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IN THE SUPREME COURT OF THE STATE OF DELAWARE

UNIVERSAL ENTERPRISE GROUP, L.P., 617 NORTH SALISBURY BOULEVARD, LLC, 176 FLATLANDS ROAD, LLC, 106 CEDAR STREET, LLC, 102 WEST CENTRAL AVENUE, LLC, 326 EAST DOVER STREET, LLC, 101 MAPLE AVENUE, LLC, 241 CYPRESS STREET, LLC, 28768 OCEAN GATEWAY HIGHWAY, LLC, 610 SNOW HILL ROAD, LLC, 5318 SNOW HILL ROAD, LLC, 302 MAPLE AVENUE, LLC, 177 OLD CAMDEN ROAD, LLC, 111 SOUTH WEST STREET, LLC, 1272 SOUTH GOVERNORS AVE, LLC, 505 BRIDGEVILLE HIGHWAY, LLC, 323 WEST STEIN HIGHWAY, LLC, 100 S. MAIN STREET, LLC, 1104 SOUTH STATE STREET, LLC, 133 SALISBURY ROAD, LLC, UNIVERSAL DELAWARE, INC., and DANIEL SINGH a/k/a/ DAMINDER S. BATRA, Plaintiffs Below/ Appellants, v. DUNCAN PETROLEUM CORPORATION and ROBERT M. DUNCAN, Defendants Below/Appellees.	No. 540,2013 Court Below – Court of Chancery of the State of Delaware C.A. No. 4948-VCL

ANSWERING BRIEF OF APPELLEES
DUNCAN PETROLEUM CORPORATION AND ROBERT M. DUNCAN

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NATURE OF PROCEEDINGS

This matter arises from the 2007 sale of nineteen gas station and convenience store properties ('the Properties") by Appellees/Defendants-Below Robert M. Duncan and Duncan Petroleum Corporation (hereinafter referred to in the singular as "Duncan") to Appellant/Plaintiff-Below Universal Enterprise Group, L.P and its assignees. In 2009, Universal Enterprise Group, L.P., its affiliate Universal Delaware, Inc., the nineteen Special-Purpose Entities ("SPEs") that took title to the individual Properties under the terms of the purchase, and Universal Enterprise Group, L.P.'s principal Daminder Batra (collectively, "Universal") filed suit against Duncan in the Court of Chancery, alleging fraud and breach of contract with respect to the sale transaction. Universal claimed that Duncan had misrepresented or omitted to inform it about the extent of environmental hazards on the Properties, the state of compliance of the Properties' underground storage tanks and dispensing equipment, the details of a Consent Order that Duncan Petroleum Corporation entered into with the EPA in 2006, and certain inquiries from the EPA during 2007. Universal sought rescission of the sale transaction, monetary damages, and the imposition of a constructive trust.

Through both its affirmative defenses to Universal's claims and a counterclaim against the SPEs and Batra, Duncan contended that any liability he bore to Universal should be offset against the principal and interest owed to him on

nineteen promissory notes ("the Notes") by which he provided Universal partial seller-financing for the sale. Because of post-pleading bankruptcies affecting all of the Plaintiffs-Below affiliated with Universal Enterprise Group, L.P. and Batra, and the automatic stays imposed, Duncan did not ultimately pursue judgment as to his counterclaim.

Following a four-day trial, the trial court issued a detailed opinion ("the Memorandum Opinion") rejecting Universal's fraud claims and its requests for rescission or rescissory damages. The trial court held that Universal had established that Duncan breached warranties regarding the condition of the Properties at closing, including compliance with rules and regulations, but found that Universal's resulting damages were limited to direct legal damages in the amount of $1,497,429. This figure represented the cost of bringing the Properties into operational compliance, inclusive of associated legal fees. The trial court requested supplemental briefing with respect to Duncan's ability to offset the amounts owed by Universal on the Notes against the cost to rectify the breach of warranty as found by the Court.

Universal now appeals the final order and judgment of the Court of Chancery that correctly held that Duncan had prevailed upon the affirmative defense of recoupment such that the judgment in favor of Universal as to its breach of contract claim ("the Universal judgment") should be offset against amounts

owed to Duncan on the Notes. Because the outstanding principal on the Notes at the time of trial was in excess of $7 million, the Court of Chancery held that the Universal judgment was completely offset. Universal has not appealed any portion of the trial court's earlier post-trial Memorandum Opinion rejecting its fraud claims and limiting the scope of its recoverable contract damages, nor does Universal appeal the power of the Court of Chancery to consider the issue of recoupment notwithstanding the bankruptcies affecting the Plaintiffs-Below.

This is Duncan's Answering Brief in opposition to Universal's appeal.

SUMMARY OF ARGUMENT

Duncan denies Universal's summary of argument as to both parts. The Court of Chancery properly applied Delaware law in permitting Duncan to rely upon the defense of recoupment.

Duncan argues as follows:

1. Universal waived any challenge to the trial court's consideration of or failure to consider the unclean hands doctrine by virtue of its failure to fairly present and preserve the issue below. At no time did Universal properly make or preserve the argument that Duncan's right to offset defensively the amounts owed to him by Universal under the doctrine of recoupment was subject to a plea of unclean hands.

2. With respect to the application of the doctrine of unclean hands, Universal's argument is incorrect on the merits because the unclean hands doctrine is inapplicable to Duncan's recoupment defense. First, while unclean hands may bar the claims of a party who "comes into equity" seeking equitable relief, Duncan does not fit that descriptor and was entitled to defend against Universal's claims by asserting his legal entitlement to the unpaid balance owed on the Notes. Second, even if the doctrine were legally relevant to his recoupment defense, Duncan's conduct in the underlying transaction would not have constituted unclean hands in the context of this case.

COUNTERSTATEMENT OF FACTS

A. The Underlying Transaction

As the trial court recognized, each party to the sale of the former Duncan Petroleum properties negotiated and consummated the transaction with a clear-eyed perspective. From the outset, Duncan disclosed that the Properties "were not exactly pristine" and that he was motivated to sell the Properties as a real estate transfer under "flexible" terms (rather than on a going-concern basis) in part because Duncan Petroleum lacked "established standards of appearance or operational guidelines for its dealers" or "the internal staff to properly supervise its network." (A1071-72, Mem. Op. 9-10.) As a prospective purchaser, Universal had its own motivations, having concluded that the stations had been "neglected" and presented "tremendous upside" if they could be brought into Universal's network and upgraded. (A1072-73, Mem. Op. 10-11.) Through their transactional counsel, Universal[1] and Duncan negotiated an agreement of sale and multiple subsequent amendments (collectively, the "Sale Agreement") that provided Universal with the ability to conduct in-depth independent investigations of the Properties for environmental hazards and noncompliance, decide whether to proceed with the transaction, and obtain full redress for expenses associated with

[1] For simplicity, and in keeping with the practice of the trial court and the parties in treating the Plaintiffs-Below as a collective unit where feasible, the "Buyer" within the meaning of the Sale Agreement will be referred to as "Universal."

achieving full compliance of the stations with regulatory requirements and for any breaches of the Sale Agreement representations by Duncan.

In the initial agreement of sale, the parties agreed to a sale price of $16 million, of which $8 million would be seller-financed by Duncan in the form of promissory notes for each property issued by the SPEs (which were formed in advance of closing) and guaranteed by Batra in his individual capacity. (A1073, Mem. Op. 11; A145-46.) Universal received a 60-day due diligence period, during which it could perform any tests or examinations of the Properties it desired and was given open access to the Properties to perform site visits and take environmental samples. (A1074, Mem. Op. 12; A147-48.) If the due diligence investigation revealed that the Properties were not "economically feasible or otherwise desirable," *in Universal's sole discretion*, Universal could demand cure from Duncan and unilaterally terminate the agreement if it was not provided. (A147.)

As recounted at trial and in the opinion below, disclosures from Duncan and the investigation conducted by Delta Environmental Consultants, Inc. ("Delta") (hired by Universal to conduct the environmental investigations for it) alerted Universal to a number of issues with the Properties. (A1078-83, Mem. Op. 16-21.) Prior to the close of the initial due diligence period, Universal was aware of at least the following:

- The existence of a 2006 Consent Agreement and Final Order between Duncan and the EPA resulting from compliance issues at five of the Properties;
- The presence of certain environmental concerns on the Properties, as well as issues with the adequacy of safeguards on gasoline dispensing equipment and underground storage tanks on the sites;
- Ongoing investigations by the Maryland Department of the Environment (MDE) at eight of the Properties; and
- The fact that Duncan's existing records, the originals of which he provided to Delta for review, were "very spotty"—not because of "deliberately withheld data," but due to poor historical recordkeeping practices.

(*Id.*) Based on these patent indicators of significant environmental concerns on the Properties, the parties agreed to extend Universal's due diligence period to permit the completion of environmental site assessments ("ESAs") on all of the Properties. (A1082, Mem. Op. 20.)

The reports Delta provided Universal during the extended due diligence period identified conditions at each of the Properties that Duncan was obligated under the Sale Agreement to cure (referred to as Recognized Environmental Conditions or "RECs"). (A1083-84, Memo. Op. 21-22.) The reports also detailed further data gaps in the available records, as well as noncompliant conditions at several sites and endemic weaknesses in Duncan's existing regulatory compliance procedures. (*Id.*) Delta provided site-specific assessments and recommendations for further testing, repairs, and preventative maintenance to be performed at each Property. (A1084, Mem. Op. 22.) Delta's reports did *not* reflect reviews of the

MDE and Delaware Department of Natural Resources and Environmental Control records that Universal had requested, which Delta stated it would undertake only after receiving the records and determining that they contained information reflecting RECs. (*Id.*)

In view of the results of the initial due diligence period and the known shortcomings of both Delta's investigations and Duncan's recordkeeping, Universal and its advisors had to determine (in the apt words of the trial court) "how to proceed in the face of both known unknowns and unknown unknowns" with respect to the Properties' histories and conditions. (A1085, Mem. Op. 23.) Although Universal's counsel recommended that it obtain a contractor's estimates on the costs of bringing the stations into compliance, neither Mr. Batra nor Universal's counsel Mr. Fox knew whether that was done. (B50; B152-61.) Delta gave Universal a median estimate of $3.0 million for environmental liability on the Properties and a high figure of $3.7 million in liability. (A1084, Mem. Op. 23.)

Based upon input from Delta and its counsel, Universal approached Duncan in October 2007 about several modifications to their earlier agreement intended to address the inherent uncertainties Universal faced. (A1083-86, Mem. Op. 22-24.) The parties agreed to a series of terms that shifted the risk of those uncertainties to Duncan (referred to in the trial court's opinion as "the October Modification"). (*Id.*; A248-252.) First, the parties agreed that Duncan would remediate existing

environmental conditions at seventeen of the Properties until the relevant state authority issued a "Notice of Compliance" or "No Further Action" letter. (A1084, Mem. Op. 23; A249.) To fund this undertaking, the parties relied upon a provision of the original agreement of sale that permitted Universal to require an escrow of funds from the sale consideration to cover remediation of RECs. (*Id.*) They agreed to an escrow amount of $1.6 million. (*Id.*) Next, Universal sought and Duncan agreed to provide offsets against the Notes to give Universal a remedy if Duncan did not complete "Corrective Action" called for under the Sale Agreement as to each REC. (A1085-86, Memo. Op. 23-24; A249.) If that occurred, Universal could perform the repairs itself and offset the expense against the Notes, up to their full value. (A1085-86, Mem. Op. 23-24; A251.) This new term expanded offset rights already included in the Notes themselves, which provided that if Duncan breached *any* "obligations, representations, indemnities, covenants, and agreements" related to the transaction, including those contained in the Sale Agreement, Universal was entitled to offset the resulting damages against the Notes, up to their full value. (A1085-86, Mem. Op. 23-24; *see, e.g.*, A258.)

With all of the modifications it had sought in place, Universal proceeded to closing on November 15, 2007. (A1086, Mem. Op. 24.)

B. The Post-Closing Period

Duncan notified DNREC and MDE of the required Corrective Actions plans for each of the Properties soon after closing. (A1086, Mem. Op. 24.) As of October 2012, all but four of the Properties had received "No Further Action" letters. (B73-74.) The environmental consultant performing the work estimated that the total cost of the remediation for all properties would be approximately $1,176,705. (*Id.*)

In January 2008, Universal retained new environmental consulting firms to inspect the Properties. (A1086, Mem. Op. 24.) Reports issued by these new consultants in February 2008 indicated (1) non-complaint underground storage tanks at three of the Properties; and (2) a history of DNREC and MDE investigations and equipment compliance issues. (A1087, Mem. Op. 25.) Universal provided copies of the reports to Duncan on April 29, 2008. (B70-72.) During 2008, Universal contended that these issues should have been disclosed under the terms of the Sale Agreement and requested that the current non-compliant conditions be repaired or else it would execute repairs itself and offset the expense against the Notes. (A1087-88, Memo. Op. 25-26.) By June 2009, Universal stated that it had decided to fix the compliance issues and exercise its right of setoff against the Notes at an estimated cost of $1.3 million. (A1087, Mem. Op. 25.)

Universal eventually undertook to remedy the stations' compliance issues. (*Id.*) The total cost of those steps, including legal fees, was $1,497,429. (*Id.*) Despite recognizing the availability of setoff against the Notes to fund the repairs, Universal never exercised its setoff rights under the parties' agreements. (*Id.*)

C. The Bankruptcies of Universal and Batra

In July 2009, Universal found itself unable to pay an $8 million loan that had been called by one of its creditors. (A1088, Mem. Op. 26.) Consequently, a Universal affiliate not party to this action, Universal Marketing, Inc. ("Universal Marketing"), filed a petition for Chapter 11 bankruptcy on July 23, 2009. (A1791-1802.) The bankruptcy was subsequently converted to a Chapter 7 case, and a trustee was appointed. (A1088, Mem. Op. 26.)

Universal Marketing's bankruptcy filing had a cascade effect for other Universal affiliates, including those involved in the operation of the Properties after the sale. Soon after the filing, gasoline suppliers to Universal's stations cut off deliveries. (*Id.*) As of August 2009, the SPEs stopped making payments to Duncan on the Notes. (B19.) In 2010 and 2011, the Properties were sold by the Trustee for a combined total of $8 million. (A1088, Mem. Op. 26.)

In April 2010, with this case underway, the SPEs assigned all of their claims in the action to the Trustee of the Universal Marketing bankruptcy. (B143-48.) Between August and November 2010, Universal Delaware, Inc. and the SPEs were

substantively consolidated into the Universal Marketing bankruptcy, effective *nunc pro tunc* as of the date of Universal Marketing's petition. (A1803-22.) Plaintiff Batra filed for personal bankruptcy in January 2011 and entered into a settlement agreement with the Universal Marketing bankruptcy Trustee by which he assigned the trustee his claims against Duncan to the Trustee. (B112-28.) Thus, the Trustee received via assignment the claims of all of the named Plaintiffs-Below.

D. Proceedings Below

On October 5, 2009, Universal Enterprise Group, L.P., its affiliate Universal Delaware, Inc., and the SPEs[2] filed suit in the Court of Chancery against Duncan. Through subsequent amendment, Batra was added as a plaintiff and Delta was made a defendant. (A86-137.) Universal's claims against Duncan were for fraudulent inducement, fraudulent concealment, equitable fraud, rescission (although, as the trial court recognized, rescission is a remedy rather than a cause of action), and breach of contract. (A1089, Mem. Op. 27; A124-35.) Universal's contract claim alleged that Duncan had breached three different aspects of the Sale Agreement: the obligation to deliver the equipment, dispensers, lines and underground storage tanks associated with the Properties in good working order; the promise to produce environmental records for the Properties; and the

[2] At the time its acquisition of the Properties closed, Universal Enterprise, L.P. executed nineteen agreements assigning its rights and interests under the Sale Agreement pertaining to each property to the particular SPE acquiring it. (B51-69.)

representation that the stations were in compliance with DNREC and MDE regulations. (A134-35.)

Duncan filed an answer and counterclaim on February 26, 2010.[3] (A569-686.) Duncan's counterclaim alleged that the SPEs and Batra were liable for breach of the Notes and sought the outstanding balances owed on them. (A647-686.) In his answer to Universal's direct claims, he asserted, *inter alia*, the affirmative defense of setoff based upon the facts stated his counterclaim. (A646.) The parties stipulated in the joint pre-trial order that the unpaid balance on the Notes as of July 2009 (when the SPEs ceased payments) was $7,692.375.06. (B19-20.)

Universal answered Duncan's counterclaim on March 22, 2010, and asserted several affirmative defenses, including that Duncan's counterclaims "are or may be barred, in whole or in part, by the doctrines of unclean hands and in *pari delicto*." (A1055-56.)

In the parties' pre-trial submissions, Duncan raised as issues that remained to be litigated "Whether Plaintiff's damages, if any, should be limited to their right of set-off" and "Whether judgment should be entered in Duncan's favor on his counterclaim." (B40.) While Universal had pled unclean hands as a defense to

[3] At the time of the filing of Duncan's answer and counterclaim, none of the plaintiffs in the Court of Chancery action had filed any bankruptcy petitions.

Duncan's counterclaim, Universal made no mention of its unclean hands affirmative defense in any subsequent pleading or pre-trial or post-trial filing; indeed, the phrase "unclean hands" appears in the Joint Pre-Trial Order only in connection with affirmative defenses raised by the *defendants*, Duncan and Delta. (B1-49; B162-217; B274-309.)

Trial was held over four days in December 2012. During the trial, Universal reached a $2.3 million settlement with Delta. (A1088, Mem. Op. 26.) The court reserved decision on Universal's claims against Duncan and Duncan's counterclaim, and the parties submitted post-trial briefing. In his post-trial Answering Brief, Duncan squarely addressed the issue of his requested offset against any judgment entered in Universal's favor. He noted that although his affirmative defense to Universal's claims had been termed "setoff," it could properly be viewed under the doctrine of recoupment because the amounts potentially owed between the parties both arose from the same transaction. (B259-60.) As with its portion of the Joint Pre-Trial Order, Universal's post-trial briefing evinced no intent whatsoever to argue unclean hands either in response to Duncan's counterclaim or in opposition to his recoupment defense. (B162-217; B274-309; A1108-31.)

On July 1, 2013, the Court of Chancery issued its post-trial Memorandum Opinion. The trial court found that each of Universal's fraud claims failed because

Universal had not reasonably relied upon Duncan's representations regarding compliance, document production, and disclosures of all material facts in negotiating terms and deciding to proceed with the sale. (A1093, A1098, Mem. Op. 31, 36.) As the trial court explained:

> Universal treated Duncan's representations with healthy skepticism. Universal relied on the representations in the sense that they contractually allocated to Duncan the risk that the representations would be incorrect, but Universal did not rely on the representations in the sense of being fraudulently induced by them to close the transaction. Universal instead relied on its advisors and the improved terms it extracted from Duncan in the October Modification.
>
> * * *
>
> Through the October Modification, Universal specifically addressed the risks it faced, including the known risks that Duncan's files were incomplete and that there were additional, as yet unknown, problems at the Properties. . . .
>
> Based on the evidence presented at trial, Universal did not in fact rely on the representations of the Sale Agreement in a manner sufficient to support common law fraud. Universal instead relied on (i) the assessments and evaluations made by Delta and [its transactional counsel] and (ii) the October Modification. Because Universal recognized the likely falsity of certain representations in the Sale Agreement and structured its affairs to manage that risk, Universal must take solace in the contractual remedies that it obtained.

(A1094-96, Mem. Op. 32-34.) With respect to Universal's contractual claims, by contrast, the trial court concluded that Universal was entitled to damages for breach of the Sale Agreement because justifiable reliance is not a necessary element of that claim. (A1099-1100, Mem. Op. 37-38.) The trial court rejected

Universal's arguments that rescission, rescissory damages, or diminution-in-value damages were the appropriate remedy for the breach. The court found rescission and rescissory damages inappropriate in significant part because Universal's own conduct demonstrated that "the breaches did not go to the heart of the transaction," given Universal's willingness to close despite understanding in advance that Duncan's representations regarding compliance were likely false. (A1102, Mem. Op. 40.) The court further noted that "after closing, Universal did not originally seek to escape the transaction but rather relied on its contractual rights to ameliorate the harm that Duncan's breaches caused" and continued to operate the stations without seeking rescission for an extended period after it became aware of all of the facts that supported its claim. (A1102-03, Mem. Op. 40-41.) The court found that diminution-in-value damages would improperly place Universal in a better position than that which it specifically bargained for, and would provide disproportionate recovery, create economic waste, and bestow a windfall. (A1105, Mem. Op. 43.) Moreover, Universal had not been able to prove its diminution-in-value damages with reasonable certainty. (*Id.*)

The trial court limited Universal's recovery to actual damages for breach of representations regarding the condition of the Properties at closing—which

consisted of the $1,497,429 in expenses it incurred in remediating the Properties to achieve compliance. (A1106-07, Mem. Op. 44-45.)[4]

In its Memorandum Opinion, the Court of Chancery observed that it had concerns, "in light of the pending bankruptcies involving both the SPEs and Batra personally," as to whether it possessed the power to grant Duncan's request to offset the Universal Judgment against the unpaid balances on the Notes (as well as Batra's related request that his obligation as the guarantor of the Notes should be reduced accordingly as a result of such offset). (AA1107, Mem. Op. 45.) The court therefore reserved judgment as to Duncan's counterclaims and stayed enforcement of the Universal judgment to permit the parties to provide supplemental briefing on that issue. (*Id.*) The parties agreed to, and the court ordered, the submission of simultaneous supplemental briefs on the issue.

In his supplemental brief, Duncan explained that because all of the plaintiffs had become bankruptcy debtors after his answer and counterclaim were filed, he would not seek judgment on his counterclaim from the Court of Chancery, due to the automatic bankruptcy stay. (A1770-71.) He therefore did not request any affirmative judgment against Universal. (*Id.*) Instead, Duncan argued (with supporting case law from both state and bankruptcy courts) that because

[4] The trial court held that Universal had not proved any damages from breaches of Duncan's obligation to produce or disclose documents related to compliance violations. (A1106.)

recoupment is strictly defensive and does not afford any affirmative recovery, it is not subject to the restrictions of the Bankruptcy Code and can properly be determined by a state court, as a matter of state law, even where the party against whom it is sought is in bankruptcy. (A1773-78.) Thus, Duncan argued, the plaintiffs' bankruptcies had no effect on the court's ability to find that he had established recoupment, as subsumed within his setoff affirmative defense, and order that the Universal judgment be offset entirely against the larger amount outstanding on the Notes. (*Id.*)

Universal's supplemental briefing argued that the entry of judgment on Duncan's counterclaim or a ruling in his favor on the affirmative defense of setoff would violate the automatic bankruptcy stay. (A1113-31.) Universal did not address recoupment as a strictly defensive means of achieving offset, nor did it distinguish the case law permitting recoupment against bankrupt parties in state court actions. (*Id.*) Universal's supplemental brief also omitted any reference to the unclean hands doctrine.[5]

[5] In general terms, Universal did argue that Duncan's alleged "inequitable conduct" would preclude an order of setoff *under the Bankruptcy Code* or, alternatively, required subordination of his claim *in the bankruptcy court* hearing the Universal Marketing bankruptcy. (A1123-25.) Having failed to raise unclean hands as an issue to be litigated at trial, Universal nowhere addressed the potential effect of unclean hands or "inequitable conduct" if the Court of Chancery determined that it did possess authority to act upon Duncan's affirmative defense.

On September 10, 2013, the Court of Chancery issued a Final Order and Judgment ("the recoupment order"). (A1786-90.) The court agreed with Duncan that "[w]hether the defendants would be able to defend or reduce a money judgment in light of their noteholdings was a central issue in this case" and that Duncan had asserted the issue in his answer and counterclaims, the Joint Pre-Trial Order, and his pre-trial and post-trial briefing. (A1788.) The court concluded that Duncan's setoff counterclaim and affirmative defense encompassed the less-expansive defense of recoupment, that the parties had tried the issue, and that the pleadings would be deemed amended by consent to reflect Duncan's recoupment defense. (A1787-89.) Recognizing that recoupment "serves to avoid needless delay and unnecessary litigation," the court found that Duncan was entitled to rely upon recoupment defensively to offset the Universal judgment. (A1789-90.)

I. UNIVERSAL HAS WAIVED ITS UNCLEAN HANDS ARGUMENT.

A. Question Presented

Has Universal waived its unclean hands argument by failing to fairly present it to the Court of Chancery?

B. Standard Of Review

The issue of waiver of appellate issues, by its nature, generally cannot be raised with the trial court in the first instance. Duncan therefore respectfully submits that the question of waiver should be assessed by this Court *de novo*.

C. Universal Has Waived Its Arguments On Appeal

Pursuant to Supreme Court Rule 8, "[o]nly questions fairly presented to the trial court may be presented for review" on appeal, unless the interests of justice require this Court to consider them. Universal should be precluded under Rule 8 from raising for the first time on appeal its two-fold argument that the Court of Chancery should have analyzed clean hands as a prerequisite to applying recoupment and that the Vice Chancellor's purported finding of "inequitable conduct" should have resulted in the denial of recoupment. Neither issue was fairly presented to the trial court.

As Universal's opening brief[6] acknowledges, the *only* point during the proceedings below at which it invoked unclean hands was in the affirmative

[6] Appellants' opening brief, filed on November 21, 2013, shall henceforth be cited as "Universal's Op. Br. __."

defenses to Duncan's counterclaim. (Universal's Op. Br. 10-11.) Universal did not present its present arguments regarding the unclean hands doctrine to the trial Court by motion or at trial. It did not mention the unclean hands doctrine in the Joint Pre-Trial Order, its post-trial briefing, the supplemental post-trial briefing ordered by the Vice Chancellor to address his authority to order offsetting of its judgment, or its additional unsolicited letter to the Court regarding that issue. (B1-11; B162-217; B274-309; A1108-31)

Universal's bare reference to unclean hands in its affirmative defense to Duncan's counterclaim was wholly insufficient to preserve the issues presented in its appeal. Indeed, even if Universal's unclean hands affirmative defense were directly at issue in its appeal (which is not the case, because, as discussed above at pp. 17-19, the counterclaim to which Universal raised that defense was never ruled upon on the merits and did not form the basis of the recoupment order), simply invoking an affirmative defense in an answer is insufficient to preserve arguments related to it on appeal if they are not brought to the trial court's attention by motion or at trial. *Wedderien v. Collins*, 937 A.2d 140, 2007 WL 3262148, at *4 (Del. 2007) (TABLE) (holding that plea of standing as an affirmative defense in an answer, without more, was insufficient to preserve related argument and refusing to consider merits of argument on appeal).

As the Court routinely recognizes, an argument not fairly presented and preserved below is deemed waived on appeal unless the appellant can demonstrate the existence of the interests of justice exception. *See, e.g.*, *Levey v. Brownstone Asset Mgmt., LP*, 76 A.3d 764, 769 (Del. 2013) (holding that an argument "never presented to the Court of Chancery . . . is therefore waived" on appeal); *Cahall v. Thomas*, 906 A.2d 24, at 27 n.12 (Del. 2006) (observing that failure to fairly present argument to trial court constituted waiver on appeal). The interests of justice exception is narrowly limited to circumstances in which the court below committed plain error requiring review. *Smith v. Delaware State Univ.*, 47 A.3d 472, 479 (Del. 2012).

Furthermore, as explained below at pp. 23-35, in this case both legal and factual issues weigh against application of the doctrine in the manner Universal urges. The Court of Chancery's failure to invoke unclean hands therefore cannot constitute a serious or fundamental error—indeed, it was not error at all. Because none of the prerequisites for the interests of justice exception apply, this Court should find Universal's grounds for appeal to be waived in their entirety.

II. THE DOCTRINE OF UNCLEAN HANDS DOES NOT APPLY TO DUNCAN'S RECOUPMENT DEFENSE.

A. Question Presented

Did the Court of Chancery's application of recoupment without consideration for the doctrine of unclean hands constitute plain error?

B. Standard Of Review

Because Universal failed to preserve the questions presented in its appeal with the Court of Chancery, the trial court's decision may be disturbed only upon a finding of plain error. *See, e.g.*, *Realty Enters., LLC v. Patterson-Woods*, 11 A.3d 228, 2010 WL 5093906, at *4 (Del. Sept. 24, 2010) (TABLE) (applying plain error standard to unpreserved argument concerning trial court's determination of damages); *Haskins v. Kay*, 963 A.2d 138, 2008 WL 5227187, at *2 (Del. Dec. 16, 2008) (applying plain error standard where appellant failed to raise recusal argument below and argued on that trial court should have acted *sua sponte*).

To satisfy the plain error standard, "the error complained of must be so clearly prejudicial to substantial rights as to jeopardize the fairness and integrity of the trial process." *Sheehan v. Oblates of St. Francis de Sales*, 15 A.3d 1247, 1255 (Del. 2011) (quoting *Culver v. Bennett*, 588 A.2d 1094, 1096 (Del. 1991)). The standard sets a high threshold met only by errors that amount to "material defects which are apparent on the face of the record; which are basic, serious and

fundamental in their character." *Smith*, 47 A.3d at 479 (quoting *Wainwright v. State*, 504 A.2d 1096, 1100 (Del. 1986)).

C. The Court Of Chancery's Acceptance Of Duncan's Recoupment Defense Did Not Constitute Plain Error.

Universal's sole argument on appeal is that the trial court should have determined whether Duncan had unclean hands that disqualified him for recoupment. The trial court's failure to address this issue did not affect Universal's substantial rights, as unclean hands is a protection for the Court and the public, rather than a legal entitlement of litigants. Furthermore, the nature of Duncan's recoupment defense and of the parties' transaction renders the unclean hands doctrine inapplicable in this case. The trial court's failure to apply the doctrine therefore did not constitute plain error. Moreover, even if the Court were to find that Universal had not waived its argument below, these considerations would render the doctrine of unclean hands inappropriate on the merits.

1. The Trial Court's Failure To Consider Unclean Hands Did Not Prejudice Universal's Substantial Rights.

Universal cannot demonstrate the existence of plain error that would require review of its newly-minted arguments on appeal, because the failure of a trial court to apply the doctrine of unclean hands could never be "clearly prejudicial to substantial rights" of a litigant. *Sheehan*, 15 A.3d at 1255. The unclean hands doctrine is a public policy rule intended to protect the Court of Chancery and the

public, and although often treated as an affirmative defense, is not "strictly" a defense belonging to any particular party to a case. *Gallagher v. Holcomb & Salter*, 1991 WL 158969, at *4 (Del. Ch. Aug. 16, 1991), *aff'd*, 692 A.2d 414 (Del. 1997); *see also Skoglund v. Ormand Indus., Inc.*, 372 A.2d 204, 213 (Del. Ch. 1976) (holding that unclean hands "is not a matter of defense to be applied on behalf of a litigant"). As such, a party possesses no legal entitlement to its application. *Gallagher*, 1991 WL 158969, at *4; *Skoglund*, 372 A.2d 204.

2. Unclean Hands Will Not Operate To Foreclose The Legal Rights Or The Defenses Of A Defendant Brought Into A Court Of Equity.

Universal's central argument—that an affirmative defense pled in response to Duncan's counterclaim should bar the recoupment affirmative defense that Duncan established against Universal's direct claims—is further flawed because it ignores crucial distinctions in the parties' positions below. The doctrine of unclean hands is rooted in the oft-recited notion that "he who comes into equity must come with clean hands." *Bodley v. Jones*, 59 A.2d 463, 469 (Del. Ch. 1947). As a corollary of that principle, unclean hands is generally applied only when a party seeking equitable relief has acted inequitably, and will not foreclose defenses or legal rights asserted by a defendant who has been *brought* into equity. *See Nakahara v. NS 1991 Am. Trust,* 718 A.2d 518, 522 (Del. Ch. 1998) ("In effect, the Court refuses to consider requests for equitable relief in circumstances where the

litigant's own acts offend the very sense of equity to which he appeals."); *Dawejko v. Grunewald*, 1988 WL 140225, at *5 n.2 (Del. Ch. Dec. 27, 1988) (denying application of unclean hands doctrine to preclude defendants in violation of deed provision from defending against plaintiffs' effort to enforce same provision in part because "[i]n this case, it is not the defendants, but the plaintiffs, who seek relief . . . ."); *Needham v. Savini Corp.*, 2004 WL 550853, at *5 (Del. Ch. Mar. 18, 2004) (Master's Report) ("The doctrine of unclean hands [which plaintiffs urged should be applied against defendants] does not apply, because the defendants here are not seeking to use this court's equitable powers to do anything: it is the plaintiffs who seek equitable relief here."); 30A C.J.S. *Equity* § 121 ("The doctrine does not deny legal rights or foreclose a defense by a defendant brought into equity."); *see also Behm v. Fireside Thrift Co.*, 76 Cal. Rptr. 849, 853 (Cal. Ct. App. 1969) ("It is the rule in this state, as well as in our sister states, that the 'clean hands' doctrine operates only against one who seeks active intervention of the court and should not be applied to a defendant who is not voluntarily seeking relief in equity but was merely brought there at the suit of another."); *Merchants Indemnity Corp. v. Eggleston,* 179 A.2d 505, 514 (N.J. 1962) ("[Plaintiff-below] misconceives the role of the 'clean hands' doctrine. It operates to deny a suitor the special remedies of

equity, leaving him to his remedies at law. It does not deny legal rights, or foreclose a defense by a defendant brought into equity.").[7]

Duncan did not "come into" equity, but rather was brought to a court of equity by Universal's suit. Although Duncan did assert a counterclaim for breach of the Notes, that fact does not alter the inappropriateness of applying unclean

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[7] Some of the cases relied upon by Universal in arguing that recoupment may be subject to the unclean hands doctrine are distinguishable as addressing factual circumstances in which a party seeking recoupment had initiated suit or otherwise sought affirmative equitable relief. In the matter of *In re American Home Mortgage Holdings, Inc.*, 401 B.R. 653, 656 (D. Del. 2009), a Securities Administrator affirmatively sought relief in the bankruptcy court through a motion for relief from the automatic stay to permit it to recoup certain overpayments erroneously made to the debtor. The District Court for the District of Delaware affirmed the denial of recoupment on the basis that the debts between the parties arose from separate and distinct transactions. *Id.* at 655-56. The court further noted in *dicta* that the unclean hands doctrine could also have applied because the *movant* had previously violated the automatic stay by exercising self-help measures to recover a portion of the overpayments. *Id.* at 656. Unlike the present case, the movant had thereby committed an independent statutory violation, not a breach of contract. *See also In re American Sunlake Ltd. P'ship*, 109 B.R. 727 (Bankr. W.D. Mich. 1989) (cited at Universal's Op. Br. 21) (denying request for recoupment and setoff by creditor who sought relief from automatic bankruptcy stay in bankruptcy action to seek reduction of liabilities to debtor).

Similarly, in *Minskoff v. United States*, 349 F. Supp. 1146 (S.D.N.Y. 1972), the party invoking recoupment principles was the *plaintiff*, executrix of an estate who filed suit against the government to recoup payments allegedly made as the result of improper double-taxation of proceeds from her decedent's sale of corporate interests, which were treated as both income during his life and part of the estate corpus after his death. The plaintiff-executrix asserted that recovery was appropriate under the doctrine of equitable recoupment in taxation, which in that context refers to the ability of a taxpayer in certain circumstances to offset amounts owed to the Internal Revenue Service on a correct tax by prior payments of incorrect tax arising from the same transaction, even if a claim for refund of the incorrect tax would be time-barred. *Id.* at 1148-49. In this context (unlike the case under consideration), "equitable recoupment" can provide the basis for an affirmative cause of action. *Id.* at 1148 ("Plaintiff's *cause of action* rests on the doctrine of equitable recoupment . . . ." (emphasis added)). The trial court in *Minskoff* denied the plaintiff her *claim* for equitable recoupment because it concluded that the proceeds had been correctly taxed. The court further noted that the plaintiff's request for recoupment of an alleged miscalculation of the estate tax amount would be improper under the unclean hands doctrine because any such error would have resulted from the plaintiff's failure to report as income capital gains "that clearly should have been reported." *Id.* at 1150.

hands to bar recoupment under the circumstances of this case. First, a recoupment defense and counterclaim remain conceptually distinct, even if both are presented in the same case and based upon the same facts. *See, e.g.*, *Household Fin. Corp. v. Hobbs*, 387 A.2d 198, 199 (Del. Super. 1978). Duncan neither requested nor received judgment on his counterclaim due to the effect of the Universal Bankruptcy. In addition, Duncan's counterclaim was mandatory because it arose out of the sale of the Properties, the same transaction or occurrence that was the subject matter of Universal's claim. Ct. Ch. R. 13(a). After Universal filed suit in the Court of Chancery, Duncan had to raise his counterclaims in that court upon risk of waiver and would have been precluded from bringing suit on the Notes in a court of law (at least until the Court of Chancery's decision in the recoupment order to dismiss the counterclaim without prejudice). Thus, to the extent that Duncan sought relief from the Court of Chancery, he was required to do so by virtue of Universal's decision to bring suit there.

Duncan's defense of recoupment did not and could not provide a basis for any request for affirmative equitable relief. Although recoupment is often referred to as a form of "relief" or a "remedy," it is *not* affirmative relief in the nature of a stand-alone claim; by definition, recoupment is strictly defensive. *Household Fin. Corp.*, 387 A.2d at 199 ("A recoupment is defensive in character and can only be used to defeat or reduce an opposing party's recovery. It does not provide a basis

for affirmative relief."). As discussed further below at p. 30, although the rationale for recoupment is rooted in equity, its application—unlike the unclean hands defense—is not confined to equitable claims, nor is it within the exclusive purview of equity courts. *See, e.g.*, *Shuman v. Santora*, 1991 WL 18101, at *4 (Del. Super. Feb. 5, 1991) (denying summary judgment as to defendant's recoupment defense to claim for monetary damages arising out of alleged breach of promissory note); *Household Fin. Corp.*, 387 A.2d at 200 (same). Universal has never disputed the amounts outstanding on the Notes, or that it ceased payments. Thus, there can be no colorable argument that recoupment would not have eliminated Universal's judgment for (legal) damages had Universal elected to pursue its breach of contract claim in a court of law. *See U.S. Bank Nat. Ass'n v. Gunn*, 2012 WL 3642703, at *1 (Del. Super. July 30, 2012) (noting that unclean hands can only be a defense to equitable claims). As the *defendant* in Universal's Court of Chancery case, Duncan was still entitled to receive the benefit of his recoupment defense to that claim without regard for the unclean hands doctrine.[8]

[8] Universal does not identify any Delaware court decisions denying an affirmative defense of recoupment on the basis of unclean hands (and Duncan is unaware of any such decisions). In the absence of case law to support its arguments on this point, Universal attempts to graft a new "element" on to the defense of recoupment, suggesting that "the party seeking recoupment" must be found to have "clean hands" before the traditional elements of recoupment are analyzed (Universal's Opening Br. 20). The sole Delaware case Universal cites as support—*TIFD III-X LLC v. Fruehauf Prod. Co.*, 883 A.2d 854 (Del. Ch. 2004)—does not state this proposition. Moreover, Universal's reinterpretation of the elements of recoupment would have the effect of improperly shifting the burden of proof as to *Universal's* defense to its opponent. When a party raises unclean hands as an

The application of unclean hands to Duncan's defense is even more problematic because the defense vindicated a legal right. While as a doctrine recoupment bears equitable origins, it may be used to pursue legal or equitable rights. 20 Am. Jur. 2d *Counterclaim, Recoupment, Etc.* § 14 ("Every claim must have a legal or equitable basis to be the subject of recoupment . . . ."); 80 C.J.S. *Set-off and Counterclaim* § 2 ("Recoupment is of common-law origin and is the abatement or reduction of the plaintiff's claim by means of a legal or equitable right . . . ."). Here, the basis of Duncan's recoupment defense was a purely *legal* right: his entitlement to monies owed for breach of the Notes. Applying unclean hands to bar his recoupment defense based upon that legal right would permit Universal an end-run around the principle that unclean hands "is generally inappropriate for legal remedies." *USH Ventures v. Global Telesystems Grp., Inc.*, 796 A.2d 7, 20 n. 16 (Del. Super. 2000) (citing *Miller v. Beneficial Management Corp.*, D.N.J., 855 F. Supp. 691, 717 n. 28 (1994)), *aff'd*, 981 A.2d 696 (Del. 2001).

3. Duncan's Conduct Does Not Reflect Unclean Hands.

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affirmative defense, it bears the burden of pleading and proof. *Niehenke v. Right O Way Transp., Inc.*, 1996 WL 74724, at *2 (Del. Ch. Feb. 13, 1996) (holding that it was incumbent upon party seeking application of unclean hands to "raise the unclean hands issue at trial and apprise the court of the possible relevance of evidence [related to it]").

Setting aside the prohibition on applying the unclean hands doctrine to a defendant's affirmative defense, Universal is also incorrect in suggesting that Duncan's conduct in the underlying transaction merits a finding of unclean hands.

Delaware courts are circumspect in applying unclean hands where the purported uncleanliness arises from a breach of contract. As the Court of Chancery has explained:

> If every breach of contract automatically evoked the unclean hands doctrine, then any non-breaching party to a breached contract would have the effective ability to act inequitably against the breaching party with impunity . . . . Any future complaint by the breaching party would be barred by the doctrine of unclean hands. This is not a sound rule of law . . . .

Merck & Co. v. SmithKline Beecham Pharm. Co., 1999 WL 669354, at *51 (Del. Ch. Aug. 5, 1999), *aff'd sub nom. Smithkline Beecham Pharm. Co. v. Merck & Co., Inc.*, 746 A.2d 277 (Del. 2000), *and aff'd,* 766 A.2d 442 (Del. 2000). Where the application of unclean hands is premised upon a contractual breach, the proper inquiry requires "closely examining the particular circumstances involved" to determine whether the breach so "transgressed equitable standards of conduct" that the Court should not reach the breaching party's claims. *Id.* (quoting *Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co.,* 324 U.S. 806, 815 (1945)). In particular, the unclean hands doctrine cannot be invoked unless the transgression involved "some sort of fraud or sharp practice." *Dittrick v. Chalfant,* 948 A.2d 400, 408 n. 18 (Del. Ch. 2007), *aff'd,* 935 A.2d 255 (Del. 2007).

The Court of Chancery found no fraud in the parties' transaction, and the nature of their contractual arrangement makes clear that Duncan did not engage in the type of "sharp practice" or inequitable conduct the unclean hands doctrine is intended to address. Delaware law recognizes that where inequitable conduct has been redressed before it is litigated, it will not support a finding of unclean hands, on the principle that "[t]he repentant sinner, especially where he has been duly punished, is not unwelcome in equity." *Gen. Elec. Co. v. Klein*, 129 A.2d 250, 252 (Del. Ch. 1956) (holding that party previously found in contempt of permanent injunction no longer bore unclean hands after punishment and was therefore not barred from seeking construction or modification of the same injunction); *see also* 2 Pomeroy, *Equity Jurisprudence* § 399 (5th ed. 1941) ("A wrong which has been righted may not be pleaded against a party to a suit in equity, on the theory that the party charged therewith is in court with 'unclean hands.'"). It follows *a fortiori* that unclean hands ought not apply where the party against whom it is alleged affirmatively seeks to *eliminate inequities in the first instance* by providing in advance for full redress for his own errors, at his opposing party's election and at his own expense. That is precisely the arrangement Duncan established with respect to Universal.[9]

[9] This is unlike the situation in *Nakahara v. NS 1991 American Trust*, in which a party already having been found with unclean hands attempted to cleanse itself by reversing the actions that constituted the unclean hands. 718 A.2d at 524-25.

Despite the vehement language of Universal's opening brief and the technical details of the stations' compliance issues, the claim upon which Universal prevailed was, in substance, a basic breach of warranty action: Duncan made warranties regarding the prior operations, status, and condition of the Properties, which the trial court determined were breached. The trial court also recognized that as the Agreement was being negotiated, Universal and Duncan anticipated the very breaches upon which Universal now rests its unclean hands argument. (A1085, Mem. Op. 23 ("Part of what Universal and its advisors had to address was how to proceed in the face of both known unknowns and unknown unknowns.").) Crucially, the parties agreed to terms by which the risk of those breaches was allocated fully to Duncan and any damages to Universal could be fully remedied. First, the parties established a $1,600,000 escrow fund for the remediation activities necessary to obtain no-further-action letters from DNREC and MDE. (A1085, Mem. Op. 23; A249.) As of October 2012, all but four stations had been remediated. (B73-74.) The environmental consultant performing the work estimated then that approximately $1,176,705 of the $1,600,000 escrow would be expended. (*Id.*) In addition, Duncan agreed to provide Universal unfettered rights to setoff any expense associated with his non-completion of Corrective Actions and any damages arising from his breach of any "obligations, representations, indemnities, covenants, and agreements" in the

transaction against the Notes, up to their full $8 million value—an amount more than twice the upper-bound estimates of potential liability provided by Universal's consultant. (A1085-86, Memo. Op. 23-24; A251; *e.g.*, A258.) However broadly the term "sharp practices" might be construed, it cannot reasonably stretch to include Duncan's acceptance of this arrangement.[10]

This suit, including the judgment Universal seeks to preserve against recoupment, resulted from Universal's decision not to exercise its contractual rights to setoff damages for breach of the Agreement against the Notes. Had Universal availed itself of that right, it would be in the same position with respect to its contractual damages and outstanding debt on the Notes as exists as a result of the Court of Chancery's recoupment order. The circumstances of this case do not

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[10] The parties' recognition and contractual allocation of risks distinguishes this case from *Transfer My Timeshare, LLC v. Selway*, 2009 WL 3271326 (D.N.H. Oct. 9, 2009), cited by Universal for the proposition that unclean hands may bar recoupment (Universal's Op. Br. 19). In *Transfer My Timeshare, LLC*, the defendant seeking recoupment had embezzled and defrauded the plaintiff with respect to the same contract that formed the basis for her recoupment claim. The plaintiff was unaware of her actions at the time of contracting, and was therefore fraudulently induced into the agreement. *Id.* at *4-5. The defendant's fraud rendered the contract voidable. *Id.* The trial court therefore determined that the plaintiff *had no right to recoupment*, and moreover had sought recoupment with unclean hands and would receive an unjust windfall and reward for her fraud if recoupment was awarded. *Id.* Here, by contrast, the trial court's unchallenged conclusion was that Duncan's conduct did *not* constitute fraud and that the parties specifically "addressed the uncertainties surrounding the accuracy of Duncan's contractual representations through due diligence and the October Modification" in advance of closing (A1095, Mem. Op. 33). In denying rescission and applying recoupment, the trial court found the Sale Agreement and the Notes to be valid and enforceable contracts, and it specifically held that Duncan's breaches "did not go to the heart of the transaction" between the parties (A1102, Mem. Op. 40). Under these circumstances, the recoupment order neither provided Duncan an unjust windfall nor rewarded fraud (or any other inequitable conduct).

warrant altering that result on the basis of unclean hands. Moreover, even if Duncan could be said to bear unclean hands, denying his recoupment defense would place Universal in a better position than the one it carefully bargained for with respect to damages for breach amounting to $1,497,429 while it remained in default to Duncan for more than $7.6 million owed on the Notes. Regardless of whether it may be otherwise applicable to a party's conduct, the doctrine of unclean hands cannot be utilized to benefit its proponent where the result would be unconscionable. *Saltar v. Wilson*, 1978 WL 176028, at *1 (Del. Ch. July 19, 1978) (holding that a party will not be denied a remedy, even if it has unclean hands, "if to do so would permit an unconscionable gain to the other party").

CONCLUSION

For the foregoing reasons, the judgment of the Court of Chancery should be affirmed in its entirety.

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