IPO that EnCap is seeking to implement, the membership interests in or assets of Caiman II are not being transferred to the IPO Issuer, and Caiman II is not merging or consolidating with the IPO Issuer. Part (i) of the IPO Cooperation Clause thus does not aid the defendants.

Part (ii)(x) of the IPO Cooperation Clause requires that Williams use commercially reasonable efforts to assist EnCap in undertaking the IPO Exchange in a tax-efficient manner. Here again, EnCap is not undertaking the IPO Exchange. EnCap is trying to implement a different structure.

More generally, an obligation to take reasonable actions or use commercially reasonable efforts obligates a party "to take all reasonable steps to solve problems and consummate the transaction" on the terms set forth in the governing agreement. *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, at *91 (Del. Ch. Oct. 1, 2018) *(quoting Williams Cos. v. Energy Transfer Equity, L.P.*, 159 A.3d 264, 272 (Del. 2017)), *aff'd*, 198 A.3d 724 (Del. 2018) (TABLE). It does not require a party "to sacrifice its own contractual rights for the benefit of its counterparty." *Id.* To the extent that Williams has rights under the Caiman LLC Agreement, such as a right to refuse to consent to amendments that are adverse to its interests, then Williams can stand on that right. EnCap cannot rely on the IPO Cooperation Clause to force Williams to waive or compromise its right.

G. The Stockholders Agreement

Blue Racer and First Reserve seek a declaration that they are not obligated to enter into a stockholders agreement with Williams that would replicate certain governance features of Caiman II in the context of PubCo. Nothing in the Caiman LLC Agreement requires a stockholders agreement. The parties may negotiate one if they choose, but there is no obligation to enter into one.

III. CONCLUSION

This decision has construed the plain language of the Caiman LLC Agreement and applied it to critical steps in the Up-C IPO. Because of the determinations made in this decision, EnCap cannot proceed with the Up-C IPO as currently structured. The parties shall prepare a form of final order that implements the rulings made in this decision. If there are additional matters that must be addressed before a final order can be entered, the parties shall submit a joint letter within ten days that identifies the issues and proposes a path for bringing this matter to conclusion at the trial level.

All Citations

Not Reported in Atl. Rptr., 2019 WL 4668350

Footnotes

1 Citations in the form "PTO ¶ —" refer to stipulated facts in the pre-trial order. Dkt. 138. Citations in the form "[Name] Tr." refer to witness testimony from the trial transcript. Citations in the form "[Name] Dep." refer to witness testimony from a deposition transcript. Citations in the form "JX — at —" refer to a trial exhibit with the page designated by the last three digits of the control or JX number. If a trial exhibit used paragraph or section numbers, then references are by paragraph or section.

2 EnCap invested through five separate funds, each of which is a defendant and counterclaim plaintiff: EnCap Flatrock Midstream Fund II, L.P., EnCap Energy Infrastructure Fund, L.P., TT-EEIF Co-Investments, LLC, UT EEIF Side Car, LLC, and LIC-EEIF Side Car, LLC. *See* PTO ¶¶ 17–21. EnCap manages the funds, and the distinctions among the entities are not important for purposes of this decision, which refers generally to "EnCap." This simplified usage should not obscure the fact that the individual funds are the formal members of Caiman II and thus the parties that are bound by and have rights under its limited liability company agreement.

3 Oaktree's predecessor firm, Highstar Capital, made the investment using defendant and counterclaim plaintiff Highstar IV Caiman II Holdings, LLC. *See* PTO ¶ 23. The distinctions between and among Oaktree, its predecessor, and the special purpose vehicle are not important for purposes of this decision, which refers generally to "Oaktree." As with the references to EnCap, this simplified usage should not obscure the fact that the special purpose vehicle is the formal member of Caiman II.

4 Williams invested through its subsidiary, Williams Field Services Group, LLC, which is the plaintiff and counterclaim defendant. The distinction between The Williams Companies and Williams Field Services Group, LLC is not important for purposes of this decision. This decision therefore refers generally to "Williams." As with the references to EnCap and Oaktree, this simplified usage should not obscure the fact that Williams Field Services is the formal member of Caiman II.

5 *See* Miller Tr. 467; Reaves Tr. 587–89; Miller Dep. 24–25; Armstrong Dep. 143–48; Carmichael Dep. 42–44; Lemmons Dep. 22, 31; Scheel Dep. 39–40, 175.

6 *See* Scheel Tr. 73–74; Armstrong Tr. 23–25; JX 31 at 5.

7 *Id.* at A-1. Schedule 3 of the Blue Racer LLC Agreement listed thirty-five counties in Ohio and five counties in Pennsylvania. Pursuant to Section 10.4, Dominion could remove certain counties from the AMI Area under specified circumstances. *Id.* § 10.4. This aspect of the Blue Racer LLC Agreement is not at issue.

8 The provision authorized limited changes pursuant to exceptions not relevant here.

9 JX 126 at '461 ("Our limited partnership agreement and Blue Racer's limited liability company agreement ... limit our ability to expand our or Blue Racer's operations beyond the Utica Shale and certain portions of the Marcellus Shale."); *id.* at '466 (disclosing that Caiman II was formed "for the sole purpose of pursuing midstream energy opportunities in the Utica Shale"); *id.* at '473 (disclosing that Blue Racer was formed "for the limited purpose of" operating in Ohio and Pennsylvania); *id.* at '475 (disclosing that the Blue Racer Agreement "restricts [Blue Racer] from engaging in operations outside of the Utica Shale and certain adjacent areas in the Marcellus Shale"); *id.* at '500 (same); *id.* at '515 to '516 (disclosing as a risk factor that "entering into any business for any purpose other than the company's stated purposes" would require approval from holders of 100% of Blue Racer's member interests).

10 *See, e.g.*, *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 588 (Del. Ch. 2006) (declining to give separate meaning to the phrase "hold harmless"; noting that "[t]he terms 'indemnify' and 'hold harmless' have a long history of joint use throughout the lexicon of Anglo-American legal practice"); *see also Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 788 (Del. Ch. 2016) (discussing functional equivalence of the terms "necessary" and "essential"), *abrogated on other grounds by Tiger v. Boast Apparel, Inc.*, —— A.3d ——, 2019 WL 3683525 (Del. Aug. 7, 2019); *Sanders v. Ohmite Hldgs., LLC*, 17 A.3d 1186, 1194 n.2 (Del. Ch. 2011) (same). *See generally* Bryan A. Garner, *The Redbook: A Manual on Legal Style* § 11.2 at 192 (2d ed. 2006) ("The doublet and triplet phrasing common in Middle English still survives in legal writing, especially contracts, wills, and trusts. That's probably the worst possible soil for it to grow in because those who interpret legal writing are impelled to strain for distinctions so that no word is rendered surplusage. Yet that is exactly [what] all but one word ... is [in these phrases].").

11 *See, e.g.*, *Facilitate*, Merriam-Webster, https://www.merriam-webster.com/dictionary/facilitate (last visited Sept. 20, 2019) ("**:** to make easier **:** help bring about"); *see also Facilitate*, Black's Law Dictionary (11th ed. 2019) ("To make the occurrence of (something) easier; to render less difficult."); *Facilitate*, Bryan A. Garner, A Dictionary of Modern English Usage 373 (4th ed. 2016) ("to aid, help, ease").

12 This reading results from the distinction between (i) action that the entity either cannot take or must take under its governing statute or constitutive documents, and (ii) the discretionary authority of the appropriate decision-maker to cause the entity to take or not to take action that falls within the entity's powers. In traditional corporate parlance, the former deals with the issue of whether the corporation has the capacity to take a particular action; the latter deals with the question of the approvals necessary for the action to be validly taken. *See* *Carsanaro v. Bloodhound Tech., Inc.*, 65 A.3d 618, 648–54 (Del. Ch. 2013) (discussing historical distinction between "capacity and power" and ability of particular constituencies, including the board, to exercise "capacity or power" on behalf of the corporation), *abrogated on other grounds by* *El Paso Pipeline GP Co. v. Brinckerhoff*, 152 A.3d 1248, 1264 (Del. 2016); 1 David A. Drexler et al., *Delaware Corporation Law and Practice* §§ 11.01, 11.05 (2018) (same); 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* §§ 2.1, 2.3 (3d ed. Supp. 2019-2) (same); *see also* Model Bus. Corp. Act. §§ 3.02, 3.04 (2016) (discussing parallel distinction under MBCA).

End of Document

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62 A.3d 676
Court of Chancery of Delaware.

Robert ZIMMERMAN, Plaintiff,

v.

Katherine D. CROTHALL, Michael Gausling, Peter Molinaro, Robert Toni, Steve Bryant, Originate Adhezion A Fund, Inc., a Delaware corporation, Originate Adhezion Q Fund, Inc., a Delaware corporation, Originate Ventures, LLC, a Delaware limited liability company, Liberty Ventures II, L.P., a Delaware limited partnership, Liberty Advisors, Inc., a Delaware corporation, and Thomas R. Morse, Defendants,

and

Adhezion Biomedical LLC, a Delaware limited liability company, Nominal Defendant.

C.A. No. 6001–VCP
|
Submitted: Sept. 14, 2012.
|
Decided: Jan. 31, 2013.

Synopsis

Background: Former chief executive officer (CEO) brought derivative action against limited liability company (LLC) and its board and some of its investors.

Holdings: The Court of Chancery, Parsons, Vice Chancellor, held that:

[1] authorization of additional units in LLC had to be accomplished by amendment to operating agreement;

[2] common unit holder approval was required to increase the number of units issued by LLC;

[3] unit holders were not a controlling shareholder group standing on both sides of the challenged transactions;

[4] LLC and its directors complied with operating agreement's safe harbor provision;

[5] challenged transactions were comparable to third party transactions and, thus, were entirely fair;

[6] CEO was entitled to nominal damages; and

[7] operating agreement required indemnification of directors' attorney fees.

Ordered accordingly.

West Headnotes (28)

[1] Corporations and Business Organizations Derivative actions; suing or defending on behalf of company

Former chief executive officer (CEO) could properly bring derivative action against limited liability company (LLC), where former CEO sought relief for injuries done to the LLC and because he pled demand excusal with particularity and sufficiently to create a reasonable doubt that, as of the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. 6 West's Del.C. § 18–1001.

[2] Contracts Language of contract

When interpreting a contract, the court's role is to effectuate the parties' intent based on the parties' words and the plain meaning of those words.

10 Cases that cite this headnote

[3] Contracts Reasonableness of construction

Of paramount importance when interpreting a contract is what a reasonable person in the

position of the parties would have thought the language of the contract meant.

2 Cases that cite this headnote

[4] **Contracts** Construction by Parties

Customs and Usages Explanation of Contract

When construing an ambiguous contract, the court will consider all relevant objective evidence, including: overt statements and acts of the parties, the business context, prior dealings between the parties, and business customs and usage in the industry; courts use such evidence to construe the ambiguous contract language in a way that best carries out the reasonable expectations of the parties who contracted in those circumstances.

1 Case that cites this headnote

[5] **Contracts** Construction as a whole

Courts attempt to give meaning and effect to each word in a contract, and assume that the parties would not include superfluous verbiage in their agreement.

7 Cases that cite this headnote

[6] **Contracts** Presumptions and burden of proof

Party seeking enforcement of contract bears the burden to prove his breach of contract claim by a preponderance of the evidence.

9 Cases that cite this headnote

[7] **Corporations and Business Organizations** Capital and Stock; Contributions

Authorization of additional units in limited liability company (LLC) had to be accomplished by amendment to operating agreement, although board purported to increase the number of units the LLC was authorized to issue using written consents of the board, where board acted without former CEO's knowledge, former CEO promptly disputed defendants' position, drafter of first amended operating agreement confirmed that the use of the term "authorize" was deliberate, and agreement did not set forth a process for authorizing units.

[8] **Evidence** Nature and Existence of Ambiguity in General

Extrinsic evidence may be used to interpret an ambiguous contract with the goal of effectuating the parties' intent.

5 Cases that cite this headnote

[9] **Contracts** Construction by Parties

Generally, the parties' actions under an agreement provide strong evidence of the contract's meaning.

[10] **Corporations and Business Organizations** Capital and Stock; Contributions

Common unit holder approval was required to increase the number of units the limited liability company (LLC) was authorized to issue, where operating agreement expressly required the consent of preferred members to create, authorize, and issue units, board had authority only to issue and create additional units, and, thus, the board would have had to amend the operating agreement to increase the number of authorized units.

1 Case that cites this headnote

[11] **Corporations and Business Organizations** Capital and Stock; Contributions

Exception to section of limited liability company's (LLC) operating agreement that governed amendments to operating agreement that allowed LLC's board to issue additional units applied to the creation of new classes or series of units, where prior version of operating agreement expressly gave the board the authority to create, not to issue, additional classes or series of units,

and operating agreement was amended so that board could issue additional units or create additional classes or series of units, attorney who drafted first amended agreement testified that the change was made to close loophole which expressly gave board authority to create additional units, and drafting history strongly implied that the language "with respect to the issuance of additional units" was not meant as limiting language, but referred to the subject matter of the provision that it referenced.

1 Case that cites this headnote

[12] **Corporations and Business Organizations** Organizing documents; operating agreement

Construing operating agreement against limited liability company (LLC) as its drafter and in favor of the meaning a reasonable investor would have attributed to the agreement was appropriate in former chief executive officer's (CEO) derivative action, where investor's attorney, who later became LLC's attorney, was involved in drafting amended and second amended operating agreements, when attorney participated in drafting the amended operating agreement, he was representing eventual investor in LLC, and at the time the second amended operating agreement was negotiated, investor was in a better bargaining position than LLC, and interests of attorney's original client generally were aligned with new private equity investors.

4 Cases that cite this headnote

[13] **Contracts** Construction against party using words

The rule of contra proferentum is one of last resort that will not apply if a document can be interpreted by applying more favored rules of construction; nevertheless, resort to the rule is appropriate in cases of standardized contracts and in cases where the drafting party has the stronger bargaining position, but it is not limited to such cases.

2 Cases that cite this headnote

[14] **Corporations and Business Organizations** Controlling or majority shareholders and minority shareholders in general

A shareholder will be considered "controlling" if it either owns more than 50% of the voting power of the company, or exercises actual control over the board of directors during the course of a particular transaction.

3 Cases that cite this headnote

[15] **Corporations and Business Organizations** Controlling or majority shareholders and minority shareholders in general

To make a showing of actual control such that a shareholder is considered controlling, plaintiff must demonstrate that, although lacking a clear majority, the shareholders have such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control.

[16] **Corporations and Business Organizations** Management of company affairs in general

Actual control of limited liability company (LLC) would exist where various director-stockholders were involved in a blood pact to act together, or where they were bound together by voting agreements or other material, economic bonds to justify treating them as a unified group.

[17] **Corporations and Business Organizations** Fiduciary duties; loyalty, care, and good faith

Unit holders were not a "controlling shareholder group" standing on both sides of the challenged transactions in former chief executive officer's (CEO) derivative action, although they owned 66% of LLC's voting shares and controlled at least two of the five directors on the board, where they neither acted together nor were connected in some legally significant way.

2 Cases that cite this headnote

[18] **Corporations and Business Organizations** Rights, duties, and liabilities

Duties of members of limited liability company's (LLC) board of directors were restricted by operating agreement as allowed by statute, where the parties to the operating agreement defined the scope of director fiduciary duties by setting a general standard for fiduciary conduct and gave directors the right to engage in transactions with the LLC subject to certain requirements. 6 West's Del.C. § 18–1101(c).

11 Cases that cite this headnote

[19] **Corporations and Business Organizations** Entire fairness of transaction in general

Corporations and Business Organizations Rights, duties, and liabilities

In the corporate context or in the case of a default fiduciary duty in the limited liability company (LLC), the initial presumption would be that the director defendant would have the burden of proving the transaction was entirely fair to the company and its unit holders.

4 Cases that cite this headnote

[20] **Corporations and Business Organizations** Rights, duties, and liabilities

Former chief executive officer (CEO) had the burden to prove a breach of obligation under limited liability company's (LLC) operating agreement that transactions be entirely fair in former CEO's action against LLC and its board and some of its investors, where agreement conferred on directors the right to deal with the LLC, provided that those dealings were on terms comparable to an unrelated third party transaction, i.e., were entirely fair.

10 Cases that cite this headnote

[21] **Corporations and Business Organizations** Rights, duties, and liabilities

Limited liability company (LLC) and its directors complied with operating agreement's safe harbor provision, which stated that a self-dealing transactions with LLC was not void or voidable solely because the director or officer was present at or participated in the board meeting that authorized the contract or transaction or solely because his or their votes were counted for such purpose, if the transaction was fair to the LLC or its subsidiary as of the time it was authorized, approved, or ratified by the LLC's board or members, where at least two directors were disinterested in the challenged transactions and gave their informed, good faith approval of them, none of the allegations or evidence presented supported a finding that the disinterested directors acted to perpetuate their tenure on the board, they were independent of board member who arguably was interested in the challenged transactions, and material facts as to the transactions were disclosed or were known to them.

2 Cases that cite this headnote

[22] **Corporations and Business Organizations** Rights, duties, and liabilities

The entire fairness standard for judging limited liability company's (LLC) transactions includes two non-bifurcated components: fair price and fair dealings.

4 Cases that cite this headnote

[23] **Corporations and Business Organizations** Rights, duties, and liabilities

Challenged transactions were comparable to third-party transactions in derivative action by former chief executive officer (CEO) against limited liability company (LLC) and its board

and some of its investors and, thus, were entirely fair, although board member failed to obtain a modification of the number of warrants granted in a particular issuance, where no third party was willing to invest in the LLC on terms more favorable to LLC, and former CEO sold a significant amount of his shares for only $2 per unit just three months after an issuance.

1 Case that cites this headnote

[24] **Fraud** Persons liable

To succeed on a claim for aiding and abetting a breach of fiduciary duty, plaintiff must prove: (1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, and (3) knowing participation in that breach by the non-fiduciary.

6 Cases that cite this headnote

[25] **Reformation of Instruments** Mutuality of Mistake

Reformation of Instruments Fraud

The remedy of reformation typically is used to conform a document to the parties' intent in cases of mutual mistake or fraud; it also can be used to remedy a breach of fiduciary duty, in which case the court has broad authority to fashion an appropriate remedy.

1 Case that cites this headnote

[26] **Corporations and Business Organizations** Trial, judgment, and relief; costs and attorney fees

Nominal damages award of $1 to former chief executive officer (CEO) of limited liability company (LLC) was warranted in former CEO's derivative action against LLC and its board and some of its investors, although defendants breached the operating agreement, where none of the challenged transactions were unfair and former CEO suffered no damages.

1 Case that cites this headnote

[27] **Corporations and Business Organizations** Rights, duties, and liabilities

Whether a party has the ultimate right to an advancement from the limited liability company (LLC) for attorney fees depends on whether his underlying conduct is indemnifiable.

1 Case that cites this headnote

[28] **Corporations and Business Organizations** Rights, duties, and liabilities

Limited liability company's (LLC) operating agreement required indemnification of directors' attorney fees, where agreement created broad indemnification rights for directors, required indemnification for directors unless there was a final adjudication that the director's acts were both not taken or made in good faith within the scope of the agreement and were the result of gross negligence, willful misconduct, or fraud on the part of the director.

Attorneys and Law Firms

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OPINION

PARSONS, Vice Chancellor.

This case addresses the allegations of a minority unitholder in a privately held medical device company. The unitholder is the co-founder and former CEO of the company. He became a minority stakeholder after accepting investments in the company in exchange for units and after he sold some of his own units. The company is managed by a board of directors

under its limited liability company operating agreement. The board of directors caused the company to enter into several financing transactions. The unitholder alleges that these transactions were in breach of the company's operating agreement and that, by undertaking the transactions, the directors also breached their fiduciary duties. He further alleges that certain unitholders breached fiduciary duties and that they and their affiliates aided and abetted the directors' breach of fiduciary duties.

A three-day trial was held on the unitholder's claims. After careful review of the evidence presented at trial and the parties' post-trial briefs and oral arguments, I conclude that the directors acted outside of their authority under the company's operating agreement, but that they did not breach the fiduciary duties they owed thereunder when they engaged in the financing transactions. Apart from entering a declaratory judgment that the directors exceeded their authority in engaging in the financing transactions, I deny the unitholder's requested relief, including his request that the defendants reimburse the company for its advancement of their attorneys' fees in this matter. I hold instead that the directors' breach caused no damage and that all defendants were entitled to indemnification notwithstanding the directors' breach of the company's operating agreement.

I. BACKGROUND

A. The Parties

Plaintiff, Robert Zimmerman, is the co-founder, former CEO, and a former director of Adhezion Biomedical LLC ("Adhezion" or the "Company"). Zimmerman currently owns 86,900 Class A Common units and 40,000 Class B Common units in Adhezion.

Nominal Defendant, Adhezion, is a privately held Delaware limited liability company with its principal place of business in Wyomissing, Pennsylvania. Adhezion is a medical device company that develops and commercializes surgical, wound management, and infection-prevention technologies.

The defendants in this action include the five members of Adhezion's board of directors (the "Board") and entities that have invested in, or are affiliated with an entity that invested in, Adhezion (collectively, "Defendants").

Defendants Katherine D. Crothall, Michael J. Gausling, Peter Molinaro, Robert Toni, and Steven R. Bryant are Adhezion's Board members (the "Director Defendants"). Molinaro is Adhezion's CEO and the Board Chairman.

Defendant Liberty Advisors, Inc. invested in Adhezion through its subsidiary, Defendant Liberty Ventures II, L.P. (collectively, "Liberty"). Defendant Thomas R. Morse is the co-founder and principal of Liberty Advisors, Inc. Crothall serves as Liberty's Board designee.

Defendant Originate Ventures, LLC is a venture capital firm that has invested in Adhezion through Defendants Originate ***682** Adhezion A Fund, Inc. and Originate Adhezion Q Fund, Inc. (collectively, "Originate"). Gausling is one of three managing partners of Originate Ventures, LLC and serves as Originate's Board designee.

B. Facts

Adhezion makes three main products: SurgiSeal, DermaSeal, and FloraSeal. The product that is the focus of the events leading up to this litigation is SurgiSeal, a medical adhesive used to close both accident-caused wounds and surgical incisions. SurgiSeal received approval from the United States Food and Drug Administration ("FDA") in December 2008. SurgiSeal competes with a Johnson & Johnson ("J & J") product called Dermabond. Dermabond holds approximately 85% of the domestic market for high-strength medical adhesives.[1] Molinaro estimates that the global market for high-strength medical adhesives was $500 million in 2008 and over $600 million in 2010.[2] Adhezion's SurgiSeal shows promise as a competitor to Dermabond. It allegedly has performance advantages over Dermabond[3] and is cheaper to produce.[4] Dermabond, however, has advantages over SurgiSeal including its existing market share and the powerful backing of J & J.[5] In 2010, the Cleveland Clinic placed SurgiSeal on its "primary vendor list."[6] In obtaining that business, Adhezion demonstrated that the Cleveland Clinic could save $300,000 annually if it converted 100% of its topical skin adhesive business to Adhezion.[7] Due to stiff competition from J & J, however, the Clinic purchased only "4 or 5 percent of their annual purchase from [Adhezion] and they stayed with the J & J product."[8]

1. Originate invests; Operating Agreement amended

Although the Company faced strong competition, it showed promise. Molinaro joined Adhezion as a consultant in 2007.[9] Zimmerman and Molinaro attracted at least two potential investors between 2007 and 2008. In March 2008, Originate invested $3 million in Adhezion in return for 375,000 Series A Preferred units at $8.00 per unit.[10] This transaction valued Adhezion at $8 million.[11] In connection with this transaction, Adhezion adopted a new operating agreement (the "Amended Operating Agreement").[12] Under the Amended Operating ***683** Agreement, the Company had five directors on its Board.[13] Its equity ownership was represented by Class A Common, Class B Common, and Series A Preferred units, the rights, preferences, and privileges of which were set forth in the Operating Agreement.

After the deal with Originate, Molinaro became Adhezion's CEO and a director. Also on the Board in March 2008 were Gausling, an initial Series A Preferred Director, and Zimmerman, the initial Common Director under the Amended Operating Agreement. In June 2008, and at Molinaro's suggestion, the Board elected Bryant to serve as Adhezion's Industry Director.[14] Bryant works at Angiotech, a customer of Adhezion. Bryant and Molinaro have worked together in various engagements since the 1980s.[15] They also have a personal friendship and have hunted together on several occasions and fished together once.[16]

2. Liberty invests; Second Amended Operating Agreement

In October 2008, while the Company was developing SurgiSeal and FloraSeal and attempting to secure FDA approvals, Molinaro sought and obtained funding from several additional investors, including Liberty, Crothall, and non-parties William Graham and his wife (collectively, the "Liberty Investors").[17] These investors contributed $2 million in exchange for 281,917 Series A Preferred units at approximately $7.05 per unit. This transaction effectively valued the Company at $10.5 million. As part of the transaction, the Amended Operating Agreement was amended again to create the Second Amended Operating Agreement. Among other things, the Second Amended Operating Agreement increased the number of directors on Adhezion's Board to six.[18] Crothall and Gausling became the Series A Directors while Molinaro and Zimmerman remained the CEO and Common Directors, respectively. Bryant continued to serve as one Industry Director. The second Industry Director position apparently was never filled. The Company obtained the consent of the Common unitholders for this transaction with the Liberty Investors, including for the execution of the Second Amended Operating Agreement.[19]

In January 2009, Zimmerman's employment with Adhezion was terminated and ***684** he was removed as the Common Director. In March 2009, the Class A Common unitholders elected Toni, former president and CEO of Closure Medical, to replace Zimmerman as the Board's Common Director.[20] In the 1980s, Toni had worked with Bryant and Molinaro for approximately four years at a company called Cilco.[21] Molinaro, Crothall, Gausling, Bryant, and Toni were the directors on the Board at all relevant times.

3. Adhezion's prospects in 2009

In January 2009, the Company began to have difficulty with its intellectual property ("IP") rights. MedLogic Global Limited ("MedLogic") notified Adhezion that MedLogic had concerns that the process Adhezion employed to sterilize SurgiSeal infringed MedLogic's '800 patent.[22] Also in early 2009, Adhezion began negotiations with 3M Company ("3M") regarding a proposed exclusive licensing and distribution agreement.[23] Adhezion initially hoped that 3M would pay a $3 million up-front licensing fee for both SurgiSeal and FloraSeal.[24] As negotiations progressed into the summer, however, 3M expressed several concerns, including that consumers perceived SurgiSeal to be not as strong as its competitor Dermabond,[25] that SurgiSeal was equivalent to Dermabond but not superior to it,[26] that SurgiSeal lacked clinical trials,[27] that SurgiSeal faced the threat of patent litigation,[28] and that SurgiSeal could not compete effectively with J & J on price.[29]

4. July 2009 Issuance

On April 30, 2009, Adhezion was running low on cash and the Board resolved to accept a "bridge loan" in an

amount up to $750,000.[30] The bridge loan was implemented in two tranches and the Board signed written consents for both.[31] The first tranche was issued on July 17, 2009 when Originate, Liberty, Molinaro, Crothall, and Graham provided the Company with $525,000 in return for promissory notes convertible into Series A Preferred units at approximately $7.05 per unit, or into a new series of units issued in the future at a different price (the "July 2009 ***685** Issuance").[32] In addition, warrant coverage of 100% was considered and rejected as "too rich and too discouraging to management."[33] Instead, the Company issued warrants for an extra 50% of the amount of the promissory notes for what Zimmerman contends was no additional consideration.[34]

Adhezion was still in negotiations with 3M when it received the first tranche of the bridge loan. The Company also was attempting to find additional sources of capital in the form of both prospective investors and possible strategic partners.[35] Between July 2009 and February 2010, Molinaro contacted over forty prospective investors and attended events sponsored by venture capital firms.[36] But all of these efforts were unsuccessful.[37]

5. 3M terminates discussions

On September 17, 2009, 3M terminated discussions with Adhezion.[38] Molinaro reported to the other Board members that he was "blind-sided" and "stunned" and that "the cash raising issue is even more critical" because the Company had "just 5 weeks of cash on hand."[39] At a September 29, 2009 Board meeting, Gausling and Morse stated that their respective firms (Originate and Liberty) would continue temporarily to satisfy Adhezion's operating cash requirements until the Company "saw where the Medline or Braun discussions finalized."[40] The Board then recommended that Molinaro cease capital-raising activities and instead focus his attention on finding a strategic distribution partner, such as Medline or Braun, to replace 3M.[41]

Zimmerman casts this Board recommendation as an attempt by Liberty and Originate to maintain control of the Company by preventing outside investment. To prove his point, Zimmerman relies on an e-mail regarding an upcoming investor presentation conference. In the e-mail, Molinaro identified the following issue to be addressed: "Explain how much money we are seeking ($2.5–5M?) This is a sensitive issue as Liberty & Originate both would like to see this a smaller number."[42] Around the same time, however, Originate's Gausling e-mailed Jim Datin, a principal at Safeguard Scientific, and asked if Datin would be "willing to have [his] team take a look at Adhezion?"[43] Gausling told Datin that the Company "would like to raise somewhere in the neighborhood of $5 ***686** mil[lion]" and that Originate "would participate in the round if that is needed, but would be equally content with new monies in alone."[44]

6. Kensey Nash makes an offer

In November 2009, Kensey Nash Corporation ("Kensey Nash") proposed to buy Adhezion for $10 million.[45] As proposed, the transaction included a $4 million cash payment and $6 million in milestone payments.[46] The Board considered this proposal to be "too low and too early."[47] On December 8, 2009, the Board made a counterproposal of $20 million in cash and an earn-out of up to $30 million.[48] Kensey Nash rejected this proposal as not "realistic."[49] After reviewing Adhezion's financial information over the next few months,[50] Kensey Nash ultimately decided not to raise its initial offer and terminated discussions.[51] As Molinaro reported to the Board, Kensey Nash "wanted to see some traction of sales to support a higher valuation."[52]

Also in November 2009, Medline demonstrated interest in partnering with Adhezion.[53] By December 2009, however, Medline had decided not to pursue a license and distribution agreement with Adhezion due in part to the risk of a patent infringement lawsuit with J & J.[54]

7. December 2009 Issuance

In December 2009, Adhezion implemented the second tranche of the bridge loan. Originate, Liberty, Molinaro, Crothall, and Graham provided the Company with a total of $315,000 in return for promissory notes subject to the same terms as the July 2009 Issuance (the "December 2009 Issuance" and together with the July 2009 Issuance, the "2009 Issuances").[55]

8. February 2010 Issuance; Third Amended Operating Agreement

By early 2010, the Company again needed money.[56] In January, Adhezion stopped producing SurgiSeal to work on a reformulation of the sterilization process that it hoped would allay any concerns of infringing MedLogic's and J & J's patents.[57] At a January 15, 2010 meeting, the Board determined that, subject to acceptable terms, it would secure an additional $1 million investment in Adhezion by the existing unitholders.[58] On January 22, ***687** Crothall circulated a term sheet to Gausling and Morse in which she proposed a $4 price per unit without including any financial analysis to support that price.[59] Rather, Crothall listed three risk factors to account for the "significantly lower price" of this January 2010 issuance in comparison to the 2009 Issuances: the lack of sales realized, the lack of a strategic deal, and a potentially difficult IP front.[60]

In early 2010, Crothall drafted an e-mail to Carl Kopfinger, a member of Liberty Ventures' investment committee. She stated, "I believe that this Company should be salable in 2–3 years for $50–$100 [million]."[61] She also mentioned that her valuation was "consistent with [the CEO and Originate's] thoughts as well."[62] While Crothall drafted this e-mail in response to an e-mail from Kopfinger, she only sent the draft to Morse. Furthermore, Crothall characterized the draft at trial as "very optimistic" and denied ever sending such an e-mail to Kopfinger."[63]

The Board, in a unanimous written consent, ultimately accepted Crothall's terms. It approved the issuance of (1) a new series of units—Series B Preferred—at a price of $4 per unit and (2) warrants for the purchase of Series B Preferred units with a $4 strike price.[64] This transaction valued the Company at $13 million.[65] Pursuant to a Third Amended Operating Agreement executed on February 17, 2010, the Company was authorized to issue 1,622,590 Series B Preferred units.[66] According to the February 2010 Purchase Agreement, executed on the same day, the Company issued 625,745 Series B Preferred units and an equal number of warrants (the "February 2010 Issuance").[67] The February 2010 Purchase Agreement allowed the existing Preferred unitholders to purchase 625,000, or approximately 77%, of the new units and an equal number of warrants. The remaining 186,295 authorized Preferred Series B units, or approximately 23%, and an equal number of warrants, were reserved for purchase by the Common A unitholders.[68] At this time, Common A unitholders owned 20.79% of Adhezion units.[69] Common unitholder Robert Greenstein participated in the offering in addition to Liberty, Originate, ***688** Molinaro, Crothall, and Graham.[70]

On April 23, 2010, the Board considered and approved "revised Option Grants to Employees as a Result of the Series B Dilution."[71] These options had strike prices reflecting a 70% discount from the last preferred round, for a strike price of $1.20 per unit.[72] As part of this option grant, Molinaro received 120,000 "profit interests."[73]

On May 18, 2010, Zimmerman sold 64,992 of his Class A Common units to Graham at a negotiated price of $2 per unit.[74] This sale reduced Zimmerman's share of the Company's total equity to approximately 3.4%.[75] On December 3, 2010, Arteriocyte made an overture to acquire Adhezion or merge with the Company based on a valuation of $15 million.[76]

9. January 2011 Issuance

By the end of 2010, Adhezion again had little money.[77] In December 2010, the Board approved a resolution to accept a bridge note for $1 million in additional financing.[78] On January 10, 2011, Toni, Bryant, and Molinaro, acting for the Board, approved the issuance of promissory notes convertible into Series B Preferred units at a purchase price of $4 per unit, up to an aggregate amount of $2.5 million.[79] Preferred unitholders were permitted to purchase up to $1,285,000 of these notes and Common A unitholders were permitted to purchase the remaining $1,215,000.[80] That same day, Preferred unitholders Molinaro, Crothall, Originate, and Graham purchased promissory notes having an aggregate principal amount of ***689** $1,285,000 (the "January 2011 Issuance," and together with the July 2009, December 2009, and February 2010 Issuances, the "Challenged Transactions").[81]

C. Procedural History

On November 18, 2010, Zimmerman filed his initial verified complaint. On February 28, 2011, he moved to amend his complaint primarily to add Originate Ventures and Morse as Defendants and to challenge the January 2011 Issuance. I granted that motion and Zimmerman filed an amended complaint on May 19, 2011 (the "Complaint"). Defendants later moved for summary judgment. In an Opinion dated March 5 and revised on March 27, 2012, I granted summary judgment in Defendants' favor on Plaintiff's duty of care claims and denied summary judgment on his claims for breach of the duty of loyalty, breach of contract, and aiding and abetting a breach of the duty of loyalty (the "Summary Judgment Opinion").[82] Trial on these surviving claims took place on April 23–25, 2012. I heard post-trial oral argument on September 14. This Opinion constitutes my post-trial findings of fact and conclusions of law on these claims.

D. Parties' Contentions

[1] Zimmerman brings this action derivatively on behalf of Adhezion challenging actions undertaken through its Board.[83] Plaintiff first contends that the Director Defendants breached their duty of loyalty by engaging in unfair, self-dealing transactions. According to Zimmerman, the Director Defendants' approval of the Challenged Transactions should be analyzed under the entire fairness standard of review. He bases that argument on two different theories. First, he contends that, at the time of the transactions, Originate and Liberty exerted actual control over the Company and benefitted from the transactions. Alternatively, Zimmerman asserts that the entire fairness standard should apply because at least a majority of the Director Defendants were interested in the Challenged Transactions and received an exclusive benefit from them. In either case, Plaintiff argues that Defendants have ***690** failed to demonstrate that the Challenged Transactions were entirely fair. Additionally, Zimmerman claims that Originate, Liberty, and Morse aided and abetted the Director Defendants' breach of their fiduciary duty.

Zimmerman also claims that Defendants breached the Company's Operating Agreement when they engaged in four financing transactions without obtaining the consent of the Common members. Specifically, Zimmerman contends that the Agreement required the Board to obtain Common members' consent to authorize the additional units of Series A Preferred that the Company issued and to amend the Second Amended Operating Agreement to reflect the creation, authorization, and issuance of Series B Preferred units. To remedy these alleged wrongs, Plaintiff requests that the Court deem Defendants to have received nonconvertible promissory notes at 10% interest redeemable in five years. Lastly, Zimmerman requests that the Court order Defendants to reimburse Adhezion for the attorneys' fees and expenses that the Company paid on their behalf in connection with this action.

Defendants deny that any of them breached a duty of loyalty. They argue, first, that Adhezion's Operating Agreement establishes a contractual standard of review that modifies traditional fiduciary duties. Second, they argue that under any of the potentially applicable standards of review—the Operating Agreement, the business judgment rule, or entire fairness—Defendants did not breach their fiduciary duty of loyalty. In response to Zimmerman's duty of loyalty claim against Originate and Liberty, Defendants deny that these entities owed any duty to Adhezion or its unitholders. Defendants also challenge Plaintiff's aiding and abetting claim against these entities and Morse. In particular, they aver that because Zimmerman did not demonstrate that the Director Defendants breached their duty of loyalty to unitholders, there is no breach for Originate, Liberty, or Morse to have aided and abetted.

Defendants further dispute Zimmerman's claim that they breached the Operating Agreement. In that regard, they assert that the Board had authority to issue new units and create a new series of preferred units without the consent of the Common unitholders. Lastly, Defendants argue that they contractually were entitled to cause Adhezion to pay their attorneys' fees and, therefore, that they should not be required to reimburse the Company for those fees.

II. ANALYSIS

A. Breach of Contract Claim

[2] **[3]** **[4]** **[5]** **[6]** I begin with Plaintiff's breach of contract claim which raises issues of contract construction. When interpreting a contract, the court's role is to effectuate the parties' intent based on the parties' words and the plain meaning of those words.[84] Of paramount importance is what a reasonable person in the position of the parties would have thought the language of the contract meant.[85] When construing an ambiguous contract, such as the one at issue

here,[86] the court will consider ***691** all relevant objective evidence, including: overt statements and acts of the parties, the business context, prior dealings between the parties, and business customs and usage in the industry.[87] Courts use such evidence to construe the ambiguous contract language in a way that best carries out the reasonable expectations of the parties who contracted in those circumstances.[88] Courts also attempt to give meaning and effect to each word in a contract, assuming that the parties would not include superfluous verbiage in their agreement.[89] As the party seeking enforcement of his interpretation of the Adhezion Operating Agreement, Zimmerman bears the burden to prove his breach of contract claim by a preponderance of the evidence.[90]

The Operating Agreement at issue in this case is a contract governed by the Delaware Limited Liability Company Act (the "LLC Act").[91] The LLC Act provides contracting parties with flexibility to craft an agreement that is tailored to their needs.[92] Here, the drafters used this flexibility to include certain corporate law terms and concepts in their Operating Agreement. As one example, they issued ownership interests in units as opposed to admitting members.[93] They also used a number of well-understood terms relating to corporate stock including the three terms relevant here: create, authorize, and issue. Because each of these terms is used in the Adhezion Operating Agreement, I interpret the Agreement in a way that gives each term meaning and effect.[94] In doing so, I recognize that the parties, working under the LLC Act, could have assigned a meaning to these terms that differs from the term's ordinary corporate law meaning.

Zimmerman's breach of contract claim centers on whether the Operating Agreement requires approval of the Common unitholders (1) to increase the number of units the Company is authorized to issue and (2) to create additional classes or series of units. My analysis of his claims focuses on four sections of the Agreement. First, Section 3.1(b) sets forth the "number and Classes and Series of Units" the Company is "authorized to issue" as of the Agreement's Effective Date.[95] Second, Section ***692** 3.2 effectively gives the Series Preferred members veto power over certain actions. Specifically, and in relevant part, it restricts the Company's ability to "engage in or take any of the following actions without the affirmative vote or written consent of a Required Interest of the Series A Preferred Members: ... (v) create, authorize or reserve any Units or Derivative Rights; (vi) issue, sell or grant any Units or Derivative Rights...."[96] Third, the Agreement gives the Board the following authority in Section 3.8:

> Subject to the provisions of Section 3.2 hereof, the Board of Directors may, at any time and from time to time, issue additional Units (including, without limitation, Class B Common Units pursuant to Section 3.3(b) hereof) or create additional Classes or Series of Units having such relative rights, powers and duties as the Board of Directors may establish, including rights, powers and duties senior to existing classes of Units.

Lastly, Section 15.11 governs amendments to the Operating Agreement and provides in pertinent part:

> *Except as otherwise provided in Section 3.8 hereof with respect to the issuance of additional Units,* this Agreement and any term hereof may be amended and the observance of any term hereof may be waived (either prospectively or retroactively and either generally or in a particular instance) with the written consent or vote of (a) a Required Interest of the Preferred Members, voting together as a single, separate class, and (b) a Majority–in–Interest of the Common Members, voting together as a single, separate class; provided that all non-consenting Members are treated in the same manner as the consenting Members by such amendment or waiver.[97]

1. Authorizing units

With these contractual provisions in mind, I consider Zimmerman's claims. His first contention is that an Operating Agreement amendment was required to increase the number of authorized units set forth in Section 3.1(b). He further contends that Section 15.11 required the consent of the Common unitholders for such an amendment. Defendants counter that, unlike the Delaware General Corporation Law ("DGCL"),[98] the LLC Act does not require the authorization of equity interests ***693** before those interests may be issued. Defendants concede that the Agreement contemplates the authorization of units. They contend, however, that this step is merely incidental to the Board's authority to create and issue units under Section 3.8 and its authority unilaterally to amend the Agreement under Section 15.11 with regard to its authority under Section 3.8.[99] Defendants further argue that such a structure is consistent with the absence of formal requirements in the LLC Act regarding the creation and issuance of LLC interests.[100] Zimmerman

disputes this interpretation. He asserts that the plain language of the Agreement contemplates three distinct steps (create, authorize, and issue) and that Section 3.8 of the Agreement only empowers the Board unilaterally to undertake, at most, two of those steps.

[7] **[8]** I agree with Zimmerman that the plain language of the Agreement indicates that the parties intended that units be authorized. Defendants' witness and the drafter of the first Amended Agreement, attorney Christopher Miller, confirmed that the use of the term authorize was deliberate.[101] He testified that, "under [the] Delaware statute as well as under this operating agreement, units [ ] are not required to be authorized prior to issuance. That said, we went through a process to authorize those units."[102]

The Operating Agreement, however, does not expressly address the process for authorizing units. Under the DGCL, the amount of authorized capital stock acts as a ceiling on the amount of stock a corporation may issue without seeking a charter amendment to increase that amount.[103] Here, Defendants contend that the statement in Section 3.1(b) of the number and classes and series of units that Adhezion is authorized to issue was not intended to limit the number of units the Board could issue unilaterally under Section 3.8. Miller provided the following explanation:

> [T]he other thing that needs to be understood here with respect to authorization, ***694** and this applies particularly in the corporate setting, and since we've adopted somewhat of a corporate structure here, it applies here as well, the idea of authorizing units is not a power vested in a particular body. Different than the act of issuing units, which both corporate statutes and this operating agreement give to the board, and the power to create units, those are powers given to the board subject to the consent of the preferred. Authorization of units is subsumed within the act of amending the agreement. Same in the corporate statutes. If you look at corporate statutes, you won't anywhere see either the board or the stockholders given the power to authorize shares. Corporate statutes say how do you amend your certificate of incorporation? What are the steps you need to follow? And in an amendment to the certificate of incorporation, that is where shares are authorized. *That was the same intent here, was that units would be authorized through an amendment to the agreement.* So the question was, what does it take to amend the agreement?[104]

As Miller stated, there is no statutory requirement that there be an amendment to the Operating Agreement to increase the number of authorized LLC interests. Accordingly, I look to the terms of the Operating Agreement to determine the parties' intent in this regard. Because the Operating Agreement does not set forth a process for authorizing units, I conclude that the most reasonable interpretation of the Agreement is that the parties intended the authorization of units to be accomplished by an amendment to the Operating Agreement. Such a reading is also consistent with Miller's testimony in that regard.

[9] I reach this conclusion notwithstanding that, in each of the first two Challenged Transactions, Defendants purported to increase the number of units the Company was authorized to issue using written consents of the Board, rather than an amendment to the Operating Agreement. Generally, the parties' actions under an agreement provide strong evidence of the contract's meaning.[105] In this case, however, the Director Defendants apparently acted without Zimmerman's knowledge and, promptly after learning of the relevant facts, he disputed Defendants' position that the Operating Agreement gave them the authority to authorize additional units without an amendment.[106]

2. Amending the Operating Agreement

Having concluded that Adhezion's units must be authorized and that an Operating Agreement amendment is the proper way to increase the number of units the Company is authorized to issue, I consider next what was required to amend the Agreement. Section 15.11 governs amendments. This Section requires the written consent or vote of both more than two-thirds of the Preferred members (the "Required Interest") and a majority-in-interest of the Common members to amend the Agreement. The sole exception to this voting requirement states: "Except as otherwise provided in Section 3.8 hereof with respect to the *issuance* of additional Units."[107] As ***695** set forth above, Section 3.8 provides the Board the authority unilaterally to issue and to create additional units.

The parties dispute two issues related to the Board's authority unilaterally to amend the Agreement under Section 15.11. First, they dispute whether the exception relates to the entirety of Section 3.8 (create and issue) or whether it is limited to the Board's authority to issue units. Second, they disagree on whether the exception to Section 15.11 allows the Board to increase the number of units the Company is authorized to

issue as part of the Board's authority under Section 3.8. There is no dispute that the consent of the Common unitholders is required for Operating Agreement amendments that do not fall within the exception to Section 15.11.

a. To authorize units

[10] I address first whether Common unitholder approval was required to increase the number of units the Company is authorized to issue. I conclude that it was. Defendants' argument that the act of authorizing units is subsumed within the Board's authority under Sections 3.8 and 15.11 is unpersuasive. The plain language of Sections 3.2, 3.8, and 15.11 indicates that the Agreement does not provide the Board unilateral authority to amend the Agreement to increase the number of units the Company is authorized to issue. Section 3.2 of the Operating Agreement expressly requires the consent of the Series Preferred members to create, authorize, and issue units, among other things. The parties similarly could have expressly provided the Board with authority to authorize units. They did not do so. Instead, Section 3.8 gives the Board authority only to issue and to create additional units. The exception to the voting requirements for an amendment to the Operating Agreement in Section 15.11 relates only to the Board's authority in Section 3.8. To increase the number of authorized units, therefore, the Board would need to amend the Operating Agreement under Section 15.11, and that would require the specified consents or votes. Those consents include "a Majority–in–Interest of the Common Members voting together as a single, separate class."[108]

b. To create units

[11] In addition, Zimmerman contends that Section 15.11 further limits the Board's authority because the exception is only "with respect to the *issuance* of additional Units."[109] Zimmerman argues that the parties easily could have omitted this limiting language if they had intended the entirety of Section 3.8 to be carved out of Section 15.11. Zimmerman's reading is reasonable, but it is not the only reasonable interpretation of Section 15.11. For example, Defendants reasonably assert that the exception to Section 15.11 to exclude Section 3.8 "with respect to the issuance of additional Units" should be read to apply also to the creation of new classes or series of units as provided for in Section 3.8.

Having concluded that the Agreement is ambiguous on this point, I consider the extrinsic evidence presented at trial. The most compelling evidence appears in the progression of the pertinent sections of the Agreement during the relevant period. In 2008, before Originate's investment, the Amended Operating Agreement expressly gave the Board the authority only to create, not to issue, additional classes or series of units.[110] The pertinent provision ***696** provided in relevant part: "[T]he Board of Directors may, at any time and from time to time, create additional Classes or Series of Units...."[111] During the negotiations of the Second Amended Operating Agreement, the drafters renumbered this provision Section 3.8 and changed its language to read: "[T]he Board of Directors may, at any time and from time to time, issue additional Units (including, without limitation, Class B Common Units pursuant to Section 3.3(b) hereof) or create additional Classes or Series of Units...."[112] Miller explained that he believed the corresponding provision in the first Amended Operating Agreement contained a "loophole" because the section only expressly gave the Board authority to create additional units.[113] According to Miller, the Second Amended Operating Agreement was changed to close that loophole. Because the Common members approved that amendment, it would appear that Zimmerman agreed with this clarification.

The operative language of Section 15.11, however, remained unchanged between the Amended and Second Amended Operating Agreements. This Section at all times began: "Except as otherwise provided in Section 3.8 [or 3.9] hereof with respect to the issuance of additional Units." That is, even before Section 3.8 or its precursor included the word "issue," and when it only referred to the action of creating new classes or series, Section 15.11 identified Section 3.8 as relating to "the issuance of additional units." This drafting history strongly implies that the language "with respect to the issuance of additional Units" is not meant as limiting language. Rather, it broadly refers to the subject matter of the provision (Section 3.8) that it references. This reading also comports with Miller's explanation that "the purpose of amending Section 3.8 in October of 2008 was to clarify that the board had the authority to issue additional units and to create additional classes, not just create additional classes."[114]

Zimmerman failed to adduce any convincing evidence to support his contrary interpretation of the Second Amended Operating Agreement. He argues that addition of the word

"issue" in Section 3.8, when that word was already in use in Section 15.11, strengthens his interpretation that the parties intended Section 15.11's exception to relate only to the portion of Section 3.8 addressing "issuance" of units. This is especially true, according to Zimmerman, because the parties "specifically negotiated" this change to Section 3.8.[115] Zimmerman admitted that he was not negotiating from a position of strength when he negotiated the Amended Operating Agreement with Originate.[116] Moreover, when Miller negotiated the clarification in Section 3.8 in the Second Amended Operating Agreement, he was representing Adhezion and possibly Originate. Nothing in the record suggests that Miller was aligned with Zimmerman or the Common ***697** unitholders at that time. In that context, I do not find credible Plaintiff's argument that he negotiated more rights for the Common unitholders in the Second Amended Operating Agreement than they previously had. To accept Zimmerman's position, I would have to accept that in the Second Amended Operating Agreement he or his representative carved back the Board's authority by leaving unchanged Section 15.11's reference to Section 3.8 "with respect to the issuance of additional Units" and adding "issue" to Section 3.8, so that it explicitly referred to both "issue" and "create." I consider that proposition too farfetched to be credible. Thus, because Zimmerman was unable to produce any more probative evidence to support his position, and based on the negotiating history of the Agreement, I conclude that Defendants' interpretation is correct on this point.

3. Did the Director Defendants breach the Operating Agreement?

Based on these findings, I conclude that the Board breached the Operating Agreement in undertaking each of the Challenged Transactions. In the 2009 Issuances, the Board purported to increase the number of Series A Preferred units the Company was authorized to issue by written consents. The Agreement, however, required an amendment approved by the Common unitholders for such an increase. The February 2010 and January 2011 Issuances were in breach of the Agreement because the Board issued unauthorized Series B Preferred units. Even though I conclude that the Board acted within its authority in amending the Agreement to reflect the creation of the Series B Preferred units, no Series B Preferred units properly had been authorized for issuance. Additionally, the purported increase in the number of Series A Preferred units that the Company was authorized to issue in the Third Amended Operating Agreement, and actually issued of those units in the February 2010 and January 2011 Issuances, were in breach of the Agreement for the same reason. That is, the Common unitholders never approved the amendment to the Agreement to increase the number of authorized units.

This outcome could have been avoided. The interpretation that Defendants advance is a plausible one that is consistent with the flexibility afforded by the LLC Act. If parties to an LLC operating agreement intend to deviate from the meaning that a reasonable investor would attribute to use of a term, however, it is incumbent upon them to manifest that intent.[117] In this case, I reject the strained meaning that Defendants place on the familiar corporate law term "authorize" when that term was incorporated imprecisely in Adhezion's Operating Agreement.[118] I have considered the extrinsic evidence Defendants presented through Miller's testimony.[119] This evidence, however, generally ***698** supports the result I reach. Miller testified that the parties intended units to be authorized and intended that such authorization would take place through an Operating Agreement amendment. Defendants ask too much, however, when they urge this Court to conclude that the power to "authorize" units is incidental to and implicitly subsumed within other authority, viz., "to issue additional Units," expressly provided to the Board in the parties' Agreement. Although this Court generally will accept an interpretation of an LLC agreement where the agreement is not inconsistent with the provisions of the LLC Act, that tendency does not warrant accepting Defendants' interpretation in this case because that would contravene the plain meaning of the words the parties used.[120]

[12] **[13]** Additionally, I find that this is a case where construing the ambiguous contract terms against the drafter is appropriate. The rule of *contra proferentum* is one of last resort that will not apply if a document can be interpreted by applying more favored rules of construction.[121] Nevertheless, resort to the rule is appropriate "in cases of standardized contracts and in cases where the drafting party has the stronger bargaining position, but it is not limited to such cases."[122] It is less likely to be appropriate where knowledgeable and experienced parties to a contract engaged in a series of negotiations.[123] Here, the Operating Agreement was negotiated by the parties.[124] Miller, however, admittedly was involved in the drafting of the Amended and Second Amended Operating Agreements. When Miller participated in the drafting of the Amended Operating Agreement, he was representing Originate in its negotiations with Adhezion

regarding its initial investment. At that time, Miller's client Originate was in a stronger bargaining position. After Originate invested in Adhezion, Miller became Adhezion's attorney. Thereafter, Miller controlled the Agreement on behalf of Adhezion, but his firm also evidently retained its affiliation with investor Originate.[125] When Miller negotiated the Second Amended Operating Agreement with the Liberty Investors, the interests of Originate, Miller's original client, generally ***699** were aligned with the new private equity investors. During these negotiations, the parties clarified the Board's authority to issue and create additional units, as discussed *supra.* They failed, however, clearly to explain their intent with regard to authorizing additional units. This concept of authorization typically would be important to the Common member because it relates to the level of dilution to which they may be subjected. Zimmerman, whose consent was obtained for the Amended and Second Amended Operating Agreements,[126] reasonably would have understood the use of the term "authorize" to place a limit on the level of dilution he would face before the Board was required to obtain his consent to increase that level. Defendants' extrinsic evidence does not clearly support a conclusion that the parties mutually agreed to modify the usual meaning of the term "authorize" in this Operating Agreement and to empower the Board implicitly to authorize additional units.[127] In the circumstances of this case, therefore, I conclude that it is appropriate to interpret the Operating Agreement against Defendants as its drafters and in favor of the meaning a reasonable investor would attribute to the Agreement.

Having concluded that the Director Defendants breached the Operating Agreement by entering into the Challenged Transactions, I also must address what would be an appropriate remedy. That analysis, however, involves equitable considerations that overlap with the issues presented by Zimmerman's breach of fiduciary duty claim. Accordingly, I defer my discussion of a remedy until Part II.D, *infra.*

B. Breach of Duty of Loyalty Claim

Zimmerman asserts breach of fiduciary duty claims against the Director Defendants and against Defendants Liberty and Originate. His claim against the Director Defendants is based on those Defendants' status as members of Adhezion's Board. As directors, those Defendants are subject to fiduciary duties specified in Adhezion's Operating Agreement. Zimmerman's second claim is that Liberty and Originate owe fiduciary duties to Adhezion and its minority unitholders by virtue of being part of a group that controls Adhezion. This claim arises from the common law duty that would attach to a shareholder "exercis[ing] control over the business affairs of the corporation."[128] I consider this claim first.

1. Liberty and Originate are not controlling shareholders

[14] **[15]** **[16]** A shareholder will be considered "controlling" if it either owns more than 50% of the voting power of the company, or exercises "actual control" over the board of directors during the course of a ***700** particular transaction.[129] Here, neither Liberty nor Originate owns a majority of the voting power. For Zimmerman to prove that Liberty and Originate are controlling shareholders, therefore, he must prove that they exercised "actual control" over the Board. To make such a showing, Plaintiff must demonstrate that "although lacking a clear majority, [the shareholders] have such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control."[130] There is no contention in this case that either Liberty or Originate on its own exercised actual control over Adhezion's Board. Nevertheless, such power would exist where "various director-stockholders ... were involved in a blood pact to act together,"[131] or where they were "bound together by voting agreements or other material, economic bonds to justify treating them as a unified group."[132] In the Summary Judgment Opinion, being constrained to take the evidence in the light most favorable to Zimmerman, I concluded that he possibly could make such a showing.[133]

[17] The evidence at trial, however, does not support Plaintiff's allegation that Liberty and Originate acted together and thus should be viewed as a controlling shareholder group standing on both sides of the Challenged Transactions. Collectively, Liberty and Originate own 66% of Adhezion's voting shares and control at least two of the five directors on the Board.[134] Based on the preponderance of the evidence, however, I am convinced that they neither acted together nor were "connected in some legally significant way."[135] Liberty and Originate are two separate entities with no common ownership or management. Each entity designated one of its affiliates as its Board designee. The evidence

also shows that the directors designated by Liberty and Originate, Crothall and Gausling, are sophisticated and competent businesspeople. There has been no showing that they acted as one unit or that one exerted control over the other. Indeed, Liberty did not participate in one of the Challenged Transactions while Originate participated in all four transactions.

Zimmerman relies heavily on a communication from the Board to Molinaro, memorialized ***701** in the September 29, 2009 Board meeting minutes, to "cease all capital raising activities."[136] Plaintiff characterizes this as an instruction from Liberty and Originate intended to ensure that, together, those entities would be the only funding source available to Adhezion. The evidence as a whole, however, does not support that position. The minutes from the September 29, 2009 Board meeting, which took place approximately ten days after 3M terminated discussions with Adhezion, state:

> The board recommended that Molinaro cease all capital raising activities at this time, including discussions with other VC firms and attendance at investment conferences. Mike Gausling and Tom Morse advised Moloinaro [sic] that their respective firms would continue to temporarily satisfy Adhezion's operating cash requirements until we saw where the Medline or Braun discussions finalized[,] at which time we would make a decision about next capital raising steps.[137]

The Director Defendants questioned about this statement remembered it not as an instruction but as a "communication."[138] Molinaro was "told to focus on the business, not focus efforts on fund-raising,"[139] and that Liberty and Originate were "giving the company runway enough in cash in order to try and do that."[140] Gausling explained that a question about the validity of the Adhezion patent was one issue that led to this discussion:

> All of that was at a point in time when 3M was gone and Medline was challenging the ... validity of the patent. And so without a strong supporting independent analysis of the patent situation, bringing other investors in didn't make any sense. And we needed to fund the company, A, because the company needed money immediately and it was a surprise because we thought 3M was going to come in and we needed to get a solid answer on that patent situation; and ultimately then we found we had to reformulate as well.[141]

Additionally, about a month after this meeting, Gausling himself attempted to secure outside funding of $5 million.[142]

Although Zimmerman relies on several other documents to support his argument, none of them supports the conclusion that Plaintiff would have this Court reach. The evidence, taken together, does not support Plaintiff's contention that Liberty and Originate were acting in concert, through a blood pact or voting agreement, and exerting "actual control" over the Board. I conclude, therefore, that there is no controlling shareholder, or group of shareholders, in this case. Thus, there is no basis for Plaintiff's breach of fiduciary duty claim against Liberty and Originate.

2. Fiduciary duties under the Company's Operating Agreement

I turn next to Zimmerman's breach of fiduciary duty claim against the Director Defendants. The starting point for analyzing this claim for breach of the fiduciary duty of loyalty is to determine what fiduciary ***702** duties the Board owes to the LLC and its members.[143] The LLC Act provides that the fiduciary duties of a member, manager, or other person that is a party to or bound by a limited liability company agreement "may be expanded or restricted or eliminated by provisions in the limited liability company agreement."[144] Accordingly, to decide fiduciary duty claims in the LLC context, the Court must closely examine and interpret the LLC's governing instrument to determine the parameters of the fiduciary relationship.[145]

Consistent with this framework, Adhezion's Operating Agreement specifically addresses both director fiduciary duties and the applicable standard of conduct for self-dealing transactions. As to the former, the Agreement sets forth the "Standard of Care of Directors" in Section 6.15. This provision provides in relevant part:

> The Directors shall stand in a fiduciary relation to the Company and shall carry out their duties and exercise their powers hereunder in good faith and in a manner reasonably believed by the Directors to be in the best interests of the Company and its Members and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.[146]

This Section provides that directors are fiduciaries of the Company. They must act with subjective good faith ("in a manner *reasonably believed by the Directors* to be in the best interests of the Company and its Members") and must comply with an objective standard of reasonableness ("*and* with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances").

The Adhezion Operating Agreement does not specifically address a duty of loyalty in those terms. Instead it expressly addresses members, directors, and officers transacting business with the Company in Section 6.13 entitled, "Dealing with the Company." That Section provides:

> The Members, Directors, and officers and any of their respective Affiliates shall have the right to contract or otherwise deal with the Company or its Subsidiaries in connection therewith as the Board of Directors shall determine, provided that such payments or fees are comparable to the payments or fees that would be paid to unrelated third parties providing the same property, goods, or services to the Company or its Subsidiaries. No transaction between the Company or its Subsidiaries and one or more of its Members, Directors or officers ... shall be void or voidable solely ***703** for this reason, or solely because the Director or officer is present at or participates in the meeting of the Directors that authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if (a) the material facts as to the transaction are disclosed or are known to the disinterested Directors and the contract or transaction is approved in good faith by the vote or written consent of the disinterested Directors; or (b) the transaction is fair to the Company or its Subsidiary as of the time it is authorized, approved or ratified by the Board of Directors or the Members.[147]

Providing scant attention to the parties' contracted-for standard of review, Zimmerman contends that Defendants must prove the entire fairness of the Challenged Transactions because a majority of the Board was interested when it approved them. Defendants counter that this Court need only determine that the Director Defendants reasonably believed their actions to be in the best interest of the Company and that they acted with the care, skill, and diligence of a person of ordinary prudence under Section 6.15. Alternatively, Defendants maintain that if they complied with either of the safe harbors in Section 6.13, which they contend they did, then Zimmerman bears the burden to prove that the Challenged Transactions were unfair and he failed to meet that burden.

[18] Preliminarily, I find that the parties, through the Adhezion Operating Agreement and consistent with their prerogative under 6 *Del. C.* § 18–1101(c), have "restricted" the fiduciary duties that the Director Defendants owed in the context of their dealings with the Company. The parties to this Operating Agreement defined the scope of director fiduciary duties in two ways: first, they set a general standard for fiduciary conduct; second, in Section 6.13, they gave directors the right to engage in transactions with the Company subject to certain requirements. The Court's role, therefore, is limited to determining whether the Director Defendants acted in compliance with their fiduciary duties as defined in Sections 6.13 and 6.15.

3. Standard of review for dealings with the Company

As is often true in our corporation law, a major issue in the resolution of this LLC dispute is determining the applicable standard of review, "[b]ecause our law has so entangled the standard of review with the ultimate decision on the merits that the two inquiries are inseparable."[148] One aspect of that determination involves examining the references to concepts of fairness in Section 6.13. The first sentence of that Section recognizes the rights of directors to engage in self-dealing transactions with Adhezion, "provided that such payments or fees are comparable to the payments or fees that would be paid to unrelated third parties providing the same property, goods, or services to the Company...." Similarly, the second means identified in the second sentence of Section 6.13 for precluding a self-dealing transaction from being deemed "void or voidable" is if "the transaction is fair to the Company or its Subsidiary as of the time it is authorized, approved or ratified by the Board of Directors or the Members." Delaware courts have interpreted similar provisions ***704** as effectively calling for review under an entire fairness standard.[149] That is, there must be a fair process and a fair price.[150]

[19] **[20]** A separate issue, however, is who has the burden of proof on the question of the fairness of a transaction. In the corporate context or in the case of a default fiduciary duty in the LLC context, the initial presumption would be that the director defendant would have the burden of proving the transaction was entirely fair to the company and its

unitholders.[151] But, that presumption would not appear to apply in this case. The relevant fiduciary duties are defined in the Operating Agreement and, therefore, are contractual in nature. The first sentence of Section 6.13 confers on Directors the right to deal with the Company, provided those dealings are on terms comparable to an unrelated third-party transaction, *i.e.,* are entirely fair. I consider that sentence to be controlling in this case. Zimmerman contends the Director Defendants have breached their contractual fiduciary duties as to the Challenged Transactions. Therefore, Zimmerman would have the burden of proving a breach of the contractual requirement that the transactions be entirely fair.

For the reasons discussed *infra,* I find that Zimmerman has not shown that the Challenged Transactions were unfair. If the question of which party bears the burden of proof were free from doubt, that would end the discussion as to Plaintiff's breach of fiduciary duty claims. Regrettably, however, there may be some doubt regarding the appropriate allocation of the burden of proof on the facts of this case due, in part, to the second sentence of Section 6.13.

As in the case of the term "authorize," the second sentence of Section 6.13 appears to import certain concepts from Delaware corporate law into the LLC Operating Agreement. Specifically, the second sentence of Section 6.13 fairly closely tracks language from 8 *Del. C.* § 144.[152] Section 144, however, addresses ***705** the common law rule or concept that self-interested transactions with a director's corporation were void or voidable.[153] That concept has no analogue in the LLC context.[154] Consequently, the apparent incorporation of corporate law concepts into Adhezion's Operating Agreement again creates unnecessary complication and potential confusion. Because the parties included this language, however, I must endeavor to give it meaning and avoid a construction that would render the sentence mere surplusage.[155]

Read in context, the second sentence of Section 6.13 appears to offer a party about to engage in a transaction with the Company a way to reduce the likelihood of, or exposure to, a future challenge. That is, the second sentence was intended to provide a safe harbor of sorts. It is less clear, however whether qualifying for such a safe harbor would result in the transaction receiving the benefit of the business judgment rule, or simply would shift the burden of proof to a future challenger of demonstrating that the transaction was not entirely fair, assuming that burden originally rested with the directors.[156] Regardless, as indicated *supra,* I conclude that a reading where the initial burden falls on the challenger to demonstrate that the defendant did not comply with Section 6.13 harmonizes the entire provision. If I were to place the initial burden of proof on the director, and not on a challenger, then one of two safe harbor options, option (b), would be redundant. A more reasonable reading places the burden on the party challenging compliance with the contractual standard. Under this reading, to decrease the likelihood that a challenger might succeed in demonstrating that a transaction was not comparable to a third-party transaction, the party engaging in a transaction with the Company could either obtain the good faith, informed approval of the disinterested directors or attempt to establish *ex ante* the fairness of the transaction, ***706** for example, by engaging in a robust market check and obtaining a fairness opinion.

This Court and the Delaware Supreme Court recently considered a somewhat different LLC Agreement provision.[157] In that case, this Court found, and the Supreme Court affirmed, that the burden of proving the fairness of the self-dealing transaction at issue fell upon the LLC manager. Unlike Section 6.13 in this case, which expressly provides that directors "shall have the right to contract or otherwise deal with the Company" subject only to a proviso that related payments or fees be comparable to those in unrelated third-party transactions for the same property or services, the following provision was at issue in *Auriga:*

> Neither the Manager nor any other Member shall be entitled to cause the Company to enter ... into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66–2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).[158]

The *Auriga* provision provides that a manager or member *cannot* cause the company to enter an agreement with an affiliate on terms less favorable than an arm's length transaction without the required consents. By contrast, Section 6.13 gives members, directors, or officers the affirmative right to engage in transactions with the Company, provided that such transaction is comparable to a third-party transaction. For this reason, I find the Adhezion Operating

Agreement provision to be distinguishable from the *Auriga* provision.

Additionally, under reasoning analogous to the Supreme Court's discussion in *Auriga,* the application of the business judgment rule could be appropriate in this case. In *Auriga,* the Supreme Court affirmed this Court's holding that the defendant—the manager who had entered into a self-dealing transaction with the company without the consent of 66–2/3% of the non-affiliated members—had the burden to prove the entire fairness of the transaction. In addition, the Supreme Court discussed what result would obtain if "counterfactually [ ], [the defendant] had conditioned the transaction upon the approval of an informed majority of the nonaffiliated members."[159] It concluded that, with such an approval, the transaction at issue—the sale of the LLC—"would not have been subject to, or reviewed under, the contracted-for entire fairness standard."[160] In addition, the Court observed that such a result "contrasts with the outcome that [ ] would obtain in the traditional corporate law setting, where an informed majority-of-the-minority shareholder vote operates to shift the burden of proof on the issue of fairness."[161] Although the Supreme Court's discussion on this point constitutes only dicta, I read it as suggesting, in effect, that the business judgment rule ***707** might apply in a case such as the one currently before me if the Director Defendants complied with one of Section 6.13's two safe harbors.

[21] I conclude that Defendants here did comply with the first of the safe harbors in Section 6.13. At least two of Adhezion's directors, Toni and Bryant, were disinterested and they gave their informed good-faith approval of the Challenged Transactions. Neither Bryant nor Toni participated in, or stood to gain a personal financial benefit from, any of the Challenged Transactions.[162] Likewise, none of the allegations or evidence presented supports a finding that Bryant or Toni acted to perpetuate their tenure on the Board.[163]

Furthermore, I find that Bryant and Toni are independent of Molinaro, who arguably was interested in the Challenged Transactions.[164] In the Summary Judgment Opinion, I found that "Zimmerman's allegations of mere friendship and shared work experience likely fall short of what is necessary to call into question the independence of Toni or Bryant."[165] The evidence presented at trial did not go beyond the allegations that I assumed to be true for purposes of the Summary Judgment Opinion. Molinaro and Bryant worked closely together and served on the same boards of directors periodically since the 1980s.[166] Molinaro and Toni also had worked together at Cilco for several years.[167] Molinaro characterized Bryant as "a long time friend and business associate" and they socialized together occasionally.[168] This evidence demonstrates that Molinaro and Bryant have extensive shared work experience and a personal friendship. The record as a whole, however, did not show that Bryant was beholden to Molinaro or otherwise unable to exercise his own independent business judgment.[169] There is even less evidence for the proposition that Toni was not independent of Molinaro. I conclude, therefore, that both Toni and ***708** Bryant are not only disinterested but also are independent of Molinaro.

Additionally, the material facts as to the transactions were "disclosed or [we]re known to" Toni and Bryant. Both men testified that they reviewed financial statements and other documents related to the Challenged Transactions.[170] They both attended Board meetings at which the Challenged Transactions were discussed.[171] Both directors also credibly testified that they approved the Challenged Transactions because they believed them to be fair to and in the best interest of the Company.[172] I find, therefore, that the Challenged Transactions were approved in good faith by the informed disinterested directors and, thus, arguably, should receive the benefit of the business judgment rule. At a minimum, however, the burden of proof on entire fairness would shift to Zimmerman, even assuming he did not bear that burden already under the first sentence of Section 6.13.

4. The Challenged Transactions were comparable to unrelated third-party transactions and were entirely fair

I consider next whether Zimmerman has proven by a preponderance of the evidence that the Challenged Transactions were *not* comparable to unrelated third-party transactions for similar property. I conclude that he has not. It follows, therefore, that Plaintiff could not meet his burden of proof if Defendants were entitled to the presumption of the business judgment rule. I review below the factual and expert evidence on whether the Challenged Transactions were entirely fair. My analysis proceeds from the premise that Zimmerman bears the burden of proof. Nevertheless, I also find that the record in this case is sufficiently strong that, regardless of which party bears the burden of proof, the

Challenged Transactions were comparable to unrelated third-party transactions for the same property and, thus, were fair to the Company.

a. Factual evidence

[22] The entire fairness standard includes two non-bifurcated components: fair price and fair dealings.[173] Moreover, this Court has recognized that "where claims for unfair dealings do not rise to the level of fraud ... the Court should primarily focus on whether the price was unfair."[174]

It is undisputed that, at the time of the Challenged Transactions, Adhezion needed money to continue its business. Before the Challenged Transactions, the Company repeatedly sought financing and obtained it from Originate in March 2008 ($3 million) and from Liberty in October 2008 ($2 million). These cash infusions did not sustain the Company for long. The continuing need for cash is not surprising and is consistent with Toni's experience at Closure, a company Plaintiff identifies as comparable to Adhezion. Closure secured $10 million from angel investors in 1994. In 1996, Closure received $4.5 million from J & J upon entering an exclusive agreement with that company and raised $15 million ***709** in a public offering. By 1996, Closure had spent $10 million.[175] In 1997, Closure raised another $10 million in a second public offering.

The evidence demonstrates that Adhezion actively pursued other possible sources for additional funds without success. Zimmerman persistently argues that Molinaro stopped looking for funds from other sources because Originate and Liberty ordered him to do so. He implies that those entities insisted on supplying any necessary funding for the Company to avoid diluting their stake in Adhezion's considerable upside potential. The evidence shows, however, that the "order" to stop fundraising was a reasonable directive from the Board at a time when the Company was quite desperate for a distribution partner to increase its sales force. The Board wanted Molinaro to focus on finding such a partner in the wake of 3M having withdrawn from the field.

Toni testified that Closure's distribution relationship with J & J was critical to its success.[176] Although Adhezion's Board had considered building a sales team itself, it ultimately chose to take a route similar to Closure's and try to find a strategic partner like J & J.[177] At the time, Medline was still a possible partner. Moreover, Originate had limited additional funds it was willing to invest in Adhezion. According to Gausling, Originate was "looking for someone else to take the lead, that we would participate ... to say that, you know, we're committed, we'll add capital but we didn't want to be the lead going forward."[178] Gausling's contemporaneous solicitation of Safeguard Scientific corroborates his testimony.[179]

Adhezion also had limited funding options because it was a risky investment. The Company was not performing at the level the parties anticipated when Originate originally invested[180] For example, as part of the deal with Originate, Zimmerman entered into an employment agreement with seven milestones. Zimmerman's ***710** employment was terminated when he failed to meet most of those milestones. Gausling testified that

> many of the items that [Zimmerman] specifically said were the value drivers going forward, we put in a performance milestone in his employment agreement, seven items.... [I]f he hit those value drivers, then the company would have done what he said it was going to do. He hit two of the seven during that period in time.... [H]e had alleged that we would get all seven of those. We got two.[181]

The threat of patent infringement litigation was another looming risk that developed in 2009.[182] One company threatening litigation was J & J, Adhezion's main competitor. J & J had significant resources and every incentive to pursue a patent infringement lawsuit against its competitor Adhezion's product SurgiSeal. In fact, the possibility that Adhezion was infringing J & J's patent dampened 3M's enthusiasm for entering into a distribution agreement with Adhezion.[183] It also influenced Medline's decision not to pursue a license and distribution agreement with Adhezion.

After the Medline transaction fell through, Adhezion embarked on a reformulation of its sterilization process in an effort to design around J & J's patent. During the reformulation, Adhezion did not produce SurgiSeal.[184] Still, Molinaro continued to seek outside investors. He recognized, however, that because the threat of patent infringement litigation had caused the Company to cease production of its main product, there "wasn't much chance of actually securing someone if they did their due diligence."[185]

Zimmerman also emphasizes that the Board did not negotiate to obtain better terms for the Company than those initially

presented by Crothall. There is no evidence, however, that any of the directors believed the terms were unfair to Adhezion. Although Molinaro raised an objection to the amount of warrants being granted in the February 2010 Issuance, he ultimately agreed to the original terms. Indeed, he testified that he "always felt that the valuation of the company and the share price was generous."[186]

[23] In the context of all the evidence, Molinaro's failure to obtain a modification of the number of warrants granted in the February 2010 Issuance does not alter my conclusion that this Issuance and the other Challenged Transactions were comparable to third-party transactions. Despite reasonable efforts on behalf of Adhezion to find additional investors, I find that no third party was willing to invest in the Company on terms more favorable to Adhezion. The Kensey Nash offer in November 2009 to buy Adhezion was for $10 million, but only $4 million of that was firm. The fact that the Adhezion Board effectively rejected that offer by making a much higher counteroffer that sought, in part, a firm commitment of $20 million does not warrant a different conclusion. No serious negotiations with Kensey Nash ever took place in the succeeding years. Additionally, Zimmerman sold a significant amount of his shares for only $2 per unit ***711** just three months after the February 2010 Issuance.

b. Expert evidence

Defendants Expert, Roy D'Souza, opined that all four Challenged Transactions were fair.[187] Zimmerman's expert, Dr. Helen Bowers, opined that the February 2010 Issuance was unfair but did not seriously question the fairness of any of the other Challenged Transactions.[188] Bowers calculated Adhezion's value to be no less than $15.63 million in February 2010.[189] The February 2010 Issuance valued the Company at $13 million.[190] In her Expert Report, however, Bowers admittedly made a troubling number of computational errors, which Defendants' expert, D'Souza, later identified.[191] To account for these errors, and to make additional corrections, Bowers submitted a Supplemental Expert Report.[192] In any case, D'Souza convincingly pointed out in his rebuttal report and at trial several ways in which Bowers's analysis overstates Adhezion's value and understates the attendant risks.[193]

One point the parties strenuously dispute is the value of the warrants issued in the February 2010 Issuance. Defendants contend they had no value because, in their view, the Company's unit price was below the $4 warrant strike price.[194] Bowers, on the other hand, valued the warrants at a ***712** $4.29 per unit.[195] Among other things, Bowers used the Black–Scholes method to arrive at this value. Although the Black–Scholes model is a formula for option valuation that is "widely used and accepted by industry figures and regulators,"[196] the model overstates the value of options "which are not liquid, freely tradeable options."[197] Adhezion's warrants are not publicly traded. Therefore, I find Bowers's reliance on the Black–Scholes formula to value Adhezion's warrants to be questionable, if not entirely misplaced.

Bowers used two analytical methods to determine a fair value range for Adhezion: a DCF analysis and a comparable companies analysis. For her comparable companies analysis, Bowers relied, in part, on the 37.6 multiple of enterprise value/EBIT paid by J & J to acquire Closure.[198] The differences between Closure when it was sold to J & J and Adhezion in February 2010, however, are stark. Unlike Closure, Adhezion had no distribution partner, faced a substantial risk of IP litigation, had raised relatively little cash, and would be the third company to enter the market, after the first entrant, J & J, and a new competitor, Medline.[199] Based on these significant differences, I find that Bowers's reliance on Closure as a "firm very similar to Adhezion" was unreasonable.[200] In summary, having considered Bowers's expert reports and testimony, as well as Plaintiff's other evidence, I find that Zimmerman has failed to prove any of the Challenged Transactions were less than entirely fair. Based on the same reasons discussed in this Part II.B, I also would find the Challenged Transactions to be entirely fair if Defendants bore the burden on that issue.

C. Aiding and Abetting

[24] To succeed on a claim for aiding and abetting a breach of fiduciary duty, Plaintiff must prove: (1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, and (3) knowing participation in that breach by the non-fiduciary.[201] Because the Director Defendants did not breach their fiduciary duties, Zimmerman cannot succeed on his claim against Defendants Originate, Liberty, and Morse for aiding and abetting a breach of fiduciary duty. I therefore find for Defendants on Plaintiff's claim for aiding and abetting.

D. Remedy

Having concluded that Zimmerman is entitled to judgment in his favor on the breach of contract claim but not on the breach of fiduciary duty and aiding and abetting claims, I consider what remedy is appropriate in the circumstances of this case. Zimmerman proposes that the Court reform the terms of the Challenged Transactions. He requests, first, that the Court cancel (1) all the warrants issued and (2) all the options issued pursuant to the 2010 employee option grant. Second, ***713** he requests that Defendants be deemed to have received, for each transaction, promissory notes at 10% interest, with no ability to convert into equity, redeemable five years from the date of judgment.

[25] The remedy of reformation typically is used to conform a document to the parties' intent in cases of mutual mistake or fraud.[202] It also can be used to remedy a breach of fiduciary duty, in which case the court has broad authority to fashion an appropriate remedy.[203] Based on the circumstances of this case, however, I do not consider the reformation proposed by Zimmerman to be an appropriate equitable remedy. Rather than rectify wrongdoing and avoid an unjust enrichment, the proposed reformation would create a windfall for Zimmerman.[204] Adhezion needed the funds that Defendants provided in each of the Challenged Transactions. Zimmerman effectively concedes this point and does not request that the Court rescind the transactions. Instead he asks the Court to allow the Company to keep Defendants' money on different terms. Yet, no evidence suggests that Defendants would have invested in Adhezion on Zimmerman's proposed terms.

[26] In this case, where Defendants have not breached their fiduciary duties, an appropriate remedy would permit Plaintiff to recover any damages he suffered as a result of the Director Defendants' breach of the Operating Agreement. Having concluded that none of the Challenged Transactions has been shown to have been unfair to Adhezion, however, I find that there are no such damages. The Challenged Transactions provided the Company with crucial capital on fair terms. The dilution Zimmerman suffered was in exchange for maintaining some value to his investment in Adhezion. In this Opinion, therefore, I declare that the parties' rights under the Operating Agreement are as discussed in Part II.A, *supra,* but otherwise decline to award any damages beyond nominal damages of $1.

E. Attorneys' Fees

[27] Zimmerman also asks this Court to order Defendants to reimburse the Company for $1,011,559 in legal fees that it advanced to Pepper Hamilton while that firm acted as counsel to Defendants, and not the Company. Zimmerman challenges the legality of this advancement. Whether a party has the ultimate right to an advancement depends on whether his underlying conduct is indemnifiable.[205]

The LLC Act defers completely to the contracting parties "to create and delimit rights and obligations with respect to indemnification and advancement of expenses."[206] Because of this deference, this Court has stated a preference for "interpret[ing] language so as to achieve where possible the beneficial purposes that indemnification can afford."[207]

***714** **[28]** Adhezion's Operating Agreement creates broad indemnification rights for directors in Section 6.17:

> *The Company shall indemnify and hold harmless each Director to the fullest extent permitted by law* from all liabilities, losses, costs, expenses and/or damages (including without limitation reasonable attorneys' fees) and for judgments and amounts paid in settlement of an action, suit or proceeding in which such Director is or was a party, or threatened to be made a party, by reason of such Director's relationship with the Company, *unless there has been a final adjudication* in the action, suit or proceeding or, in the event of settlement of the action, suit or proceeding, counsel to the company is of the opinion *that the Director's act or omission was not taken or made in good faith within the scope of this Agreement and was the result of gross negligence, willful misconduct or fraud on the part of the Director.* The foregoing right of indemnification shall be in addition to any other rights to which the Directors may otherwise be entitled, including, without limitation, as a result of any indemnification agreement entered into between the Directors and the Company, and shall inure to the benefit of the successors, assigns, executors, administrators and personal representatives of the Directors.[208]

This provision requires indemnification for directors unless there has been a final adjudication that the directors' acts were both "not taken or made in good faith within the scope of

this Agreement" and were "the result of gross negligence, willful misconduct or fraud on the part of the Director."[209] In this Opinion, I have concluded that the Director Defendants breached the Agreement by failing to obtain the approval of the Common unitholders for the Challenged Transactions. Zimmerman has not shown, however, that any of the Defendants' actions in connection with the Challenged Transactions either were not taken in good faith or resulted from gross negligence, willful misconduct, or fraud. Thus, the Agreement requires indemnification for the Director Defendants in the circumstances of this case.[210]

***715** An indemnification provision also appears in the February 2010 Purchase Agreement.[211] Defendants Originate, Crothall, Liberty, and Molinaro are parties to this agreement. Its indemnification provision states in relevant part:

> (b) The Company shall indemnify, defend and hold harmless each Indemnified Party[212] against any and all direct costs, fees, expenses and monetary damages of such Indemnified Party resulting directly from or arising directly out of any third party or governmental action or claim brought against such Indemnified party, primarily relating to the Indemnified Party's status as a security holder, board observer, or as a director of the Company....[213]

This provision provides security holders of Adhezion broad indemnification for expenses arising directly out of any "third party action." Adhezion is both a party to this action as a nominal defendant and a party to the February 2010 Purchase Agreement. Arguably, therefore, Zimmerman's derivative claim brought on behalf of Adhezion is not a "third party action."

Subsection (a) of the above-quoted Section 6.1 directly addresses derivative actions. It provides for indemnification of expenses arising out of or related to any derivative action "based upon, resulting from, relating to or arising out of any misrepresentation or breach of any representation, warranty, covenant or agreement by the Company in any Transaction Document."[214] One such representation and warranty by the Company is that the Company "has all power and authority ... (b) to execute, deliver and perform this Agreement ... and the Operating Agreement."[215] At a minimum, Plaintiff's breach of contract and breach of fiduciary duty claims "relate to" the Company's breach of this representation and warranty. I conclude, therefore, that either through Section 6.1(a) or 6.1(b) of the February 2010 Purchase Agreement, the non-Director Defendants also are entitled to indemnification.

Having concluded that Defendants are entitled to indemnification, whether Defendants also have a right to advancement is largely moot at this stage in the litigation.[216] Plaintiffs counsel effectively acknowledged as much at oral argument.[217] Furthermore, the Operating Agreement confers upon the Board the authority to "make all decisions and take all actions for ***716** the Company not otherwise provided for in this Agreement."[218] Therefore, even though the Operating Agreement does not explicitly address advancement rights, the Board had the authority to approve the advancement of Defendants' legal fees. Because I find that Defendants have not breached the fiduciary duties they owe to the Company or to Zimmerman, I also see no basis for invalidating the Board's decision to advance Defendants' legal fees. Indeed, that decision appears to comport with the Operating Agreement's requirement that the Company indemnify its directors "to the fullest extent permitted by law."[219]

Thus, I deny Plaintiff's request for an order directing Defendants to reimburse the attorneys' fees advanced on their behalf by the Company.

III. CONCLUSION

For the foregoing reasons, I find that the Director Defendants breached the Operating Agreement by entering into the Challenged Transactions without obtaining the approval of the Common unitholders. But, I find that the breach caused no damage to Zimmerman and, therefore, award only nominal damages of $1. I further find that Defendants did not breach any fiduciary duties and that, therefore, there can be no liability for aiding and abetting such a breach. Defendants promptly shall submit, on notice, an appropriate form of final judgment.

All Citations

62 A.3d 676, 38 Del. J. Corp. L. 339

Footnotes

1 Trial Tr. ("Tr.") 14 (Zimmerman); Tr. 533 (Toni). Where the identity of the testifying witness is not clear from the text or a nearby citation, it is indicated parenthetically after the cited page of the transcript.

2 JX 200 (Molinaro) (stating that "[e]ither everyone is blowing smoke or the market is well over $600 MM today").

3 Tr. 19–31 (Zimmerman).

4 Tr. 284, 316–17 (Molinaro).

5 Tr. 317.

6 Tr. 283 (Molinaro).

7 *Id.*

8 Tr. 283–84 ("[I]mmediately after we had made their presentation and gave [the Cleveland Clinic] a price, we were told that J & J flew in there with [ ] their top brass and dropped their price and gave them discounts on additional products.").

9 Tr. 239 (Molinaro).

10 *Id.*

11 Tr. 243–44 (Molinaro); Tr. 432–33 (Gausling).

12 For the most part, the relevant provisions in the various versions of Adhezion's Operating Agreement are identical. In this Opinion, I refer or cite to the "Operating Agreement" in general unless a distinction is relevant. The Amended Operating Agreement appears in the record at JX 25; the Second Amended Operating Agreement appears at JX 38; and the Third Amended Operating Agreement appears at JX 226.

13 Am. Operating Agreement § 6.2(a). The Company's directors included: a "CEO Director," who is the then-current CEO; two "Series A Preferred Directors," who are elected by a majority-in-interest of the Series A Preferred unitholders; a "Common Director," who is elected by a majority-in-interest of the Class A Common unitholders; and an "Industry Director" who is elected by a majority of the CEO Director, the Series A Preferred Directors, and the Common Director and who is neither a Member nor an Affiliate of any Member, as those terms are defined in the Operating Agreement

14 JX 28.

15 Tr. 296–97 (Molinaro).

16 Tr. 295–96.

17 Tr. 244–45.

18 Second Am. Operating Agreement § 6.2. The Second Amended Operating Agreement gave Liberty and Originate the right to designate a director and increased the number of Industry Directors to two. The CEO and Common directorships remained in place.

19 JX 35 (email from Molinaro to Zimmerman: "Looks like we now have to get Common B Shareholder consent (at least the majority) for the transaction to occur"); Tr. 655 (Miller) (stating that the consent of the Common unitholders was required because, in addition to issuing additional units, the Company made changes for which Section 15.11 required Common unitholder consent, such as changing the Board composition and the consent requirement threshold for the Preferred unitholders).

20 JX 55; JX 56. Zimmerman contends that the Common Directorship has been vacant since his removal and that Toni is the second Industry Director. There is some evidence to support Zimmerman's view. *See, e.g.,* JX 67; Tr. 97–99

(Zimmerman); Tr. 536–38 (Toni). I find the evidence that Toni was the Common Director slightly more persuasive, but ultimately have concluded that which directorship remained vacant is immaterial to my resolution of this case.

21 Tr. 288–89 (Molinaro) (recalling that he worked at Cilco between 1977 and 1986 and that Toni worked there from 1982 to 1986).

22 JX 48.

23 JX 66 (e-mail discussing "3M Term Sheet Counters for Consideration"); JX 67, April 30, 2009 Board of Directors' Meeting Minutes.

24 JX 110.

25 JX 72 (June 26, 2009 e-mail from John Prelaz to Molinaro and Manuel Rodriguez discussing 3M).

26 JX 109 (August 28, 2009 e-mail chain among Crothall, Molinaro, Gausling, Toni, and Bryant regarding "Important 3M Update").

27 JX 107 (August 21, 2009 e-mail chain between Toni and Molinaro discussing 3M).

28 Tr. 250–51 (Molinaro).

29 *Id.*

30 JX 67.

31 JX 100, July 17, 2009 Written Consent of Directors in Lieu of Meeting; JX 182, December 15, 2009 Written Consent of Directors in Lieu of Meeting.

32 JX 77, July 17, 2009 Adhezion Biomedical LLC Note and Warrant Purchase Agreement.

33 JX 70 at D026179.

34 JX 89, July 17, 2009 Adhezion Biomedical, LLC Warrant to Purchase Series A Series A Preferred Units for subscriber Molinaro.

35 Tr. 247–48, 254–55 (Molinaro).

36 JX 384, Molinaro's contact log; Tr. 247–48.

37 Tr. 248.

38 JX 113.

39 *Id.*

40 JX 117, September 29, 2009 Board Meeting Minutes; *see also* Tr. 373–74 (Bryant) (stating that the minutes reflect that Morse represented Crothall at the September 29, 2009 Board meeting); Tr. 421 (Morse) ("I was attending ... for Liberty Ventures as a visitor to the board meeting. I have visitation rights, I think. I can go to board meetings if I want.").

41 JX 117; Tr. 254–55 (Molinaro).

42 JX 116. This September 25, 2009 e-mail also indicates that Molinaro had not completely ceased fundraising efforts after the September Board meeting.

43 JX 130, October 28, 2009 e-mail from Gausling to Datin. Gausling serves on the healthcare advisory board at Safeguard Scientific. Tr. 442 (Gausling).

44 *Id.*

45 JX 139.

46 *Id.*

47 Tr. 312 (Molinaro).

48 JX 154.

49 JX 197.

50 JX 156; JX 158; JX 200.

51 JX 212.

52 *Id.*

53 JX 138.

54 JX 157; JX 191; JX 194, January 15, 2010 Board of Directors' Meeting Minutes.

55 JX 182, December 15, 2009 Written Consent of Directors in Lieu of Meeting. The December 2009 Issuance brought the total amount of the bridge loans up to $840,000, $90,000 more than the $750,000 approved by the Board at the April 30, 2009 Board meeting. The full amount of the December 2009 Issuance, however, was approved by a unanimous written consent of the Board on December 15, 2009. *Id.*

56 Tr. 479–80 (Crothall).

57 Tr. 261–65, 275 (Molinaro). By early 2011, the reformulation was completed and Adhezion's new sterilization process was approved and validated. Tr. 356 (Molinaro).

58 JX 194.

59 JX 201 at D24534.

60 *Id.* at D24352.

61 JX 210, February 2, 2010 e-mail from Crothall to Morse; Tr. 486 (Crothall).

62 JX 210. Gausling testified that he “didn't say in two to three years, [Adhezion] would be sold for 50 to $100 million” but that “[u]nder certain qualifying events, there could be that possibility, if certain things happened but it's all subject to a whole bunch of qualifiers.” Tr. 468.

63 Tr. 486.

64 JX 241, February 17, 2010 Written Consent of Directors in Lieu of Meeting, at D28416–25; JX 224, February 17, 2010 Series B Preferred Unit and Warrant Purchase Agreement (“February 2010 Purchase Agreement”), at D28136.

65 Tr. 273 (Molinaro).

66 Third Am. Operating Agreement § 3.1(b)(iv). The main differences between the Second Amended and Third Amended Operating Agreements are that the latter reflects the creation of the Series B Preferred units, sets forth the number of Series B Preferred units the Company is authorized to issue, and purports to increase the number of Common B and Series A Preferred units the Company was authorized to issue.

67 JX 224.

68 JX 224 §§ 1.1, 1.3.

69 JX 159, December 15, 2009 "Adhezion Membership Schedule," at D022244.

70 JX 224 at D028175. Greenstein purchased 745 units; the existing Preferred unitholders purchased 625,000 units. Pursuant to the terms of the 2009 Issuances, the holders of the promissory notes issued in those transactions could convert the notes into any units issued in a future financing at the cash purchase price per unit of such future financing. *See* JX 79 § 5(b); JX 170 § 5(b); JX 224 § 7.15. Accordingly, the Preferred members paid $875,000 of the $2.5 million aggregate purchase price of the February 2010 Issuance by converting the promissory notes they had received in the 2009 Issuances. Tr. 272 (Molinaro).

71 JX 259 (e-mail from Molinaro circulating the proposed revised option grants to the Board); JX 411 (stating, in a document titled "April 23, 2010 Telephonic Board Resolution of Options," that the Board approved the option grants following a telephonic meeting on April 23, 2010).

72 JX 411.

73 *Id.* Two employees, Molinaro and Ruiz, received "profit interests" and ten others received "options." *Id.* at D029937. The Operating Agreement provides that "the Class B Common Units are intended to constitute 'profits interests,' as such term is used by Rev. Proc. 93–27 and Rev. Proc. 2001–43." Operating Agreement § 3.3(b)(v). The parties presented no additional evidence explaining the structure of this option grant.

74 JX 265, Unit Purchase Agreement; JX 260 (e-mail chain from Zimmerman to Graham and then from Graham to Crothall and Molinaro).

75 JX 297 at D032627.

76 JX 298; Tr. 318 (Molinaro: "I received an oral expression of interest").

77 Tr. 284 (Molinaro: "We had a very little bit of money at the end of 2010, and I think we lost 1.7 million on the 2010 year on $425,000 in sales."). According to Molinaro, Adhezion had little chance of attracting short-term outside funding at this time. *Id.* Indeed, even Liberty, an existing investor, did not participate in the January 2011 Issuance. *Id.*

78 JX 296, December 3, 2010 Board of Directors' Meeting Minutes.

79 JX 326, January 10, 2011 Written Consent of Directors in Lieu of Meeting; JX 312, January 10, 2011 Note and Warrant Purchase Agreement.

80 JX 312 § 1.1.

81 JX 312.

82 *Zimmerman v. Crothall,* 2012 WL 707238 (Del.Ch. Mar. 27, 2012).

83 In the Summary Judgment Opinion, I held that Plaintiff "properly has brought this fiduciary duty claim regarding the alleged overpayment by the Company on at least a derivative basis." *Id.* at *15. I left open the possibility that Zimmerman also had asserted a claim for direct relief pending development of the record at trial. *Id.* at *15 n. 83. The parties neither briefed nor argued this issue after trial. I therefore consider Zimmerman to be proceeding on a derivative basis only.

> This is an appropriate derivative action because Plaintiff seeks relief for injuries done to the LLC and because he pled demand excusal with particularity and sufficiently to "create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Ishimaru v. Fung,* 2005 WL 2899680, at *12 (Del.Ch. Oct. 26, 2005); *see also* 6 *Del. C.* § 18–1001 (providing LLC members and assignees the right "to bring an action in the Court of Chancery in the right of a limited liability company to recover a judgment in its favor" when managers or members with authority to do so have refused, or an effort to cause them to do so "is not likely to succeed"); *id.* § 18–1003 ("In a derivative action, the complaint shall set forth with particularity the effort, if any, of the plaintiff to secure initiation of the action by a manager

or member or the reasons for not making the effort."); *Eureka VIII LLC v. Niagara Falls Hldgs. LLC,* 899 A.2d 95, 96 (Del.Ch.2006) (recognizing the right of an LLC member or assignee to bring a derivative action on behalf of the LLC when another member breaches a contractual or fiduciary duty owed to the LLC).

84 *Lorillard Tobacco Co. v. Am. Legacy Found.,* 903 A.2d 728, 739 (Del.2006).

85 *Id.* (citing *Rhone–Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.,* 616 A.2d 1192, 1195–96 (Del.1992)).

86 In the Summary Judgment Opinion, I concluded that Sections 3.8, 6.13, and 15.11 of the Operating Agreement are ambiguous. *See Zimmerman v. Crothall,* 2012 WL 707238, at *19–21 (Del.Ch. Mar. 27, 2012). Because no evidence presented at trial has caused me to change that conclusion, I reaffirm it here.

87 *Bell Atlantic Meridian Sys. v. Octel Commc'ns Corp.,* 1995 WL 707916, at *6 (Del. Ch. Nov. 28, 1995).

88 *Id.*

89 *NAMA Hldgs., LLC v. World Mkt. Ctr. Venture, LLC,* 948 A.2d 411, 419 (Del.Ch.2007).

90 *Lillis v. AT & T Corp.,* 2008 WL 2811153, at *4 (Del.Ch. July 21, 2008); *Estate of Osborn ex rel. Osborn v. Kemp,* 2009 WL 2586783, at *4 (Del.Ch. Aug. 20, 2009), *aff'd,* 991 A.2d 1153 (Del.2010).

91 6 *Del. C.* ch. 18.

92 *Elf Atochem North Am., Inc. v. Jaffari,* 727 A.2d 286, 290 (Del.1999) ("The [LLC Act] can be characterized as a 'flexible statute' because it generally permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the [LLC Act].").

93 *See* 6 *Del. C.* § 18–301 (discussing admission of members and providing that a person may be admitted as a member of an LLC without making a contribution to the LLC or acquiring an LLC interest in the company).

94 *See NAMA Hldgs., LLC v. World Mkt. Ctr. Venture, LLC,* 948 A.2d 411, 419 (Del.Ch.2007).

95 Under Section 3.1(b) of the Amended Operating Agreement, the Company was authorized to issue 340,000 Class A Common units; 266,250 Class B Common units; and 393,750 Series A Preferred units. In the Second Amended Operating Agreement, the number of Class A Common units remained the same; the number of Class B Common units increased to 415,972; and the number of Series A Preferred units increased to 741,248. In the Third Amended Operating Agreement, the number of Class A Common units remained the same, the number of Class B Common units increased to 655,972; the number of Series A Preferred units increased to 1,040,464; and the Series B Preferred was added and 1,622,590 units were authorized to be issued. *See* JX 25; JX 38; JX 226. The Board increased the number of Series A Preferred units that the Company purportedly was authorized to issue twice by written consents between the Second and Third Amended Operating Agreements: to 815,623 in connection with the July 2009 Issuance; and then to 858,123 in the December 2009 Issuance. *See* JX 100; JX 182.

96 The "Required Interest" is defined to mean "Members holding greater than two-thirds (2/3) of either all the issued and outstanding Units or all the issued and outstanding Units of a particular Class or Classes or Series, as the context requires." Operating Agreement § 2.1.

97 *Id.* § 15.11 (emphasis added). The Common unitholders "have the right to vote or consent as a single class with the Members holding Preferred Units on all matters on which Members may vote and on all matters for which the consent of Members may be obtained." *Id.* § 3.3(a). The principal matter on which Common members can vote is an amendment to the Operating Agreement under Section 15.11.

98 8 *Del. C.* §§ 101–619.

99 The Board's authority to act under Section 3.8 actually is subject to Section 3.2 which requires the approval of more than two-thirds of the Series Preferred members. In the circumstances of this case, however, the interests of the Series Preferred members were aligned with at least those of Defendants Originate, Liberty, and Molinaro, who accounted for

at least two-thirds of the Series Preferred members. At all relevant times, each of those parties or their designees served on the Board. Section 3.2, therefore, did not practically restrict the Board's authority to engage in any of the Challenged Transactions. Thus, I refer to the Board's authority to act under Section 3.8 as though it were authorized to act unilaterally.

100 *See* Robert L. Symonds, Jr. & Matthew J. O'Toole, *Symonds & O'Toole on Delaware Limited Liability Companies* § 5.15, at 5–89 (2010 Supplement) (emphasis added) ("The [LLC Act] establishes no formalities that must be observed for the creation and issuance of limited liability company interests.").

101 Although Miller's testimony is relevant and useful, its significance is limited. Extrinsic evidence may be used to interpret an ambiguous contract with the goal of effectuating the parties' intent. *See* *Lorillard Tobacco Co. v. Am. Legacy Found.,* 903 A.2d 728, 739 (Del.2006). In this regard, Miller's intent as the drafter of the Operating Agreement is at least one step removed from the intent of his client and those who actually negotiated the Agreement. There is no evidence, for example, that the parties negotiated about the meaning of "authorize" in the context of the Challenged Transactions. Because Miller evidently had some involvement in the negotiations, however, I infer that he knew about his own client's intentions.

102 Tr. 646.

103 *See* 8 *Del. C.* § 242 (requiring an amendment to a corporation's certificate of incorporation to increase or decrease its authorized capital stock).

104 Tr. 646 (emphasis added); *see also* 8 *Del. C.* § 151.

105 *See* *Personnel Decisions, Inc. v. Bus. Planning Sys., Inc.,* 2008 WL 1932404, at *6 n. 29 (Del.Ch. May 5, 2008).

106 Zimmerman's employment was terminated at the end of 2008. Tr. 474–75 (Gausling). He contends that he learned of the 2009 Issuances in 2010 after filing the initial complaint in this case. Compl. ¶ 5.

107 Operating Agreement § 15.11 (emphasis added).

108 *Id.* § 15.11.

109 *Id.* (emphasis added).

110 Am. Operating Agreement § 3.9. The Amended Operating Agreement references Section 3.9 which is the equivalent of Section 3.8 in the Second Amended Operating Agreement.

111 *Id.*

112 Second Am. Operating Agreement § 3.8

113 Tr. 651–52 (Miller) ("It was clearly the intent under Section 15.11 that the board have the authority to issue additional units. The language says so itself.").

114 Tr. 654.

115 Tr. 649 (Miller) (testifying that the provisions related to additional units were "specifically negotiated" so that the Company could issue additional units without having to get the consent of the Common unitholders).

116 Tr. 103 (Zimmerman) (claiming that he "agreed to take that $3 million because they forced me and put me over a barrel").

117 *See* *Lorillard Tobacco Co. v. Am. Legacy Found.,* 903 A.2d 728, 739 (Del.2006) ("The true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant." (quoting *Rhone–Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.,* 616 A.2d 1192, 1195–96 (Del.1992))).

118 *Id.* ("Courts will not torture contractual terms to impart ambiguity where ordinary meaning leaves no room for uncertainty.").

119 *See Harrah's Enter., Inc. v. JCC Hldg. Co.,* 802 A.2d 294, 313 (Del.Ch.2002) (concluding, in a case where the plaintiff stockholder took part in negotiating the corporate charter and bylaws, that *contra proferentum* against the corporation should be resorted to only after consideration of extrinsic evidence in part because "human imperfection ... creates an ever-present risk that even talented negotiators may fail to spell out their intentions unambiguously").

120 *See Elf Atochem North Am., Inc. v. Jaffari,* 727 A.2d 286, 292 (Del.1999) (noting that "the commentators observe that only where the agreement is inconsistent with mandatory statutory provisions will the members' agreement be invalidated"); *see also Lorillard Tobacco Co.,* 903 A.2d at 739 ("[The Court] is constrained by a combination of the parties' words and the plain meaning of those words").

121 *See E.I. du Pont de Nemours & Co., Inc. v. Shell Oil Co.,* 498 A.2d 1108, 1114 (Del.1985).

122 *Restatement (Second) of Contracts* § 206 (1981).

123 *E.I. du Pont de Nemours & Co.,* 498 A.2d at 1114.

124 Tr. 102–03 (Zimmerman) (stating that Adhezion's counsel negotiated with Originate's attorneys, Pepper Hamilton, but asserting that "it wasn't like there was even any real negotiation. They said, 'Take it or leave it' "); Tr. 639–40 (Miller) (stating that there were negotiations, changes were made to the original draft, and that it was not a "take-it-or-leave-it" situation). I find that there were negotiations as to the Second Amended Operating Agreement, but that the Company and the Preferred unitholders had the upper hand in those negotiations vis-à-vis the Common unitholders.

125 Miller is an attorney at Pepper Hamilton. Pepper Hamilton represented Defendants, including Originate, at the outset of this litigation.

126 Miller testified that Common unitholders' consent was obtained for the Second Amended Operating Agreement because, in addition to reflecting an increase in the number of Series A Preferred units that were authorized, the amendment changed the board composition and the consent requirement threshold for the Preferred unitholders. Tr. 655.

127 *Cf. Harrah's Enter., Inc.,* 802 A.2d at 313 (holding, in the context of disenfranchisement of a stockholder, that if the Court concludes that a negotiated charter and bylaws are ambiguous, it should evaluate the extrinsic evidence, but that it must rule against the drafting corporation "unless the evidence clearly and convincingly supports the conclusion that the usual right [the plaintiff] would have to nominate more than one candidate was limited by the charter and bylaws").

128 *See Kahn v. Lynch Comm'n Sys., Inc.,* 638 A.2d 1110, 1113–14 (Del.1994) (citing *Ivanhoe P'rs v. Newmont Mining Corp.,* 535 A.2d 1334, 1344 (Del.1987)).

129 *In re PNB Hldg. Co. S'holders Litig.,* 2006 WL 2403999, at *9 (Del.Ch. Aug. 18, 2006); *Zimmerman v. Crothall,* 2012 WL 707238, at *11 (Del.Ch. Mar. 27, 2012).

130 *In re PNB Hldg. Co. S'holders Litig.,* 2006 WL 2403999, at *9.

131 *Id.* at *10.

132 *Id.* at *1.

133 *Zimmerman,* 2012 WL 707238, at *12.

134 Second Am. Operating Agreement § 3.12(b). Zimmerman asserts that Liberty and Originate actually have even more control over the Board. Specifically, he notes that the Operating Agreement allows the Series A Directors to fire Molinaro and then appoint a new CEO, who would serve as the CEO director. Pl.'s OB 7 (citing Sections 6.5 and 7.1 of the Operating Agreement). Neither of the provisions Zimmerman cites, however, expressly provides the Series A Directors with this authority and it is not clear that, together, they operate as Plaintiff suggests.

135 *See Dubroff v. Wren Hldgs., LLC,* 2009 WL 1478697, at *3 (Del.Ch. May 22, 2009) ("Although a controlling shareholder is often a single entity or actor, Delaware case law has recognized that a number of shareholders, each of whom individually cannot exert control over the corporation (either through majority ownership or significant voting power coupled with

formidable managerial power), can collectively form a control group where those shareholders are connected in some legally significant way—*e.g.,* by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal.").

136 JX 117 at D030039.

137 *Id.*

138 Bryant Dep. 56. The parties placed substantially all of Bryant's deposition testimony into evidence, including all portions relied upon in this Opinion.

139 Tr. 374 (Bryant).

140 Tr. 423 (Morse).

141 Tr. 441 (Gausling).

142 JX 130.

143 *See Auriga Capital Corp. v. Gatz Props., LLC* [*Auriga I*], 40 A.3d 839, 849 (Del.Ch.2012) (citing *Douzinas v. Am. Bureau of Shipping, Inc.,* 888 A.2d 1146, 1149–50 (Del.Ch.2006)), *aff'd,* 59 A.3d 1206 (Del.2012).

144 6 *Del. C.* § 18–1101(c). The LLC Act does not allow for the elimination of the implied contractual covenant of good faith and fair dealing. Zimmerman has not claimed that Defendants breached this covenant.

145 *See Douzinas,* 888 A.2d at 1149–50. The Delaware Supreme Court has not yet definitively determined whether the LLC statute imposes default fiduciary duties. *See Gatz Props., LLC v. Auriga Capital Corp.* [*Auriga II*], 59 A.3d 1206, 1218–20 (Del.2012). This Court recently considered the issue of default fiduciary duties and held that, subject to clarification from the Supreme Court, managers and managing members of an LLC do owe fiduciary duties as a default matter. *See Feeley v. NHAOCG, LLC,* 2012 WL 5949209, at *8–10 (Del.Ch. Nov. 28, 2012).

146 Operating Agreement § 6.15. The term "Directors" is defined in Section 2.1 as "any Person who is a member of the Board of Directors of the Company."

147 Operating Agreement § 6.13.

148 *See In re Cysive, Inc. S'holders Litig.,* 836 A.2d 531, 547 (Del.Ch.2003) ("This case brings to the fore an aspect of our corporation law that is passing strange. Although the trial in this matter has already been held, a major aspect of the parties' post-trial briefs focuses on the standard of review I am to apply to decide this case.")

149 *See Auriga II,* 59 A.3d at 1213 ("To impose fiduciary standards of conduct as a contractual matter, there is no requirement in Delaware that an LLC agreement use magic words, such as 'entire fairness' or 'fiduciary duties.' ").

150 *See id.* at 1213–15; *see also infra* Part II.B.4.

151 *See Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1156, 1162 (Del.1995) ("If the [business judgment] rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transactions, to prove to the trier of fact the 'entire fairness' of the transaction...."). The business judgment rule is rebutted if the plaintiff provides evidence that the directors, in reaching a challenged decision, are interested or breached any of their fiduciary duties. *Id.* at 1164; *Aronson v. Lewis,* 473 A.2d 805, 812 (Del.1984) ("[The] protections [of the business judgment rule] can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment.").

152 Section 144 of the DGCL states in relevant part:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be *void or voidable* solely for this reason, or solely because

> the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:
>
> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
>
> ...
>
> (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders.

8 *Del. C.* § 144 (emphasis added).

153 *See* Blake Rohrbacher, John Mark Zeberkiewicz, Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144,* 33 Del. J. Corp. L. 719 (2008).

154 *See Feeley v. NHAOCG, LLC,* 2012 WL 4859132, at *11 (Del.Ch. Oct.12, 2012) ("Nothing about the [LLC Act] suggests a desire on the part of the General Assembly to transplant into a new and flexible form of entity an old and rigid common law rule that had been displaced substantially over the prior century, first by private ordering and later by statute.").

155 *See NAMA Hldgs., LLC v. World Mkt. Ctr. Venture, LLC,* 948 A.2d 411, 419 (Del.Ch.2007) (citing *Majkowski v. Am. Imaging Mgmt. Serv.,* 913 A.2d 572, 588 (Del.Ch.2006)).

156 Defendants contend that, at a minimum, compliance with the requirements of a safe harbor under Section 6.13 would create a burden shift to Zimmerman to prove unfairness. Zimmerman apparently agrees with this interpretation. Pl.'s Answering Br. in Opp'n to Defs.' Mot. for Summ. J. 32 n. 20 ("At most, compliance with [Section 6.13's] terms can only shift the burden of proof to plaintiff, not restore the business judgment rule entirely."). The effect of compliance with one of the three subsections of Section 144(a) of the DGCL on the appropriate standard of review for an otherwise self-interested corporate transaction has been the subject of numerous prior decisions in Delaware, as well as scholarly commentary. *See, e.g., Benihana of Tokyo, Inc. v. Benihana, Inc.,* 906 A.2d 114, 120 (Del.2006); *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 366 n. 34 (Del.1993); *Marciano v. Nakash,* 535 A.2d 400, 405 n. 3 (Del.1987); Rohrbacher et al., *supra* note 153. For purposes of this LLC case, however, I do not consider it necessary or productive to delve into those issues.

157 *See Auriga II,* 59 A.3d 1206, 1212–15 (Del.2012); *Auriga I,* 40 A.3d 839 (Del.Ch.2012).

158 *Auriga I,* 40 A.3d at 857.

159 *Auriga II,* 59 A.3d 1206, 1213.

160 *Id.*

161 *Id.* at 1213 n. 20 (citing *Kahn v. Lynch Commc'n Sys., Inc.,* 638 A.2d 1110, 1117 (Del.1994))

162 *See Aronson v. Lewis,* 473 A.2d 805, 812 (Del.1984).

163 *See Grobow v. Perot,* 539 A.2d 180, 188 (Del.1988) (citing *Aronson* for the proposition that director interestedness requires "either a financial interest or entrenchment"), *overruled on other grounds by Brehm v. Eisner,* 746 A.2d 244, 253 (Del.2000).

164 Molinaro participated in each of the Challenged Transactions. But the parties dispute whether the transactions conveyed a benefit to Molinaro that was not open to unitholders generally and whether Molinaro's participation in the Challenged Transactions was material to him. *See Orman v. Cullman,* 794 A.2d 5, 25 n. 50 (Del.Ch.2002). Zimmerman further argues that Molinaro was not independent of Liberty and Originate. Because I find it unnecessary to resolve these disputes, I assume, without deciding, that Molinaro was interested.

165 *Zimmerman v. Crothall,* 2012 WL 707238, at *13 (Del.Ch. Mar. 27, 2012); *see also Beam v. Stewart,* 845 A.2d 1040, 1050 (Del.2004) ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence"); *id.* at 1051 (stating that director's independence may be doubted when a relationship is one of "financial ties, familial affinity, a particularly close or intimate personal or business affinity or ... evidence that in the past the relationship caused the director to act non-independently vis-à-vis an interested director").

166 *See* Tr. 289–95 (Molinaro); Tr. 377 (Bryant).

167 Tr. 289 (Molinaro).

168 Tr. 295 (Molinaro); JX 28.

169 *Benerofe v. Cha,* 1996 WL 535405, at *7 (Del.Ch. Sept. 12, 1996) ("A director is 'independent' if that director is capable of making decisions for the corporation based on the merits of the subject rather than 'extraneous considerations or influences.' " (citing *Aronson,* 473 A.2d at 816)).

170 Tr. 554 (Toni); Bryant Dep. 33–34, 65.

171 *See, e.g.,* JX 67 (Bryant and Toni attended April 30, 2009 Board meeting); JX 117 (Bryant attended September 29, 2009 Board meeting); JX 194 (Bryant and Toni attended January 15, 2010 Board meeting).

172 Tr. 367 (Bryant); Tr. 528 (Toni).

173 *See Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1156, 1162–63 (Del.1995) (quoting *Weinberger v. UOP, Inc.,* 457 A.2d 701, 711 (Del.1983)).

174 *ONTI, Inc. v. Integra Bank,* 751 A.2d 904, 930 n. 108 (Del.Ch.1999) (citing *Weinberger,* 457 A.2d at 711).

175 Tr. 507 ("Q: So you had $29.5 million of capital to fund your investment by 1996? A: Yes. Now, we had burned 10 million by the time we—by #06 [sic], we had already burned through 10").

176 Tr. 510–11 ("Q. With your experience in Adhezion, tell me, do you regard it as the next Closure? A. No, not at all. You know, first of all, they are so strapped in terms of cash, availability of cash, to try and build the business. How do they compete with J & J? How do they distribute their product? ... You need a pipeline.").

177 Tr. 511 (Toni) ("Q. With all the money [Closure] raised [$39.5 million], why did you go to Johnson & Johnson rather than develop your own channels of distribution? A. [W]e realized that we never could be able to raise enough money to compete with 200 sales reps. How could we build a 200–sales–rep organization to compete with Ethicon, [J & J's division that sells Dermabond]?"); Tr. 440 (Gausling) ("[W]e, as a collective board, took a strategy that we would go with a corporate partner for distribution versus building a sales team ourselves."). Gausling further explained: "[T]hat's the value drivers for any investor to look at, is how's the business doing and we needed—need strategic partners or some revenue traction or some clarity on the patent situation." *Id.*

178 Tr. 439.

179 JX 130; *see also* Tr. 442 (Gausling).

180 Gausling ascribed the increased riskiness of the Adhezion investment over time to three main reasons: (1) Adhezion needed more money within twelve months of Originate's investment; (2) Zimmerman met only two of his seven performance milestones; and (3) the budgeted revenues for 2008 ($5.6 million) dwarfed the actual revenues ($140,000). Tr. 436–38. Zimmerman does not dispute that he failed to meet many of the milestones in his employment agreement, except to note that Adhezion achieved a third milestone fifteen days after his termination. Tr. 112.

181 Tr. 437.

182 Tr. 246–47 (Molinaro); JX 48, January 8, 2009 Letter from Medlogic to Adhezion regarding potential patent infringement.

183 Tr. 251 (Molinaro).

184 The Company sold out its existing inventory of SurgiSeal by extending the shelf life. Tr. 282 (Molinaro).

185 Tr. 270.

186 Tr. 335.

187 JX 370; JX 372.

188 Bowers stated that, although she did not perform an analysis for the other three Challenged Transactions, "in the analysis [she] did in this whole matter—[she] did not find anything that would cause [her] to suspect that they were unfair." Tr. 151; *see also* JX 369, Bowers's Expert Report; JX 371, Bowers's Rebuttal Report; JX 376, Bowers's Supplemental Expert Report. Bowers did state in her Rebuttal Report, however, that D'Souza overstated Adhezion's value due to mistakes and errors, and that his calculated valuation "does not support a determination of fairness nor does it support that the disputed transactions were fair." JX 371 at 6, 25–26. As the party with the burden of proof to show that the other Challenged Transactions were unfair, Zimmerman's general criticisms of those transactions, without the benefit of any expert analysis, were insufficient to meet his burden. Furthermore, Defendants' expert credibly concluded that "the capital raising activities of Adhezion during 2009–2011 were fair and reasonable." JX 370, Expert Report of Roy P. D'Souza, at 71.

189 JX 376 at 4. Bowers's discounted cash flow ("DCF") model yielded a value of $16.18 million and her comparable companies, or relative, valuation yielded a value of $13.97. In arriving at a valuation of $15.63, she gave her DCF model 75% weight and her relative valuation 25% weight.

190 Tr. 273 (Molinaro). In February 2010, the total number of Adhezion units if all outstanding warrants and options were exercised was 3,249,633. Tr. 585–88 (D'Souza). This number multiplied by the $4.00 per unit price equals $12,998,532.

191 *See* JX 372.

192 JX 376.

193 *See* JX 372 at 9–11 (discussing size risk, legal risks, and regulatory risks). The parties disagree, for example, on how to characterize the Company. Defendants call it an "early-stage" medical products company. Defs.' Answering Post–Trial Br. ("Defs.' AB") 1; Tr. 431 (Gausling). Zimmerman describes Adhezion as a "growth-stage" company, and his expert appears to use that characterization to justify assigning less risk to the Company than Defendants' expert did. Pl.'s Opening Post–Trial Br. ("Pl.'s OB") 1; Pl.'s Reply Post–Trial Br. ("Pl.'s RB") 17; JX 369, Expert Report of Dr. Helen M. Bowers, 8–9 (describing an "expansion-stage" company as one that has products in production, has products that are commercially available, and is experiencing revenue growth though it may not yet show a profit). In the circumstances of this case, I find Defendants' characterization of Adhezion as an early-stage company slightly more appropriate.

194 Tr. 606–07 (D'Souza); Tr. 517–18 (Toni).

195 Tr. 142 (Bowers); Tr. 601 (D'Souza).

196 *In re Walt Disney Co. Deriv. Litig.,* 907 A.2d 693, 705 n. 42 (Del.2005).

197 *Louisiana State Employees' Retirement Sys. v. Citrix Sys., Inc.,* 2001 WL 1131364, at *7 (Del.Ch. Sept. 19, 2001); *see also Lewis v. Vogelstein,* 699 A.2d 327, 331 (Del.Ch.1997) (noting that Black–Scholes "assumes that the options being valued are issued and publicly-traded"); Tr. 598 (D'Souza).

198 *See* JX 369 at 4; Pl.'s OB 30; *see also* JX 372 at 18.

199 *See* Tr. 502–09 (Toni).

200 JX 369 at 4.

201 *Allied Capital Corp. v. GC–Sun Hldgs., L.P.,* 910 A.2d 1020, 1039 (Del.Ch.2006).

202 *Waggoner v. Laster,* 581 A.2d 1127, 1135 (Del.1990).

203 *In re Loral Space & Commnc'ns Inc.,* 2008 WL 4293781, at *33 n. 161 (Del.Ch. Sept. 19, 2008).

204 *Id.*

205 *Reddy v. Elec. Data Sys. Corp.,* 2002 WL 1358761, at *5 (Del.Ch. June 18, 2002).

206 *See Delphi Easter P'rs Ltd. P'ship v. Spectacular P'rs, Inc.,* 1993 WL 328079, at *2 (Del.Ch. Aug. 6, 1993) (interpreting a section of the Delaware Revised Uniform Limited Partnership Act ("DRULPA"), 6 *Del. C.* § 17–108, which similarly allows a partnership to "indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever").

207 *Id.* at *2.

208 Operating Agreement § 6.17 (emphasis added). Plaintiff does not challenge the reasonableness of the attorneys' fees advanced. I therefore do not consider that issue.

209 *Id.*

210 In addition to the indemnification provision in the Operating Agreement, the Company also entered into indemnification agreements with at least directors Molinaro and Crothall. Although Defendants assert that "Adhezion entered into indemnification agreements with each of [the] directors," they cited only two exhibits in support of this assertion. Defs.' AB 49 (citing JX 40 (Crothall Indemnification Agreement) and JX 43 (Molinaro Indemnification Agreement)). These agreements expressly address "Advancement of Expenses" and provide that the Company will advance expenses incurred by the contracting director after the director submits a statement requesting the advance *and* a written undertaking. There is no evidence, however, that any director provided an oral or written undertaking to the Company. *See Carlson v. Hallinan,* 925 A.2d 506, 541 (Del.Ch.2006) (finding that 8 *Del. C.* § 145 permits an undertaking to be in oral or written form). In the corporate context, this Court held in *Carlson v. Hallinan* that a company's advancement of directors' litigation expenses without the directors first submitting an undertaking was *ultra vires. Id.* Nevertheless, the Court noted that the directors still could "apply to this Court, pursuant to 8 *Del. C.* § 145(b), for indemnification." *Id.* at 542 n. 240. In light of the extensive findings of wrongdoing and liability by Defendants in *Carlson,* however, the Court required the directors to repay the advanced funds to the company pursuant to both 8 *Del. C.* § 145(b) and § 145(e). Because Defendants are entitled to indemnification in this case, I reach a different result.

211 JX 224 art. 6.

212 The agreement defines "Indemnified Party" to include "the Purchasers and their affiliates and their respective officers, directors, trustees, agents, representatives, employees, partners and controlling persons." *Id.* § 6.1(a). This broad definition would include Defendant Morse as an agent of Liberty.

213 *Id.* § 6.1(b). This provision contains a carve-out for claims resulting from a party's grossly negligent or willful misconduct, but it is not relevant here.

214 *Id.* § 6.1(a).

215 *Id.* § 3.1.

216 To avoid this result, Zimmerman could have sought, for example, to have this question resolved in advance of trial pursuant to 6 *Del. C.* § 18–111, which permits this Court to "interpret, apply or enforce the provisions of a limited liability company agreement." *See Morgan v. Grace,* 2003 WL 22461916, at *1 (Del.Ch. Oct. 29, 2003) ("The value of the right to advancement is that it is granted or denied while the underlying action is pending.").

217 Sept. 14, 2012 Post–Trial Oral Arg. Tr. 47 ("*To the extent the Court finds for Plaintiff,* [we request] that it order repayment of advanced attorneys' fees as no longer permitted." (emphasis added)).

218 Operating Agreement § 6.1(a).

219 *Id.* § 6.17. The comparable language under Section 6.1(b) of the February 2010 Purchase Agreement is less broad, but still supports the same conclusion as to the non-Director Defendants. That Section requires the Company to indemnify parties to that agreement "against any and all direct costs, expenses and monetary damages of such Indemnified Party resulting directly from or arising directly out of [a claim] primarily relating to the Indemnified Party's status as a security holder." JX 224 § 6.1(b).

25

Restat 2d of Conflict of Laws, § 187

Restatement of the Law, Conflict of Laws 2d - Official Text > Chapter 8- Contracts > Topic 1- Validity of Contracts and Rights Created Thereby > Title A- General Principles

§ 187 Law of the State Chosen by the Parties

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties choice, or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

(3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

COMMENTS & ILLUSTRATIONS

Comment:

a. Scope of Section. The rule of this Section is applicable only in situations where it is established to the satisfaction of the forum that the parties have chosen the state of the applicable law. When the parties have made such a choice, they will usually refer expressly to the state of the chosen law in their contract, and this is the best way of insuring that their desires will be given effect. But even when the contract does not refer to any state, the forum may nevertheless be able to conclude from its provisions that the parties did wish to have the law of a particular state applied. So the fact that the contract contains legal expressions, or makes reference to legal doctrines, that are peculiar to the local law of a particular state may provide persuasive evidence that the parties wished to have this law applied.

On the other hand, the rule of this Section is inapplicable unless it can be established that the parties have chosen the state of the applicable law. It does not suffice to demonstrate that the parties, if they had thought about the matter, would have wished to have the law of a particular state applied.

Illustration:1. A contract, by its terms to be performed in state Y, is entered into in state X between A, a domiciliary of X, and B, a domiciliary of Y. The contract recites that the parties "waive restitution in integrum in case of laesio enormis." These notions are foreign to X local law. They exist, on the other hand, in Y local law which furthermore empowers the parties to waive such right of restitution. A court could properly find on these facts that the parties wished to have Y local law applied.

Comment:

b. Impropriety or mistake. A choice-of-law provision, like any other contractual provision, will not be given effect if the consent of one of the parties to its inclusion in the contract was obtained by improper means, such as by misrepresentation, duress, or undue influence, or by mistake. Whether such consent was in fact obtained by improper means or by mistake will be determined by the forum in accordance with its own legal principles. A factor which the forum may consider is whether the choice-of-law provision is contained in an "adhesion" contract, namely one that is drafted unilaterally by the dominant party and then presented on a "take-it-or-leave-it" basis to the weaker party who has no real opportunity to bargain about its terms. Such contracts are usually prepared in printed form, and frequently at least some of their provisions are in extremely small print. Common examples are tickets of various kinds and insurance policies. Choice-of-law provisions contained in such contracts are usually respected. Nevertheless, the forum will scrutinize such contracts with care and will refuse to apply any choice-of-law provision they may contain if to do so would result in substantial injustice to the adherent.

Illustrations:2. A presents to B for signature a contract which embodies the terms of their prior agreement but which also provides that the rights of the parties under the contract shall be governed by the law of state X. A does not wish B to know of the provision calling for application of X law and therefore says that there is no reason for B to read the contract since it does no more than set forth their earlier agreement. B signs the contract without reading it in reliance upon A's word. The forum will not give effect to the provision calling for application of X law.

3. In state X, A buys from the B company a ticket on one of B's steamships for transportation from X to state Y. The ticket recites that it shall be governed by Y law and also contains a provision stating that B shall not be liable for injuries resulting from the negligence of its servants. The latter provision is valid under Y local law, but invalid under that of X. In the course of the voyage, A is injured through the negligence of B's servants. A brings suit to recover for his injuries against B in state Z. In determining whether or not to give effect to the choice-of-law provision, the Z court will give consideration to the fact that the contract was drafted unilaterally by B, the dominant party, and then presented to A on a "take-it-or-leave-it" basis.

Comment on Subsection (1):

c. Issues the parties could have determined by explicit agreement directed to particular issue. The rule of this Subsection is a rule providing for incorporation by reference and is not a rule of choice of law. The parties, generally speaking, have power to determine the terms of their contractual engagements. They may spell out these terms in the contract. In the alternative, they may incorporate into the contract by reference extrinsic material which may, among other things, be the provisions of some foreign law. In such instances, the forum will apply the applicable provisions of the law of the designated state in order to effectuate the intentions of the parties. So much has never been doubted. The point deserves emphasis nevertheless because most rules of contract law are designed to fill gaps in a contract which the parties could themselves have filled with express provisions. This is generally true, for example, of rules relating to construction, to conditions precedent and subsequent, to sufficiency of performance and to excuse for nonperformance, including questions of frustration and impossibility. As to all such matters, the forum will apply the provisions of the chosen law.

Whether the parties could have determined a particular issue by explicit agreement directed to that issue is a question to be determined by the local law of the state selected by application of the rule of § 188. Usually, however, this will be a question that would be decided the same way by the relevant local law rules of all the potentially interested states. On such occasions, there is no need for the forum to determine the state of the applicable law.

Illustrations:4. In state X, A establishes a trust and provides that B, the trustee, shall be paid commissions at the highest rate permissible under the local law of state Y. A and B are both domiciled in X, and the trust has no relation to any state but X. In X, the highest permissible rate of commissions for trustees is 5 per cent. In Y, the highest permissible rate is 4 per cent. The choice-of-law provision will be given effect, and B will be held entitled to commissions at the rate of 4 per cent.

5. Same facts as in Illustration 4 except that the highest permissible rate of commissions in X is 4 per cent and in Y is 5 per cent. Effect will not be given to the choice-of-law provision since under X local law the parties lacked power to provide for a rate of commissions in excess of 4 per cent and Y, the state of the chosen law, has no relation to the parties or the trust.

Comment on Subsection (2):

d. Issues the parties could not have determined by explicit agreement directed to particular issue. The rule of this Subsection applies only when two or more states have an interest in the determination of the particular issue. The rule does not apply when all contacts are located in a single state and when, as a consequence, there is only one interested state. Subject to this qualification, the rule of this Subsection applies when it is sought to have the chosen law determine issues which the parties could not have determined by explicit agreement directed to the particular issue. Examples of such questions are those involving capacity, formalities and substantial validity. A person cannot vest himself with contractual capacity by stating in the contract that he has such capacity. He cannot dispense with formal requirements, such as that of a writing, by agreeing with the other party that the contract shall be binding without them. Nor can he by a similar device avoid issues of substantial validity, such as whether the contract is illegal. Usually, however, the local law of the state chosen by the parties will be applied to regulate matters of this sort. And it will usually be applied even when to do so would require disregard of some local provision of the state which would otherwise be the state of the applicable law.

Permitting the parties in the usual case to choose the applicable law is not, of course, tantamount to giving them complete freedom to contract as they will. Their power to choose the applicable law is subject to the two qualifications set forth in this Subsection (see Comments f-g).

e. Rationale. Prime objectives of contract law are to protect the justified expectations of the parties and to make it possible for them to foretell with accuracy what will be their rights and liabilities under the contract. These objectives may best be attained in multistate transactions by letting the parties choose the law to govern the validity of the contract and the rights created thereby. In this way, certainty and predictability of result are most likely to be secured. Giving parties this power of choice is also consistent with the fact that, in contrast to other areas of the law, persons are free within broad limits to determine the nature of their contractual obligations.

An objection sometimes made in the past was that to give the parties this power of choice would be tantamount to making legislators of them. It was argued that, since it is for the law to determine the validity of a contract, the parties may have no effective voice in the choice of law governing validity unless there has been an actual delegation to them of legislative power. This view is now obsolete and, in any event, falls wide of the mark. The forum in each case selects the applicable law by application of its own choice-of-law rules. There is nothing to prevent the forum from employing a choice-of-law rule which provides that, subject to stated exceptions, the law of the state chosen by the parties shall be applied to determine the validity of a contract and the rights created thereby. The law of the state chosen by the parties is applied, not because the parties themselves are legislators, but simply because this is the result demanded by the choice-of-law rule of the forum.

It may likewise be objected that, if given this power of choice, the parties will be enabled to escape prohibitions prevailing in the state which would otherwise be the state of the applicable law. Nevertheless, the demands of certainty, predictability and convenience dictate that, subject to some limitations, the parties should have power to choose the applicable law.

On occasion, the parties may choose a law that would declare the contract invalid. In such situations, the chosen law will not be applied by reason of the parties' choice. To do so would defeat the expectations of the parties which it is the purpose of the present rule to protect. The parties can be assumed to have intended that the provisions of the contract would be binding upon them (cf. § 188, Comment b). If the parties have chosen a law that would invalidate the contract, it can be assumed that they did so by mistake. If, however, the chosen law is that of the state of the otherwise applicable law under the rule of § 188, this law will be applied even when it invalidates the contract. Such application will be by reason of the rule of § 188, and not by reason of the fact that this was the law chosen by the parties.

Illustrations:6. In state X, P and D initial an agreement which calls for performance in state Y. The contract states that the rights of the parties thereunder shall bedetermined by Y law. In X, P sues D for breach of the contract, and D defends on the ground that the contract is void under the X statute of frauds, since it was not signed by him. The contract, however, is valid under Y local law. The X court will find for P.

7. H and W, husband and wife, are domiciled in state X. In state Y, W enters into a contract with C, who is domiciled and doing business in that state, in which C agrees to sell goods to H on credit in return for a guaranty from W in the amount of $ 1,000.00. The contract recites that it shall be governed by X law. Under the local law of X, married women have full contractual capacity. Under the local law of Y, however, they lack capacity to bind themselves as sureties for their husbands. In an action by C against W, the contract will not be held invalid for lack of contractual capacity on the part of W.

8. A executes and delivers to B in state X an instrument in which A agrees to indemnify B against all losses arising from B's liability on a certain appeal bond on behalf of C, against whom a judgment has been rendered in state Y. The instrument recites that it shall be governed by the law of Y. The instrument is valid and enforceable under the local law of Y but is unenforceable for lack of consideration under the local law of X. In an action by B against A, the instrument will not be held invalid for lack of consideration.

Comment:

f. Requirement of reasonable basis for parties' choice. The forum will not apply the chosen law to determine issues the parties could not have determined by explicit agreement directed to the particular issue if the parties had no reasonable basis for choosingthis law. The forum will not, for example, apply a foreign law which has been chosen by the parties in the spirit of adventure or to provide mental exercise for the judge. Situations of this sort do not arise in practice. Contracts are entered into for serious purposes and rarely, if ever, will the parties choose a law without good reason for doing so.

When the state of the chosen law has some substantial relationship to the parties or the contract, the parties will be held to have had a reasonable basis for their choice. This will be the case, for example, when this state is that where performance by one of the parties is to take place or where one of the parties is domiciled or has his principal place of business. The same will also be the case when this state is the place of contracting except, perhaps, in the unusual situation where this place is wholly fortuitous and bears no real relation either to the contract or to the parties. These situations are

mentioned only for purposes of example. There are undoubtedly still other situations where the state of the chosen law will have a sufficiently close relationship to the parties and the contract to make the parties' choice reasonable.

The parties to a multistate contract may have a reasonable basis for choosing a state with which the contract has no substantial relationship. For example, when contracting in countries whose legal systems are strange to them as well as relatively immature, the parties should be able to choose a law on the ground that they know it well and that it is sufficiently developed. For only in this way can they be sure of knowing accurately the extent of their rights and duties under the contract. So parties to a contract for the transportation of goods by sea between two countries with relatively undeveloped legal systems should be permitted to submit their contract to some well-known and highly elaborated commercial law.

g. When application of chosen law would be contrary to fundamental policy of state of otherwise applicable law. Fulfillment of the parties' expectations is not the only value in contract law; regard must also be had for state interests and for state regulation. The chosen law should not be applied without regard for the interests of the state which would be the state of the applicable law with respect to the particular issue involved in the absence of an effective choice by the parties. The forum will not refrain from applying the chosen law merely because this would lead to a different result than would be obtained under the local law of the state of the otherwise applicable law. Application of the chosen law will be refused only (1) to protect a fundamental policy of the state which, under the rule of § 188, would be the state of the otherwise applicable law, provided (2) that this state has a materially greater interest than the state of the chosen law in the determination of the particular issue. The forum will apply its own legal principles in determining whether a given policy is a fundamental one within the meaning of the present rule and whether the other state has a materially greater interest than the state of the chosen law in the determination of the particular issue. The parties' power to choose the applicable law is subject to least restriction in situations where the significant contacts are so widely dispersed that determination of the state of the applicable law without regard to the parties' choice would present real difficulties.

No detailed statement can be made of the situations where a "fundamental" policy of the state of the otherwise applicable law will be found to exist. An important consideration is the extent to which the significant contacts are grouped in this state. For the forum will be more inclined to defer to the policy of a state which is closely related to the contract and the parties than to the policy of a state where few contacts are grouped but which, because of the wide dispersion of contacts among several states, would be the state of the applicable law if effect were to be denied the choice-of-law provision. Another important consideration is the extent to which the significant contacts are grouped in the state of the chosen law. The more closely this state is related to the contract and to the parties, the more likely it is that the choice-of-law provision will be given effect. The more closely the state of the chosen law is related to the contract and the parties, the more fundamental must be the policy of the state of the otherwise applicable law to justify denying effect to the choice-of-law provision.

To be "fundamental," a policy must in any event be a substantial one. Except perhaps in the case of contracts relating to wills, a policy of this sort will rarely be found in a requirement, such as the statute of frauds, that relates to formalities (see Illustration 6). Nor is such policy likely to be represented by a rule tending to become obsolete, such as a rule concerned with the capacity of married women (see Illustration 7), or by general rules of contract law, such as those concerned with the need for consideration (see Illustration 8). On the other hand, a fundamental policy may be embodied in a statute which makes one or more kinds of contracts illegal or which is designed to protect a person

against the oppressive use of superior bargaining power. Statutes involving the rights of an individual insured as against an insurance company are an example of this sort (see §§ 192-193). To be "fundamental" within the meaning of the present rule, a policy need not be as strong as would be required to justify the forum in refusing to entertain suit upon a foreign cause of action under the rule of § 90.

Illustrations:9. In state X, A and B, who are both domiciled in that state, negotiate the terms of a contract which is to be performed in X. The contract provides that it shall be governed by the law of state Y; it is signed first by A in X and then by B in Y. A suit involving the validity of the contract is brought before a court of state Z. The court will be more inclined to deny effect to the choice-of-law provision in deference to X policy than it would have been if the elements had not been massed to so great an extent in X.

10. In state X, the A insurance company issues a life insurance policy insuring the life of B. A is incorporated and has its "home office" in X while B is domiciled in state Y. The policy contains a provision stating that the rights of the parties thereunder shall be determined by X law. In his application for the policy, given by B to A's agent in Y, B made a misstatement which under the local law of X would serve as a complete defense to the insurer in a suit on the policy, but would not have this effect under a statute of Y. B brings suit on the policy in a court in state Z. Under the rule of § 192, Y is the state whose local law would govern the validity of the contract in the absence of an effective choice of law by the parties. The Z court will deny effect to the choice-of-law provision.

Comment on Subsection (3):

h. Reference is to "local law" of chosen state. The reference, in the absence of a contrary indication of intention, is to the "local law" of the chosen state and not to that state's "law," which means the totality of its law including its choice-of-law rules. When they choose the state which is to furnish the law governing the validity of their contract, the parties almost certainly have the "local law," rather than the "law," of that state in mind (compare § 186, Comment b). To apply the "law" of the chosen state would introduce the uncertainties of choice of law into the proceedings and would serve to defeat the basic objectives, namely those of certainty and predictability, which the choice-of-law provision was designed to achieve.

i. Choice of two or more laws. Subject to the limitations imposed by the rule of this Section, the parties may choose to have different issues involving their contract governed by the local law of different states. The parties' power is unlimited in the case of issues lying within their contractual capacity, i.e., issues that the parties could have resolved by an explicit provision in their agreement directed to that issue. (See Subsection (1) of the rule of this Section.) As to other issues, i.e., issues which the parties could not have resolved by an explicit provision in their agreement, the parties' power to choose to have different issues governed by the local law of different states is subject to the limitations imposed by Subsection (2) of the rule.

REPORTER'S NOTES

Changes: The only change is to Comment *i*, which has been revised to make clear that the parties may elect to have different laws govern different issues in the contract.

Comment i: The power of the parties to choose to have different issues in their contract governed by different laws follows from the fact that in this country and under the rules of this Restatement questions of choice of law depend upon the particular issue and may vary from issue to issue.

A case directly in point is *Kronovet v. Lipchin, 288 Md. 30, 415 A.2d 1096 (1980)*, where the court gave effect to a choice-of-law provision calling for application of Maryland law to the issue of usury and of New York law to the remaining aspects of the contract.

There are a number of cases giving effect to a choice-of-law provision providing that the validity of an arbitration clause should be determined by the local law of a state which was not the state whose local law would govern other aspects of the contract. See, e.g., *Joseph L. Wilmotte & Co. v. Rosen Bros., 258 N.W.2d 317 (Iowa 1977)*; *Application of Electronic & Missile Facilities, Inc., 38 Misc.2d 423, 236 N.Y.S.2d 594 (1962)*; Hamlyn & Co. v. Talisker Distillery, 1894 A.C. 202. See also 18 Am.Jur. Legal Forms 2d, UCC § 253:34, which expressly permits the parties to choose to have different issues governed by the different local law rules of different states. Cf. *Shannon v. Irving Trust Co., 275 N.Y. 95, 9 N.E.2d 792 (1937)* (court gave effect to a provision in an inter vivos trust that the local law of New York should be applied to determine trustee commissions while other issues should be governed by the local law of New Jersey.)

The power of the parties to choose to have different issues in their contract governed by the law of different states is well recognized in Europe. For example, the European Communities Convention on the Law Applicable to Contractual Obligations provides in Article 3: "By their choice the parties can select the law applicable to the whole, or a part only, of the contract." See also Blom, Choice of Law Methods in the Private International Law of Contracts, 16 Can.Y.B. of Int.L. 230, 260 (1978); Drobnig, American-German Private International Law, 228 (2d ed. 1972); Kegel, Internationales Privatrecht 291 (4th ed. 1977); Lagarde, The European Convention on the Law Applicable to Contractual Obligations: An Apologia, 22 Va.J.Int.L. 91, 96 (1981); Lagarde, Le Depecage dans le Droit International Prive des Contrats, 11 Rivista di Diritto Internazionale Private e Processuale 649, 652 (1975).

IN THE MATTER OF THE *COMPANIES CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

Court File No: CV-23-00696017-CL

ONTARIO
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(COMMERCIAL LIST)

Proceeding commenced at Toronto

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