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IN THE SUPREME COURT OF THE STATE OF DELAWARE

PATRICK DAUGHERTY, Plaintiff Below/Appellant, v. JAMES DONDERO, HUNTON ANDREWS KURTH LLP, MARC KATZ, MICHAEL HURST, SCOTT ELLINGTON, and ISAAC LEVENTON, Defendants Below/Appellees.	No. 60, 2023 (Appeal from Court of Chancery C.A. No. 2019-0956-MTZ)

REPLY BRIEF OF APPELLANT PATRICK DAUGHERTY

Thomas A. Uebler (#5074)
MCCOLLOM D'EMILIO SMITH
UEBLER LLC
2751 Centerville Road, Suite 401
Wilmington, DE 19808
(302) 468-5960

Attorneys for Appellant Patrick Daugherty

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INTRODUCTION

When Highland declared bankruptcy during the final day of trial of the Delaware Related Action, procedural disarray ensued, but not at the fault of Daugherty. A day earlier, Dondero had implicated Highland's internal and external lawyers as the architects of wrongdoing but Daugherty's ability to pursue claims against those wrongdoers in the Delaware Related Action was stymied because of the automatic bankruptcy stay. Faced several months later with an expiring limitations period against those wrongdoers—the defendants in this action—but unable to pursue new claims in the Delaware Related Action because of the bankruptcy stay, Daugherty filed this nominally new action to preserve his claims and later sought consolidation.

The Court of Chancery dismissed this action, however, finding that Daugherty had impermissibly split his claims and declined to consolidate the related actions. The dismissal was reversible error under these unique circumstances. The claim-splitting doctrine should not preclude this action where (1) no defendant here is also a defendant in the Delaware Related Action or any other action brought by Daugherty and (2) there is no threat of a double recovery, either to the benefit of Daugherty or to the detriment of any defendant here. No defendant here faces the type of prejudice that the claim-

splitting doctrine is meant to avoid: "exposure to duplic[ative] litigation and/or double recoveries." *J.L. v. Barnes*, 33 A.3d 902, 921 (Del. Super. 2011).

The appellees' arguments in support of the dismissal are unavailing.[1] First, the proper standard of review of the dismissal is *de novo*, not abuse of discretion. Second, an exception to the claim-splitting doctrine applies because of Dondero's novel and unexpected trial testimony in the Delaware Related Action. Third, there is no risk of double recovery because the trial court is capable of allocating damages between different claims and different defendants. Fourth, consolidation, not dismissal, is the proper way out of this procedural disarray. And, fifth, the appellees' arguments unrelated to claim splitting, which were not addressed by the court below, do not provide a basis to affirm the dismissal and should not be considered by this court in the first instance. The Court of Chancery's dismissal should be reversed, and this action should be consolidated with the Delaware Related Action.

[1] This brief replies to the answering briefs of Dondero, Ellington, and Leventon (D.I. 12 ("Dondero AB")); Andrews Kurth and Katz (D.I. 13 ("Katz AB")); and Hurst (D.I. 11 ("Hurst AB")).

ARGUMENT

1. The Standard of Review Applicable to Dismissal Based on Claim Splitting Is *De Novo*

Daugherty, Dondero, Ellington, and Leventon agree that the standard of review applicable to dismissal based on claim splitting, which is an aspect of *res judicata*,[2] is *de novo*. *See* Dondero AB at 24 (citing *Betts v. Townsends, Inc.*, 765 A.2d 531, 533 (Del. 2000), and *Bailey v. City of Wilm.*, 766 A.2d 477, 479–81 (Del. 2001)).

Hurst, Andrews Kurth, and Katz, on the other hand, propose the abuse-of-discretion standard. *See* Hurst AB at 12; Katz AB at 20. But they cite no controlling authority suggesting that dismissal based on claim splitting should be reviewed for abuse of discretion. Although they cite federal decisions in their favor (Hurst AB at 12 n. 45; Katz AB at 20–21), they ignore the split of authority in those courts. *See, e.g.*, *Sensormatic Sec. Corp. v. Sensormatic Elecs. Corp.*, 273 F. App'x 256, 264 (4th Cir. 2008) ("Consequently, the standard of review on the district court's decisions to dismiss two of SSC's claims as violations of the rule against claim splitting is *de novo*.") (citing *Pueschel v. U.S.*, 369 F.3d 345, 354 (4th Cir. 2004) ("We review *de novo* a district court's application of the principles of *res judicata.*").

[2] *See Kossol v. Ashton Condo. Ass'n, Inc.*, 1994 WL 10861 (Del. 1994) (Table) (citing *Maldonado v. Flynn,* 417 A.2d 378, 382–83 (Del. Ch. 1980)).

The court should review this *res judicata* issue *de novo*, just as it has reviewed other *res judicata* issues before. *See, e.g.*, *RBC Cap. Markets, LLC v. Educ. Loan Tr. IV*, 87 A.3d 632, 639 (Del. 2014) ("A trial court determination that a claim is barred as *res judicata* raises a legal question that we review *de novo*."); *Sutton v. Coons*, 940 A.2d 946, 2007 WL 4293073, at *2 (Del. 2007) (Table) (reviewing *de novo* dismissal based on *res judicata*).

2. An Exception to the Claim-Splitting Doctrine Applies

Even if Daugherty's claims in this action resulted in overlapping defendants in multiple actions (they do not, as discussed below), Daugherty's claims fall within a recognized exception to the claim-splitting doctrine. "[W]here the defendant has committed fraud on the plaintiff by concealing evidence of a part or phase of claim that the plaintiff failed to include in the earlier action" or where "the information on which the second action is based was not reasonably discoverable during the pendency of the first action" then claim-splitting will not bar the claims. *Havercombe v. Dep't of Educ. of Com. of P.R.*, 250 F.3d 1 (1st Cir. 2001) (internal quotations omitted); *see also Salvati v. Fireman's Fund Ins. Co.*, 368 F. Supp. 3d 85, 92 (D. Mass. 2019); Restatement (Second) of Judgements § 26, cmt. j.

Appellees seek to avoid this exception on the ground that Daugherty could have or should have anticipated Dondero blaming Highland's former

attorneys at trial in the Delaware Related Action as the architects of wrongdoing. *See* Dondero AB at 33; Katz AB at 22; Hurst AB at 16–17, 21. The appellees point to Highland's affirmative defense that "Defendants did not act with the necessary knowledge, intent, or scienter, and instead acted in good faith and with due care at all times." Dondero AB at 33; A247. They argue that written discovery, Highland's pretrial brief, and Dondero's deposition testimony in the Delaware Related Action previewed that Dondero would blame his attorneys at trial and assert an advice-of-counsel defense. *See, e.g.*, Dondero AB at 33–36. But the record speaks for itself:

- Interrogatory response. The interrogatory response on which the appellees rely to suggest that an advice-of-counsel defense was asserted before trial states as follows: "Defendants object to Interrogatory No. 64 on the grounds that it seeks information that is publicly available and the burden of identifying the requested information would be the same for Plaintiff and Defendants, equally available to Plaintiff from sources other than Defendants, or already in the possession of Plaintiff. Defendants also object to this Interrogatory on the grounds that it is premature and would require Defendants to marshal the entire evidence that they will use at trial before conducting discovery. To the extent this Interrogatory seeks the identification of privileged documents and communications, Defendants assert the attorney-client privilege and/or work product doctrine pursuant to Rule 26(b)(1), and are not identifying such information, except to the extent identified in Defendants' privilege log. Subject to and without waiver of the foregoing, Defendants refer Plaintiff to their Motion to Dismiss filed in this lawsuit on September 22, 2017. The Amended Complaint alleges no specific facts establishing that the transfer of the Deposit Assets was made with the actual intent to hinder, delay, or defraud. The Amended Complaint, similarly, does not allege an inadequate exchange, instead incorrectly alleging that HERA became insolvent due to the transfer of the Deposit Assets. *Defendants, Defendants' Counsel, and Plaintiff have knowledge*

concerning the defense. Defendants will amend and/or supplement their response to Interrogatory No. 64, if necessary, as discovery progresses." B136–37 (emphasis added). This is not an assertion of an advice-of-counsel defense.

- Pretrial brief. The pretrial brief statement on which the appellees rely to suggest that an advice-of-counsel defense was asserted before trial states as follows: "Highland relied upon legal advice received *from A&B* … in finalizing and executing the Escrow Agreement." B264 (emphasis added); *see also* B280 (referring to "act[ing] on the advice of counsel"). This is not an assertion of an advice-of-counsel defense. To the contrary, this is an example of the defendants here trying to shift blame to Abrams & Bayliss, the escrow agent, which was not serving as legal counsel or rendering legal advice in its escrow-agent capacity, for their own wrongdoing. The Court of Chancery held, "Documents regarding A&B's nonlegal work and resignation as escrow agent are not privileged or work product because when A&B agreed to be an escrow agent, it stepped into a nonlegal role despite its status as a law firm." A57. Highland did not refer in its pretrial brief to reliance on any other lawyers or law firms.

- Dondero deposition testimony. The Dondero deposition testimony on which the appellees rely to suggest that an advice-of-counsel defense was asserted before trial (B218 ("strategized, reviewed, and vetted by counsel as appropriate"), B221 ("I was just gonna say we rely on counsel to tell us when and how and what amount we should pay, based on whatever the court rules.")) falls well short of Dondero's trial testimony in which he blamed the defendants here for Highland's actions: "the whole situation was the most lawyered thing we've ever done" and "[w]e would have done whatever counsel told us." A325–26; A366–68; *see also* A329, A334, A339–41, A349–54, A383. Although Dondero made passing references to counsel's involvement and advice in his deposition, he did not directly implicate counsel as the architects of wrongdoing as he did at trial, and there was no prior indication he would do so at trial.

Thus, the court below misinterpreted the record when it held that the "defendants in the First Delaware Action indicated they would argue that they

did not act with the mental state required for Daugherty's claims because they relied on the advice of counsel." OB Ex. A at 12.

Dondero also argues that Daugherty deposed several attorneys in the Delaware Related Action and "those depositions also informed Daugherty that counsel were involved in preparing, negotiating, and advising on the subjects discussed in Dondero's testimony." Dondero AB at 35–36. But deposition testimony suggesting the involvement of counsel is far different from blaming the attorneys at trial, as Dondero did.

The appellees also argue that although Daugherty's request to depose Highland's litigation counsel was denied, Daugherty had "an opening to pursue such further discovery from the Katz Defendants if he could demonstrate that there were gaps in the records." Katz AB at 23. But again, the appellees ignore that Daugherty was not on notice of an advice-of-counsel defense and thus, lacked a reason to pursue more discovery or an at-issue waiver on that basis. And while Hurst argues that Daugherty "could have issued discovery or filed motions to identify these issues," Hurst AB at 16, he ignores the efforts that Daugherty made, including seeking the basis of Highland's good-faith affirmative defense, serving discovery on Andrews Kurth, and trying, unsuccessfully, to take the deposition of Katz. *See* OB at

21–22; A52. Daugherty should not be faulted, in hindsight, for others' discovery and pretrial shortcomings in the Delaware Related Action.

Hurst is incorrect that this action is analogous to *J.L. v. Barnes*, 33 A.3d 902 (Del. Super. Ct. June 17, 2011). There, the court found that claim splitting barred the second action, in part, because the defendants in the second action who were not named in the first action could eventually be named. *Id.* at 917–919. There was a risk of double recovery based on the plaintiff seeking two damage awards relating to a single transaction and a single injury. *Id.* at 919–920. In contrast, here, there is no risk of double recovery or additional defendants. Daugherty has released Highland. The defendants here would be the defendants going forward. And any recovery Daugherty receives from the Highland settlement will reduce the damages attributable to claims for which the defendants here bear joint and several liability. *See* OB at 19–20.

3. There Is No Risk of Double Recovery

The claim-splitting doctrine is meant to prevent duplicative litigation and double recovery. *See J.L.*, 33 A.3d at 921. The appellees argue that claim splitting should bar this action because there is a risk of double recovery. Dondero AB at 31; Hurst AB at 19. Hurst posits that reducing damages against the defendants here based on settlement proceeds from Highland would be "difficult" because "a settlement with Highland would also encompass claims

made against the new defendants." Hurst AB at 19. And Dondero argues that the pleadings in the Delaware Related Action formed the basis for Daugherty's proof of claim in the Highland bankruptcy. Dondero AB at 31. But the claims from the Delaware Related Action were just one component of Daugherty's bankruptcy proof of claim. B969–70.

No matter how many times the appellees repeat it, Daugherty is not seeking to recover twice from multiple defendants for the same injury. In the Delaware Related Action and in the bankruptcy, Daugherty asserted certain claims solely against Highland, including claims for indemnification and attorneys' fees. There could not be double recovery for those claims because Highland was the only defendant. As for the escrow-related claims that Daugherty has asserted against both Highland and the defendants here, if the defendants here are found to be jointly and severally liable, any damages that Daugherty receives from the defendants here would be reduced by his Highland settlement proceeds attributable to those claims. This would not be a "difficult" task, as Hurst suggests. *See* OB at 19–20. Delaware courts can allocate damages to avoid double recovery. *See, e.g.*, *In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205, 263 (Del. Ch. 2014).

What the appellees are actually seeking is their own hall pass simply because *some* of the claims that Daugherty and Highland settled overlap with

the claims here and Daugherty has recovered for *some* of his overall injury. Dondero and his co-conspirators do not deserve a hall pass or any sympathy whatsoever, especially after their antics came to light during the bankruptcy proceedings. *See, e.g.*, A1194 ¶ 79 (Highland acknowledging that "Dondero, through HCMLP, engaged in an asset-stripping campaign designed to render HERA judgment-proof, further exposing HCMLP to liability and unnecessary legal costs."); A1357 (Highland's new CEO, James Seery, testifying, "It actually looks like, frankly, the escrow was never really an escrow and it was a -- it was a fraud from the beginning. And that one's a pretty disturbing one."). The appellees should be required to answer for their actions until Daugherty is made whole, a point that has not been reached and cannot properly be assessed at the pleading stage.[3]

[3] There is also no risk of multiplicity of suits against the same parties. None of the defendants here faced trial in the Delaware Related Action. To the extent Dondero and his enablers, both internal and external lawyers, were in privity with Highland in the past, and to the extent such privity affects the claim-splitting analysis, an argument for which the appellants cite no Delaware authority, those parties, all of whom have been severed from their relationship with Highland, are no longer in privity with any party that faced trial in the Delaware Related Action. *See Grunstein v. Silva*, 2011 WL 378782, at *8 (Del. Ch. Jan. 31, 2011) ("Two parties are in privity for purposes of *res judicata* where the relationship between two or more persons is such that a judgment involving one of them may justly be conclusive on the others, although those others were not party to the lawsuit. A critical factor for the privity analysis is whether the interests of a party to the first suit and the party in question in the second suit are aligned.") (internal quotations omitted).

4. Consolidation Is the Best Path Forward

Consolidation of the related actions is procedurally permissible, most efficient, and fair, despite the appellees' arguments to the contrary. *See* Hurst AB at 21–22; Dondero AB at 39–42; Katz at 24–28. Dondero, who once suggested consolidation himself, A773, now relies on *Wilson v. Urquhart* to avoid consolidation. In *Wilson*, the Superior Court initially declined to consolidate that action with a first-filed action because there was a delay in bringing the claims and the claims prejudiced the defendants. 2010 WL 2683031, at *11 (Del. Super. July 6, 2010). That is not true here. Daugherty did not delay in bringing these claims because Dondero did not blame his lawyers until trial, which was then stayed. Additionally, these claims will not prejudice the defendants here. They have not defended these claims on the merits or participated in discovery on an individual basis (to the extent some of the appellees participated in discovery in the Delaware Related Action, they did so as custodians of Highland).[4]

[4] Dondero argues that Daugherty was not required to follow the bankruptcy stay as to the defendants here, Dondero AB at 41 n.6, but Daugherty could not have pursued claims against a non-debtor that are "inextricably interwoven with claims against the debtor." *GATZ Aircraft Corp. v. M/V Courtney Leigh*, 768 F.2d 711, 716 (5th Cir. 1985) (citing *Fed. Life Ins. Co. of Tex. v. First Fin. Grp. of Tex.,* 3 B.R. 375 (S.D. Tex. 1980) (internal quotation marks omitted)); *Blundell v. Home Quality Care Home Health Care, Inc.*, 2017 WL 5889715, at *6 (N.D. Tex. Nov. 29, 2017).

Katz argues that consolidation is "not feasible, as the First Delaware Action is no longer justiciable." Katz AB at 24. To the contrary, the Delaware Related Action remains stayed and "the trial record remains open." OB Ex. A at 6. At a minimum, after the trial record closes and there is a final order from which an appeal may be taken, Daugherty plans to appeal the pleading-stage dismissal of Dondero from the Delaware Related Action. A1294–1300.

Katz also argues that consolidation would violate Court of Chancery Rules 15(aaa), 15(b), and 59. Katz AB at 25–26. Consolidation would not violate any of those rules. First, Rule 15(aaa) simply requires that a party responding to a motion to dismiss with an amendment to file an amended complaint in lieu of an answering brief or risk dismissal with prejudice. This is not an appeal of a Rule 15(aaa) issue and contrary to Katz's suggestion, Daugherty is not trying to avoid the Rule 12(b)(6) arguments raised by the appellees below but not addressed by the court. If this matter is remanded, the appellees will be free to make their other arguments. Second, under Rule 15(b), "[t]he primary consideration is determining whether to grant leave to amend under Rule 15(b) is prejudice to the opposing party." *Those Certain Underwriters at Lloyd's, London v. Nat'l Installment Ins. Servs., Inc.*, 2008 WL 2133417, at *10 (Del. Ch. May 21, 2008). There would be no unfair prejudice to the defendants here from having to face claims against them on

the merits in a single proceeding. Third, this is not a "do-over" of the Delaware Related Action and thus Rule 59 does not apply. Daugherty is not seeking a new trial. The earlier "trial record remains open." OB Ex. A at 6.

Katz also argues that consolidation is not appropriate because Daugherty "has received nearly $8 million, with further payments to be made" through the Highland settlement. Katz AB at 28. However, as discussed above, that settlement resolved certain claims against Highland only and not against the defendants here. Roughly one-fourth of Daugherty's $40.7 million bankruptcy claim was based on claims unique to Highland and unrelated to the defendants here. OB at 15 (citing A1423–557). In the Delaware Related Action, Daugherty sought damages of $8,573,934.69 (a figure on which interest continues to accrue) apart from his unique claims against Highland. *Id.* (citing A291–92 ¶¶ 100–01). Contrary to Katz's assertions, the Highland settlement has not, and will not, make Daugherty whole. In any event, the pleading stage is not the time to entertain Katz's double-recovery assertions.

5. No Alternative Grounds Exist to Affirm the Dismissal

Hurst, Andrews Kurth, and Katz argue that the dismissal should be affirmed on numerous alternative grounds, none of which were addressed by the court below. *See* Katz AB at 29–43; Hurst AB at 23, 29–49. The Court of Chancery explicitly declined to address the Texas attorney immunity

argument. OB Ex. A at 8 n.22. It did not reference the others. This court should not affirm a dismissal based on grounds not reached by a lower court without giving the lower court a chance to address the issue. *See, e.g.*, *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1391 (Del. 1995); *Kroll v. City of Wilm.*, 276 A.3d 476, 479 (Del. 2022) (declining to affirm trial court decision on the basis of a different rationale than articulated by the trial court and remanding for further proceedings); *see also Mayfield v. Presbyterian Hosp. Admin.*, 772 Fed. Appx. 680, 687 (10th Cir. 2019) ("Where an issue has not been ruled on by the court below, we generally favor remand for the district court to examine the issue.") (internal quotations omitted); *Mt. Hawley Ins. Co. v. Vigilant Ins. Co.*, 112 F.3d 504, 1997 WL 215953, at *2 (2nd Cir. 1997) (Table) (finding that cases should be remanded to district court to deal with issues that the court did not rule on); *Perez v. Aetna Life Ins. Co.*, 150 F.3d 550, 554 (6th Cir. 1998) ("Typically, we will not address issues unless ruled upon by the trial court below.") (internal citations omitted). Further, for the reasons Daugherty discussed below (A948–1014; A1642–1724), those arguments lack merit and provide no basis for dismissal.

CONCLUSION

The Court of Chancery's dismissal based on the claim-splitting doctrine should be reversed, and this action should be remanded and consolidated with the Delaware Related Action.

/s/ Thomas A. Uebler
Thomas A. Uebler (#5074)
MCCOLLOM D'EMILIO SMITH
UEBLER LLC
2751 Centerville Road, Suite 401
Wilmington, DE 19808
(302) 468-5960

Attorneys for Appellant Patrick Daugherty

May 23, 2023

CERTIFICATE OF SERVICE

I certify that on May 23, 2023, a true and correct copy of the Appellant's Reply Brief, was served by File & Serve*Xpress* on the following.

Jason C. Jowers, Esquire
Stephen B. Brauerman, Esquire
Brett M. McCartney, Esquire
Elizabeth A. Powers, Esquire
BAYARD, P.A.
600 N. King Street, Suite 400
Wilmington, DE 19801

Kurt M. Heyman, Esquire
Jamie L. Brown, Esquire
HEYMAN ENERIO GATTUSO & HIRZEL LLP
300 Delaware Avenue, Suite 200
Wilmington, DE 19801

Loren R. Barron, Esquire
MARGOLIS EDELSTEIN
300 Delaware A venue, Suite 800
Wilmington, Delaware 19801

/s/ Thomas A. Uebler
Thomas A. Uebler (#5074)