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Case Number 460,2012

IN THE SUPREME COURT OF THE STATE OF DELAWARE

KIM WALTERS, JOSEPH AYLOR and ENVIRONMENTAL SOLUTIONS GROUP, INC.,	)	No. 460, 2012
Defendants-below/Appellants,	)	On appeal from the Court of Chancery in C.A. No. 4156-VCP
v.	)	
ENVO, INC.,	)	
Plaintiff-below/Appellee.	)	

APPELLANTS' OPENING BRIEF ON APPEAL

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Dated: October 3, 2012

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NATURE AND STAGE OF THE PROCEEDINGS

On November 11, 2008, plaintiff-below/appellee Envo, Inc. ("Envo") filed suit in the Court of Chancery of the State of Delaware against defendants-below/appellants Kim Walters and Joseph Aylor, asserting causes of action for fraud (legal and equitable) and breach of contract. (D.I. 1).

On April 27, 2009, Mr. Walters filed a motion to dismiss the Complaint for lack of subject matter jurisdiction. (D.I. 17). On June 26, 2009, in a bench ruling, the Court of Chancery dismissed the action but granted Envo leave to amend the Complaint. (D.I. 27).

On July 15, 2009, Envo filed an Amended Complaint, adding E S G, Inc. and Environmental Solutions Group, Inc. ("ESGI") as additional defendants, and asserting causes of action for fraud (legal and equitable), breach of contract (express and implied), reformation, quasi-contract, unjust enrichment and promissory estoppel. (D.I. 38).

On July 24, 2009, Mr. Walters and ESGI filed a motion to dismiss the Amended Complaint on the grounds of lack of subject matter jurisdiction and failure to state a claim upon which relief may be granted. (D.I. 32). In a Memorandum Opinion dated December

30, 2009, the Court of Chancery dismissed the reformation claim[1] but otherwise denied the motion to dismiss. (D.I. 38; Ex. A hereto).

On August 5, 2011, Mr. Walters and ESGI filed a motion for summary judgment. (D.I. 55). The Court of Chancery denied that motion in a ruling from the bench on September 7, 2011. (D.I. 68).

Trial was held on September 12 and December 9, 2011. (D.I. 69, 73). The Court of Chancery issued a Memorandum Opinion on July 18, 2012, holding the defendants jointly liable under a theory of promissory estoppel. (D.I. 90). The Court of Chancery entered a Final Order on July 31, 2012 (D.I. 92), and an Amended Final Order on August 17, 2012. (D.I. 94).

Mr. Walters, Mr. Aylor and ESG filed a Notice of Appeal on August 21, 2012. (D.I. 95). This is their opening brief on appeal.

[1] In its reformation claim, Envo sought to reform the APA to name only Mr. Walters and Mr. Aylor as the purchasers, and did not seek to reform the APA to name ESGI as a purchaser.

SUMMARY OF ARGUMENT

1. The Court of Chancery erred in holding that there was a basis for equitable jurisdiction, as money damages provided a full, fair and complete remedy for breach of an agreement to pay money for purchased assets where Envo did not seek to rescind the agreement but only sought compensation, and there was no allegation demonstrating that a constructive trust was necessary to ensure payment of any judgment.

2. The Court of Chancery erred by not applying the relevant Statute of Limitations to bar this action. Envo, by not receiving payment at the outset as contracted, was fully aware of the breach of the agreement, yet sat by idly beyond the three-year limitations period without justification, making no effort to collect the debt.

3. The Court of Chancery erred in holding Mr. Walters and Mr. Aylor personally liable as partners. In the absence of any showing of a lack of good faith in attempting to incorporate, and given that Envo negotiated only for corporate liability, Mr. Walters and Mr. Aylor are not subject to personal liability.

STATEMENT OF FACTS

A. THE AMENDED COMPLAINT.[2]

According to the Amended Complaint, on July 21, 2005, Envo (then called Environmental Solutions Group, Inc.) entered into a written Asset Purchase Agreement ("APA") to sell certain assets (including the name Environmental Solutions Group) to ESG, Inc. for $300,000. At closing, Envo was to receive $10,000 in cash and two promissory notes, one for $71,632 and the other for $218,369. (A-27, 46-77).

At the closing, Envo tendered all of the purchased assets, and Mr. Walters occupied the business premises. Although Envo received the promissory notes at closing, it did not receive the initial $10,000 cash payment. (A-27-28).

Some time after the closing Envo changed its name from Environmental Solutions Group, Inc. to Envo, and Mr. Walters created a new corporation, ESGI, which thereafter operated the business. (A-27). Envo never received payment. (A-28).

Envo alleged that Mr. Walters and Mr. Aylor falsely represented that they owned a corporation called ESG, Inc. which

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[2] Subject matter jurisdiction is determined from the face of the Complaint. *Janowski v. Div. of State Police, Dept. of Safety and Homeland Sec., State*, 981 A.2d 1166, 1169 (Del. 2011); *Stidham v. Brooks*, 5 A.2d 522, 524 (Del. 1939).

would pay for the purchased assets, and fraudulently induced Envo into entering into the Asset Purchase Agreement with ESGI. (A-28).

B. THE EVIDENCE AT TRIAL.

Envo is a Delaware corporation solely owned by Basil Kollias, Esq. Mr. Kollias is a member of the Delaware Bar, having been admitted in 2001, after having previously been admitted to the Bar of the State of New Jersey. (A-159-65).

In 1991, Mr. Kollias formed Envo (then called Environmental Solutions, Inc.), an environmental consulting, construction and remediation firm. (A-160-62).

After admission to the Delaware Bar, Mr. Kollias began practicing law. Although Mr. Kollias continued to maintain Envo, he eventually decided that he wanted to put all of his effort into the practice of law, and decided to sell his business. Mr. Kollias put out feelers to contacts he had through his work with Envo. One of those contacts had an employee named Kim Walters, who was interested in assuming the business. (A-163-66, 172-73).

Mr. Walters and Mr. Aylor, represented by Thomas C. Marconi, Esq., approached Mr. Kollias about purchasing Envo. (A-98-99). Mr. Marconi recommended to his clients that they not structure it as a stock purchase, instead favoring forming a new corporation to purchase and hold the assets. The parties negotiated a transaction whereby, instead of purchasing Envo outright, they would form a new

corporation known as ESG, Inc. which would purchase the assets of Envo, including its then-name, Environmental Solutions Group. (A-138, 235-36).

Mr. Marconi drafted the APA, initially based on a form he had in his files. (A-120). Mr. Kollias and Mr. Marconi exchanged drafts. (A-99-100, 121, 175). Mr. Kollias had a full opportunity to review and comment on the APA, and to have an attorney review it before signing it if he so chose. (A-122-23). Mr. Kollias, a lawyer, represented himself in the transaction. (A-206).

The parties to the APA were Envo, Mr. Kollias in his individual capacity (as he had personal obligations under the APA), and ESG, Inc. Although Mr. Kollias had sought personal guarantees from Mr. Walters and Mr. Aylor, they refused, and although their refusal nearly derailed the transaction, Mr. Kollias ultimately relented on that point. (A-138-39).

Neither Mr. Walters nor Mr. Aylor signed the APA in their individual capacities, and nothing in the APA identifies any personal obligations of Mr. Walters and Mr. Aylor in their individual capacities. (A-46-73).

At the closing, Mr. Marconi witnessed the signatures of all parties to the APA. He also served as notary for two promissory notes issued in the name of ESG, Inc. in favor of Envo. Mr. Marconi

testified that, at the time he notarized the documents, he believed that his notarial statement was true. (A-162-28, 131-32).

At the closing, the parties realized that it was important that the new entity have the name Environmental Solutions Group to maintain certain existing contracts, and so some steps had to be taken to obtain that name. However the parties felt a need to go forward immediately with the closing. It was decided that the closing would go forward with ESG, Inc. being named in the APA as a "placeholder," and that afterwards Mr. Kollias' company would change its name, and that a new corporation would be formed with the name Environmental Solutions Group, Inc., to be owned by Mr. Walters and Mr. Aylor. (A-109-115, 130-31, 139-41).

Mr. Kollias was a party to those discussions and was fully aware of this plan of action. (A-123-24, 127-29). Indeed, Mr. Kollias, in response to a question from his counsel as to whether he had at the time an understanding of the structure of how the transaction was going to be played out, made clear that he understood that ESG was to become Environmental Solutions Group, Inc.:

> My understanding was that they either had a company or were going to form a company to purchase the assets of my company. And at the settlement table, once everything was said and done at settlement, they were going to B *we were going to have the name of my company changed to something else, and then they were going to immediately change the*

> *name of their company to Environmental Solutions Group, Inc.*

(A-176, italics added).

Mr. Kollias re-confirmed that point in response to questioning on cross-examination:

> What I did know was that a company owned by Mr. Walters and Mr. Aylor was purchasing the assets, and I believe shortly thereafter, the name of that corporation was supposed to have been changed to Environmental Solutions Group, Inc.

(A-211).

Mr. Walters, in his testimony, confirmed the testimony of Mr. Marconi and Mr. Kollias, stating that there were meetings with Mr. Kollias present where there was a need to transfer the assets ultimately to a corporation named Environmental Solutions Group, Inc. Mr. Walters further testified that everyone (including Mr. Kollias) agreed that ESG, Inc. would be named as an interim company, with the assets subsequently transferred to a company named Environmental Solutions Group, Inc. when that name became available. (A-243-47, 255-56, 282-84). Mr. Aylor also confirmed those events. (A-309-10,376).

Mr. Kollias signed a certificate of name change and came up with the new name Envo at settlement. (A-194-95). On August 9, 2005, Mr. Marconi prepared a certificate of incorporation for the new entity. On August 15, 2005, Mr. Marconi faxed the Certificate

of Name Change and the Certificate of Incorporation together to the Division of Corporations. With Mr. Kollias' corporation changing its name to Envo, Mr. Marconi named the new entity Environmental Solutions Group, Inc. (A-141).

At all times Mr. Walters relied on Mr. Marconi, as his lawyer, to handle and be responsible for the legal work, including the formation of their corporation. Mr. Walters never represented to Mr. Marconi or Mr. Kollias that he had formed a corporation named ESG, Inc., and neither Mr. Marconi nor Mr. Kollias testified to the contrary. Mr. Walters never had any reason to inquire as to how Mr. Marconi was implementing the agreed-upon objectives. (A-236, 242-49, 256, 278).

Relying on his attorney to handle the legal work, Mr. Walters believed that ESG, Inc. existed at the time he signed the APA and the promissory notes. (A-280–83). Counsel for Mr. Kollias stated that he accepted that as a fact. (A-285).

Mr. Aylor testified that, subsequent to the closing, Mr. Marconi informed him that the filing to form ESG, Inc. had been rejected by the Division of Corporations. Mr. Aylor then met with Mr. Walters, Mr. Marconi and Mr. Kollias to discuss that fact, at which meeting the parties (including Mr. Kollias) decided not to re-do the APA, but simply recognize ESG as a "transition" name; that Mr. Kollias would change the name of his entity to Envo, Inc.;

and Mr. Marconi file a new certificate of incorporation using the name Environmental Solutions Group, Inc. instead of ESG, Inc. (A-314-16, 319, 321-24, 342-346, 362-63, 368-69, 381, 394). Mr. Kollias did not deny attending these meetings (and, indeed, expressly declined to deny it), but merely stated that he did not recall them. (A-401, 402, 406).

Although the APA provided for a payment of $10,000 at closing on July 21, 2005, Mr. Kollias did not receive any of that money prior to the institution of this litigation. (A-188, 209-10).

ARGUMENT

I. THE COURT OF CHANCERY ERRED IN HOLDING THAT THERE WAS A BASIS FOR EQUITABLE JURISDICTION, AS MONEY DAMAGES PROVIDED A FULL, FAIR AND COMPLETE REMEDY FOR BREACH OF AN AFFIRMED AGREEMENT TO PAY MONEY FOR PURCHASED ASSETS.

A. PRESERVATION OF THE ISSUE.

The issue of subject-matter jurisdiction was raised by Mr. Walters and ESGI on a motion to dismiss (D.I. 32), which motion was denied by the Court of Chancery. (D.I. 38, Ex. A hereto at *6-8).

B. SCOPE OF REVIEW.

This Court reviews *de novo* whether there is a basis for the assertion of subject-matter jurisdiction by the Court of Chancery. *Candlewood Timber Group, LLC v. Pan American Energy, LLC*, 859 A.2d 989, 998 (Del. 2004).

C. MERITS OF THE ARGUMENT.

The Court of Chancery is a court of limited jurisdiction. *Clark v. Teeven Holding Co., Inc.*, 625 A.2d 869, 875 (Del. Ch. 1982). Apart from cases where a statute specifically confers jurisdiction upon the Court of Chancery, that court has jurisdiction only where (1) the plaintiff asserts a claim that is equitable in character, 10 *Del. C.* §341, or (2) there is a need for relief that is equitable in nature, 10 *Del. C.* §342. *Candlewood Timber Group, LLC*, 859 A.2d at 997.

1. The Causes of Action Do Not Justify Equity Jurisdiction.

The asserted claims for breach of contract, whether express (Count II), implied or quasi-contract (Counts III & VI) or by promissory estoppel (Count VI), are all legal claims. *Testa v. Nixon Uniform Service, Inc.*, 2008 WL 4958861 at *3 n.23 (Del. Ch. Nov. 21, 2008).[3]

A claim for unjust enrichment/quasi-contract (Count VI) where, as here, the plaintiff seeks damages as an alternate theory of recovery to a contract claim, is a legal, and not an equitable, cause of action. *Crosse v. BCBSD, Inc.*, 836 A.2d 492, 496-97 (Del. 2003). Indeed, this Court has held that, for a claim of unjust enrichment to be cognizable in equity, there must be no adequate remedy at law. *Otto v. Gore*, 43 A.3d 120, 138 (Del. 2012); *Nemec v. Shrader*, 991 A.2d 1120, 1130 (Del. 2010).

The jurisdiction of the Court of Chancery over fraud claims is limited to those cases where either (I) fiduciary or other special relationships are involved, or (ii) there is no adequate remedy at law. *See Harman v. Masoneilan Intern., Inc.*, 442 A.2d 487, 498 (Del. 1982); *Cochran v. F.H. Smith Co.*, 174 A. 119, 121 (Del. Ch. 1934) ("[i]t is not every fraud case that is entitled to be

[3] Unreported decisions cited to herein are attached hereto in alphabetical order beginning at Exhibit C.

redressed in equity. If all that is sought in equity as a relief against fraud is nothing more than what legal tribunals can afford, then equity will not stir itself"); *U.S. West, Inc. v. Time Warner, Inc.*, 1996 WL 307445 at *26 (Del. Ch. June 6, 1996)("[t]he notion of equitable fraud does not swallow common law fraud whole because equitable fraud can only be applied in those cases in which one of the two fundamental sources of equity jurisdiction exist: (1) an equitable right founded upon a special relationship over which equity takes jurisdiction, or (2) where equity affords its special remedies, *e.g.,* "rescission, or cancellation; where it is sought to reform a contract...or to have a constructive trust decreed," citation omitted). There are no fiduciary relationships here.

Equitable jurisdiction in this case, therefore, depends on whether there is a legitimate need for equitable relief. As demonstrated below, there is not.

2. As Envo Affirmed the APA It Is Not Entitled to Equitable Relief.

In its Amended Complaint, Envo alleged that it was induced into entering into the APA by fraud. (A-28). As such it had two options: it could affirm the APA and seek damages at law, or it could disaffirm the APA and seek rescission and restitutionary remedies. *Clark,* 625 A.2d at 877. Envo chose the former.

In *Wolf v. Magness Const. Co.*, 1994 WL 728831 (Del. Ch. Dec. 20, 1994), the Court of Chancery stated that:

> The Wolfs could have elected to reject the contract and request a return to the status quo ante. If they had chosen this option, they could have brought an equitable action for rescission, which contains a lesser scienter requirement than a common law fraud action. The Wolfs have chosen to accept the contract and assert an ex contractu claim for the tort of fraud. The Wolfs do not seek to return to the status quo ante, but request an injunction that will force Magness to make good on its agent's misrepresentation. Because the Wolfs have affirmed the contract and sought a further remedy in tort, their claim is one for common law fraud, not equitable fraud.

WL Op. at *5 (citations omitted).

Similarly here, in its Amended Complaint, Envo did not seek to rescind the agreement (not even in the alternative), but only to enforce it and utilize an equitable remedy to obtain the bargained-for purchase price.[4] This does not justify equitable jurisdiction.

3. As Money Damages Provides Full, Fair and Complete Relief, There Is No Justification for Equitable Remedies.

Although Envo requested a constructive trust, merely requesting equitable relief is insufficient to confer equitable jurisdiction. *McMahon v. New Castle Associates*, 532 A.2d 601, 603

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[4] Envo's original Complaint, which was dismissed for lack of subject matter jurisdiction, asserted a claim for rescission. (A-3-4). By filing an Amended Complaint without the rescission claim, thereby withdrawing that claim, Envo affirmed the agreement, limiting its relief to damages at law. *Lightning Litho, Inc. v. Danka Indus., Inc.*, 776 N.E.2d 1238, 1240-41 (Ind. App. 2002).

(Del. Ch. 1987). Instead, when jurisdiction is asserted based on a request for equitable relief, the Court must determine "if the complaint, objectively viewed, discloses a need for such equitable relief." *Candlewood Timber Group, LLC*, 859 A.2d at 997.

Had Envo brought suit in the law courts for fraud or breach of an express or implied contract, and been successful as to any one of the defendants, it could have recovered the contract price of $300,000, plus interest, constituting full, fair and complete relief. As such, there is no need for any equitable relief.

Delaware courts have consistently found that a constructive trust is not needed when contract damages are available. For example, in *Testa*, the Court held:

> Testa feels that he was not paid what he was due under the Plan. If he is correct, the Superior Court can award him monetary damages that will make him whole. Although Testa has asked for a constructive trust, that request is insufficient to create jurisdiction in this case. A request for the imposition of a constructive trust will only invoke this court's equitable jurisdiction if there is "either an identifiable fund to which plaintiff claims equitable ownership...or the legal remedy will be inadequate for another reason-such as the distinctively equitable nature of the right asserted." Here, there is no specific fund that Testa claims is rightfully his, the right he is asserting is fundamentally a legal one, and his legal remedies are entirely sufficient.

WL Op. at *3 (footnote omitted).

In *Metro Ambulance, Inc. v. Eastern Medical Billing, Inc.*, 1995 WL 409015 (Del. Ch. July 5, 1995), the plaintiff sought a

constructive trust to obtain the defendant's billing records to determine the amount of damages. The Court held that:

> Metro's claim for a constructive trust is not based on an equitable theory of beneficial entitlement. Metro desires money damages. The source documents are nothing more than a tool for calculating the damages. The documents can be "recovered" through discovery in a court of law. Furthermore, an adequate legal remedy exists for conversion in an action at law for trover. Therefore, Metro has an adequate remedy at law.

WL Op. at *4 (citation omitted).

In *Woodcock v. Neel*, 1990 WL 154142 (Del. Ch. Sept. 26, 1990), in dismissing the action for lack of subject matter jurisdiction, the Court stated:

> Woodcock does not seek the specific property at issue. Although he does seek the proceeds from the sale of the specific property, the identifiability of these proceeds is very much in doubt. The purported sale occurred well over a year ago with no action being taken to preserve or identify the proceeds of that sale. In addition, Woodock's pleadings contain no indication that the proceeds are identifiable. Any constructive trust would, therefore, amount to a vehicle to facilitate the recovery of money.
>
> Constructive trusts have been, and can be, used to recover money. In such cases, however, there must be either an identifiable fund to which equitable ownership is claimed or no adequate legal remedy. As noted, Woodock's pleadings have not identified any such fund nor does it appear likely that one exists. In addition, Woodcock has an adequate legal remedy, i.e., money damages against Neel in connection with their 1986 agreement. Such money damages can be obtained in Superior Court under a variety of legal theories.

WL Op. at *2-3 (citations omitted).

In *McMahon*, the Court held:

> When the right asserted is not distinctly equitable in origin, the request for a constructive trust will ordinarily succeed in conferring jurisdiction in equity only when a claim to specific property is asserted. For example, if A defrauds B of Blackacre, equity should stand ready to require a reconveyance through the device of a constructive trust upon proof of the elements of fraud even if there is no fiduciary relationship between them. If, however, A defrauds B of $10,000, equity will not – absent some other fact that renders the legal remedy for the recovery of money inadequate – entertain a suit to recover the money, even if, as here, plaintiff characterizes the remedy as a request to impress the funds wrongfully obtained with a constructive trust.
>
> Here we have no claim to equitable ownership of specific property and, thus, the prayer for the remedy of constructive trust does not alone confer jurisdiction on this court. Nor is the right asserted when properly understood based upon a fiduciary duty or other duty recognized solely in equity. All that the complaint presents, in my view, is a request for damages for breach of an arms-length relationship. So long as we remain undazzled by labels, a request of this kind must be denied. Plaintiff's remedy at law is fully adequate to redress any valid claim that may be presented by his complaint.

532 A.2d at 609.

These principles are properly applicable here.

4. The Trial Court Erred in Finding Equitable Jurisdiction by Considering a Constructive Trust As a Device to Ensure Payment of Any Judgment.

The trial court justified the potential imposition of a constructive trust on the ground that (i) the measure of damages may be different, depending on whether Envo could prove legal fraud or equitable fraud, and (ii) if ESGI were found innocent of any

wrongdoing but the individual defendants were found liable, a constructive trust might be necessary to reach retained profits to pay any judgment. As demonstrated below, these justifications do not demonstrate that an award of damages at law would be insufficient or uncollectible.

a. The Court of Chancery Confused the Measure of Damages.

The Court of Chancery justified a constructive trust in part by noting that, if Envo proved only negligent misrepresentation as opposed to fraud, the measure of damages would be as set forth in *Restatement (Second) of Torts* §552B, and would result in "the focus in terms of relief...be[ing] much more on the assets Defendants obtained under the APA." (Ex. A at *8).

The Court of Chancery's reliance on a measure of damages for negligent misrepresentation appears to be the result of unfortunate confusion. The phrase "negligent misrepresentation" is frequently used as a synonym for equitable fraud, *e.g., Deloitte LLP v. Flanagan*, 2009 WL 5200657 at *7 (Del. Ch. Dec. 29, 2009); *Williams v. White Oak Builders, Inc.*, 2006 WL 1668348 at *7 (Del. Ch. June 6, 2006), *aff'd mem.*, 913 A.2d 571 (Del. 2006), and that is how it was used in Envo's Amended Complaint. (A-10-11).

There is no "measure of damages" for equitable fraud, because equitable fraud may only be asserted to obtain equitable relief,

and not money damages. *NCP Litigation Trust v. KPMG LLP*, 901 A.2d 871, 896 n.8 (N.J. 2006). To the extent a plaintiff seeks damages in addition to equitable relief, the plaintiff must prove "legal fraud," including knowing or reckless falsity, *i.e.*, scienter, which need not be proven to establish equitable fraud. *Asbury Square, L.L.C. v. Amoco Oil Co.*, 396 F.Supp.2d 1009, 1010-11 (S.D. Iowa 2005); *Nalley Northside Chevrolet, Inc. v. Herring*, 450 S.E.2d 452, 455 (Ga. App. 1994); *Hardwick v. Morrison Co. v. Albertson*, 605 A.2d 529, 532 (Vt. 1992); *Foont-Freedenfeld Corp. v. Electro-Protective Corp.*, 314 A.2d 69, 71 (N.J. Super A.D. 1973), *aff'd*, 314 A.2d 68 (N.J. 1974). Were it otherwise, all plaintiffs seeking damages would file fraud claims in the Court of Chancery so as to avoid the scienter requirement.

However, the phrase "negligent misrepresentation" is also used to denote a separate legal tort, based in negligence and not fraud:

> One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Restatement (Second) of Torts §552 (quoted and adopted in *Guardian Const. Co. v. Tetra Tech Richardson, Inc.*, 583 A.2d 1378, 1383-86 (Del. Super. 1990)). That tort claim is not asserted in Envo's

Complaint, since that tort is limited to circumstances where (I) the defendant is in the business of providing the type of information in question, and (ii) the plaintiff utilizes the information in connection with transactions with third parties. *Danforth v. Acorn Structures, Inc.*, 1991 WL 269956 (Del. Super. Nov. 22, 1991),*aff'd*, 608 A.2d 1194 (Del. 1992). Neither of those circumstances is alleged or applicable here.

Thus, when the Court of Chancery referred to the measure of damages for "negligent misrepresentation" as part of the justification for a constructive trust, its citation to *Restatement (Second) of Torts* §552B was erroneous, as Section 552B applies to the negligence-based tort identified in Section 552, and not to "negligent misrepresentation" as used here as a synonym for "equitable fraud."

b. The Difference in the Measure of Damages Does Not Implicate Equitable Jurisdiction.

Even if the Court were to allow damages for negligent misrepresentation/equitable fraud and accept *Restatement (Second) of Torts* §552B as a measure of such damages, the fact remains that it is a measure of *damages*, and that damages are available in an action at law. As Envo was not seeking to rescind the contract and recover the assets, and as there is no showing that execution process under court rules would not be availing, an award of

damages would constitute full, fair and complete relief, while preserving the defendants' constitutional right to a jury trial under *Del. Const.* Art. I, §4.

II. ENVO'S CLAIMS ARE BARRED BY THE STATUTE OF LIMITATIONS.

A. PRESERVATION OF THE ISSUE.

The issue of the Statute of Limitations was raised by Mr. Walters and ESGI on a motion to dismiss (D.I. 32), on a motion for summary judgment (D.I. 55-56) and in post-trial briefing. (D.I. 82). The Court of Chancery rejected that defense. (Exs. A, B).

B. SCOPE OF REVIEW.

Whether a Complaint is barred by the Statute of Limitations is a legal question subject to *de novo* review. *LeVan v. Independence Mall, Inc.*, 940 A.2d 929, 932 (Del. 2007). Post-trial factual findings bearing on the application of the Statute of Limitations are reviewed for clear error. *SmithKline Beecham Pharmaceuticals Co. v. Merck & Co., Inc.*, 766 A.2d 442, 450 (Del. 2000).

C. MERITS OF THE ARGUMENT.

1. Legal Standards.

In the absence of fiduciary relationships, "an action in the Court of Chancery for damages or other relief which is legal in nature is subject to the statute of limitations rather than the equitable doctrine of laches." *Laventhol, Krekstein, Horwath and Horwath v. Tuckman*, 372 A.2d 168, 170 (Del. 1976).

"Absent some unusual circumstances, a court of equity will deny a plaintiff relief when suit is brought after the analogous

statutory period." *U.S. Cellular Inv. Co. of Allentown v. Bell Atlantic Mobile Systems, Inc.*, 677 A.2d 497, 502 (Del. 1996).

The Statute of Limitations starts to run when a cause of action accrues. *WalMart Stores, Inc. v. AIG Life Ins. Co.*, 860 A.2d 312, 219 (Del. 2004). A cause of action accrues at the time of the injury, for tort claims, *Kaufman v. C.L. McCabe & Sons, Inc.*, 603 A.2d 831, 834 (Del. 1992), and, for contract claims, at the time of the breach. *Allstate Ins. Co. v. Spinelli*, 443 A.2d 1286, 1292 (Del. 1982). The period is 3 years, 10 *Del. C.* §8106(a), including tort and express and implied contract claims. *See Freedman v. Beneficial Corp.*, 406 F.Supp. 917, 922-23 (D. Del. 1975).

Under the time of discovery rule, a cause of action accrues when the harmful effect of an otherwise unknowable injury first manifests itself and becomes physically ascertainable. *Cole v. Delaware League for Planned Parenthood, Inc.*, 513 A.2d 1119, 1121 (Del. 1987). In order to toll the statute of limitations, the injury or conditions giving rise to the claim must have been inherently unknowable and the plaintiff must have been blamelessly ignorant. *Layton v. Allen*, 146 A.2d 794, 798 (Del. 1968).

As to the first element, it is the injury, and not the cause of action, which must be inherently unknowable. *Boerger v. Heiman*, 965 A.2d 671, 674 (Del. 2009); *Coleman v. PriceWaterhouse Coopers, LLC*, 854 A.2d 838, 842 (Del. 2004). *See also Began v. Dixon*, 547

A.2d 620, 623 (Del. Super. 1988) (knowledge of the legal theory is not required before the Statute of Limitations begins to run).

If the injury is known, it is not necessary that the plaintiff know the specific cause of the injury, the full extent of the injury, or even the identity of every party liable for the damage. *PPG Industries, Inc. v. JMB/Houston Centers Partners Ltd. Partnership*, 146 S.W.3d 79, 93 (Tex. 2004). *See also New Castle County v. Halliburton NUS Corp.*, 111 F.3d 1116, 1125 (3rd Cir. 1997).

2. <u>On the Motion to Dismiss.</u>

a. The Injury Occurred, and Was Known to Envo, Over Three Years Before the Complaint Was Filed, and There is No Basis for Tolling the Statue of Limitations.

As noted above, the default on payment to Envo occurred on the day the agreement was signed, July 21, 2005, and no payment was ever made at that time or any time prior to the instigation of litigation. As such, the injury was not "inherently unknowable." Rather, it was fully known. Suit was filed over three years later.

On a motion to dismiss, where the Complaint on its face reveals that the suit was brought beyond the limitations period, the plaintiff is obligated to plead facts demonstrating that the Statute of Limitations should be tolled. *State ex rel. Brady v. Pettinaro Enters.*, 870 A.2d 513, 525 (Del. Ch. 2005).

(1). Contract Claims.

The trial court ignored the tolling issue, electing instead to find that a different Statute of Limitations applied to the implied contract and estoppel claims:

> Count III is analogous to a cause of action arising from a promissory note. This count seeks to hold Defendants Walters and Aylor liable for breaching a contract implied in fact by not paying on the promissory notes they signed on behalf of a nonexistent entity when they took possession of Envo's environmental consulting firm. Because Envo's basis for implying a contract in Count III is Walters and Aylor's signing of the promissory notes, this cause of action arises from a promissory note and would be subject at law to the six-year statute of limitations prescribed by Section 8109.

(Ex. A at *9).

The Legislature has expressly provided that "no action to recover a debt *not evidenced by a record* or by an instrument under seal" shall be brought within three years. 10 *Del. C.* §8106(a). Thus, absent a writing, Section 8106(a) applies, not Section 8109.

A "promissory note," by definition, must be in writing. 6 *Del. C.* §§3-103(a)(9), 3-104(a); *Saunders v. Stella*, 1989 WL 89518 (Del. Super. June 29, 1989); *Black's Law Dictionary* 1093 (5th ed. 1978). Thus, there is no such thing as an "implied" promissory note, and the implied (non-written) contract claims cannot be analogized to claims arising from a (written) promissory note.

As claims of implied contract arise independently of any written agreements, they cannot support a theory of an implied

promissory note. *See F.D.I.C. v. Dintino*, 84 Cal. Rptr. 3d 38, 50 (Cal. App. 2008) ("[b]ank's cause of action for unjust enrichment based on its mistaken request for recordation of the Reconveyance is not based on, and does not arise out of, a written contract (i.e., the Note), but rather is based on an obligation implied by law because of the equities in the circumstances of this case"); *Iverson, Yoakum, Papiano & Hatch v. Berwald*, 90 Cal.Rptr.2d 665 (Cal. App. 1999) (where promissory notes were unenforceable, claim for quantum meruit was subject to limitations period for contracts not in writing); *Sherling v. Long*, 50 S.E. 935 (Ga. 1905) (right of co-obligor under promissory note to recover contribution arises from implied contract, not promissory note, and so statute of limitation for promissory notes does not apply). As such, it is incorrect to characterize Envo's claims as "arising from" the promissory notes.

Even if this Court were to reject this analysis, the trial court's analogy still does not hold, because the proper focus is the APA, not the promissory notes. The promissory notes arise from the terms of the APA, which expressly refers to and incorporates the promissory notes, and which constitutes the consideration for the notes. (A-46-77).

"As between the immediate parties a negotiable instrument is merely a contract or part of an overall contractual

transaction...Any defense to the underlying obligation...is also a defense to the promissory note so long as the instrument remains in the hands of one who is not a holder in due course." *Perry v. Cain*, 581 P.2d 891, 894 (Ok. 1978). *Accord MetalCraft, Inc. v. Pratt*, 500 A.2d 329, 333 (Md. 1985) ("the contract expressly referred to and made provision for the note. The parties to this proceeding are the original parties to both contract and note. Under these circumstances, and to the extent established, a defense to or claim arising out of the contract is a defense against the note..."); *Seamans v. Miller*, 235 S.E.2d 542, 543 (Ga. App. 1977); *Impex Metals Corp. v. Oremet Chemical Corp.*, 333 F.Supp. 771, 773 (S.D.N.Y. 1971) ("[t]he third cause of action is based upon a commercial draft, drawn on defendant's New York bank. However, inasmuch as no negotiation, assignment, or other transfer of the draft has taken place, all personal and real defenses available against the other two causes of action based upon the underlying agreement are available here as well"); *Zehring v. Driskel*, 339 P.2d 57, 58 (Kan. 1959) ("any defense available against enforcement of the underlying contract may be set up in the action on the note, since this was an action between the original parties to the note").

In other words, as any claim for breach of the underlying APA is barred by the Statute of Limitations applicable to it (three

years under 10 *Del. C.* §8106(a)), then no action can brought on the dependant promissory notes.

Moreover, to the extent that implied or quasi-contract claims, by definition, do not arise from the written APA, then by the same token they do not arise from the written promissory notes, and so Section 8109 is not applicable.

(2). Tort Claims.

The trial court deemed the Statute of Limitations tolled as to the tort claims on the ground that the signing and notarization of the APA constituted fraudulent concealment of the claim. (Ex. A at *10). As those are the same acts upon which the tort claims are based, however, the fraudulent concealment exception cannot apply.

"A plaintiff may not rely on the same act that forms the basis for the claim – the later fraudulent misrepresentation must be for the purpose of concealing the former tort." *Ross v. Louise Wise Services, Inc.*, 868 N.E.2d 189, 198 (N.Y. 2007). Therefore, the act of executing the APA and the promissory notes cannot serve as the basis for a claim of fraudulent concealment in addition to the claim of fraud. Envo had to identify an independent affirmative act of fraudulent concealment. *Ross v. Citifinancial, Inc.*, 344 F.3d 458, 463-64 (5th Cir. 2003) (applying Mississippi law).

As there was no such event, there was no act of fraudulent concealment, and the three-year limitations period must be applied.

3. **Post-Trial Decision.**

In its post-trial decision, the Court of Chancery ruled that the Statute of Limitations was tolled under the "inherently unknowable injury rule" on the ground that non-payment did not signal breach, or intent to breach, the APA because the parties were negotiating post-closing issues. (Ex. B at *8-10). This conclusion is contrary to law.

First, the "inherently unknowable injuries" rule (also known as the "time of discovery" rule, *Benge v. Davis*, 553 A.2d 1180, 1182-83 (Del. 1989)), is not properly applicable here. As one court has explained:

> a claim for breach of contract accrues under D.C. law at the time of the breach, and not when the promisee receives notice that the promisor does not intend to pay. And while D.C. uses the "discovery rule" in cases involving latent injuries, the rule has no application in this case because the failure to receive funds owed pursuant to a contract is not a latent injury. To the contrary, the alleged injury manifests itself at the time of the breach.

Hunter Innovations Co. v. Travelers Indem. Co. of Connecticut, 753 F.Supp.2d 597, 604 (E.D. Va. 2010)(citation, parenthetical and footnote omitted). Once a contract is breached, notice of intention not to perform is not required.

Further, under Delaware law negotiations and discussions about payment do not toll the Statute of Limitations. *Mergenthaler v. Asbestos Corp. of America*, 500 A.2d 1357, 1365 (Del. Super. 1985);

VLIW Technology, LLC v. Hewlett-Packard Company, 2005 WL 1089027 at *13 (Del. Ch. May 4, 2005). The *VLIW* court stated that tolling the limitations period for negotiations would undermine the public policy behind statutes of limitations:

> In almost all disputes that end up in court, the parties attempt some sort of negotiation to avoid litigation. Tolling the statute of limitations during such negotiations, without agreement of the parties, would encourage potential plaintiffs to engage in bad faith negotiations to lengthen the time they would have to bring a suit. It would also discourage potential defendants from engaging in negotiations to avoid giving plaintiffs more time to bring their suits. This is to be avoided.

Id.

Moreover, in *Central Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC*, 2012 WL 3201139 (Del. Ch. Aug. 7, 2012), the Court of Chancery stated that:

> Equitable estoppel works to excuse an untimely filing only when the offer to repair persists throughout the statutory period and the plaintiff became aware of the need to bring suit only after it was too late. In other words, if the plaintiff has adequate time to sue within the statutory period once he is put on notice that the defendant no longer plans to cure the breach, then the plaintiff is expected to do so.

WL Op. at *27 (footnote omitted). The Court went on to explain:

> If, for example, the plaintiff learns at the end of the first year of the statutory period that the defendant no longer intends to cure the breach at issue, then the plaintiff is not entitled under an equitable estoppel theory to tack on to the three-year limitations period that first year spent in settlement negotiations.

Id. WL Op. at *27 n.213.

In the present action, there is no evidence that any of the defendants said or did anything to lull Envo into believing that payment would be forthcoming, or that they would not seek the benefits of the Statute of Limitations.

The evidence only showed that (i) a dispute over certain missing assets was resolved within days of closing (with the initial $10,000 or any other amounts due still not paid to Envo thereafter), and (ii) Mr. Kollias, on behalf of Envo, refused to renegotiate the purchase price, but agreed to consider any proposal as to the payout terms, which resulted in a rescheduling of payment of accounts receivable (but not the purchase price). (Ex. B at *9; A-190, 250-54). This does not meet the required "clear and convincing" standard required for estoppel. *See Skalniak v. Dey*, 793 A.2d 1250, 1253-54 (Del. Fam. Ct. 2001).

III. THE COURT OF CHANCERY ERRED IN ASSESSING PERSONAL LIABILITY WHEN IT WAS THE UNDERSTANDING OF THE PARTIES THAT THERE WOULD BE ONLY CORPORATE LIABILITY FOR THE DEBT.

A. PRESERVATION OF THE ISSUE.

This issue came up during post-trial oral argument, as memorialized in a letter to the Court of Chancery (D.I. 86), and was addressed in the post-trial opinion. (Ex. B at *13).

B. STANDARD OF REVIEW.

The propriety of a court-ordered remedy is ordinarily reviewed for abuse of discretion, but where the issue is whether the disputed remedy was erroneous as a matter of law, because the trial court erred in formulating or applying legal principles, review is *de novo*. *Berger v. Pubco Corp.*, 976 A.2d 132, 139 (Del. 2009).

C. MERITS OF THE ARGUMENT.

The Court of Chancery found Mr. Walters and Mr. Aylor personally liable on the ground that, since a corporation was not properly formed, the result was that they entered into a contract as a partnership. (Ex. B at *13).

"When a party contracts with an imperfectly organized corporation, he is estopped to deny its corporate existence and is precluded from recovering from its members individually as if they were partners." *American Gas Const. Co. v. Lisco*, 241 N.W. 89 (Neb. 1932). *See also Cleary v. North Delaware A-OK Campground, Inc.*, 1987 WL 28317 at *4 (Del. Super. Dec 09, 1987) (personal liability

not imposed because there was a good faith effort to incorporate which failed because the name was not available); *Inter-Ocean Newspaper Co. v. Robertson*, 129 N.E. 523, 524-25 (Ill. 1920) (stockholders of de facto corporations dealing in good faith are not liable as partners absent statute); *Jennings v. Dark*, 92 N.E. 778, 781-82 (Ind. 1910) (where corporation was not properly formed but could have been, and plaintiff deals with corporation, there is no personal liability).

It is undisputed that Envo sought but did not obtain personal guarantees from the individual defendants, thereby limiting itself to recovery from an entity. It is also undisputed that the individual defendants relied in good faith on their attorney, who attempted to form a corporation but failed. It is also undisputed that subsequently a new corporation was formed assuming the assets and business under the APA. Mr. Kollias did not deny knowledge of these events. There is no evidence of bad faith conduct.

The circumstances, as a whole, reveal that it was Envo's intent at the time not to require personal liability, and, as such, Mr. Walters and Mr. Ayer should not be held personally liable. *See GS Petroleum, Inc. v. R and S Fuel, Inc.*, 2009 WL 1554680 at *3-4 (Del. Super. June 4, 2009).

CONCLUSION

WHEREFORE, for the foregoing reasons, defendants-below/appellants respectfully request that this Court reverse the decision of the trial court, and dismiss this action for lack of subject matter jurisdiction, and, for reasons of judicial efficiency, make such dismissal with prejudice on the ground that the claims are barred by the Statute of Limitations:

Respectfully submitted,

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