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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,
Appellant,

v.

DUNCAN PETROLEUM CORPORATION and ROBERT M. DUNCAN.

Defendant Below,
Appellee.

No. 540-2013

On appeal from the Court of Chancery of the State of Delaware,
C.A. No. 4948-VCL

APPELLANTS' OPENING BRIEF

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TABLE OF CONTENTS

Page

TABLE OF CITATIONS iii

NATURE OF PROCEEDINGS 1

SUMMARY OF ARGUMENT 4

STATEMENT OF FACTS 5

A. The Parties 5

B. Underlying Transaction 6

C. Due Diligence and Environmental Representations 6

D. Duncan's Regulatory Problems 9

E. Universal's Suit against Duncan and Duncan Petroleum 10

F. Bankruptcy 11

G. The Trial Court Found that Duncan Knowingly Made False Representations to Induce Universal to Purchase the Properties 11

H. The Trial Court's Ruling on Duncan's Equitable Recoupment Defense 13

ARGUMENT 16

A. The Trial Court Erred, First, By Not Applying the Proper Standard for Allowing the Equitable Defense of Recoupment and, Second, By Determining That Duncan Can Rely on the Defense of Recoupment Despite His Unclean Hands 17

1. Question Presented 17

2. Scope of Review 18

3. Merits of the Argument 19

CONCLUSION..32

TABLE OF CITATIONS

Cases **Page**

Allen v. State, 2012 WL 1658351 (Del. 2012) 20

American Sunlake Ltd. P'ship, 109 B.R. 727 (Bankr. W.D. Mich. 1989) 21

Ashland Petroleum Co. v. Appel (In re B&L Oil Co.), 782 F.2d 155 (10th Cir. 1986) 20

Belle Isle Corp v. Corcoran, 49 A.2d 1 (Del. 1946) 20

Bodley v. Jones, 59 A.2d 463 (Del. 1947) 22, 23, 26

Derickson v. Derickson, 281 A.2d 487 (Del. 1971) 24

Deweese v. Reinhard, 165 U.S. 386 (1897) 23

E.J. Stephen, Inc. v. Ceccola, Del. Ch. C.A. No. 7578, 1984 WL 8238, Berger, V.C. (July 9, 1984) 26

Federal United Corp. v. Havender, 11 A.2d 331 (Del. 1940) 23

Gallagher v. Holcomb & Salter, 1991 WL 158969 (Del. Ch. Aug. 16, 1991) 24

General Motors Corp. v. Wolhar, 686 A.2d 170 (Del. 1996) 18

Gravel Express, Inc. v. Meadow Valley Contractors, Inc., 2000 WL 875319 (9th Cir. June 30, 2000) 20

In re American Home Mortgage Holdings, Inc., 401 B.R. 653 (D. Del. 2009) 19, 20

In re M&L Business Mach. Co., Inc., 198 B.R. 800 (D. Colo. 1996) 20

In re R&C Petroleum, Inc., 247 B.R. 203 (Bankr. E.D. Tex. 2000) 21

In re Wilbert L., 2010 WL 3565489 (Del. Ch. Sept. 1, 2010) 24

Mfrs. and Traders Trust Co., v. Washington House Partners, LLC, 2012 WL 1416003 (Del. Super. Ct. March 22, 2012)....23

Minskoff v. U.S., 349 F. Supp. 1146 (S.D.N.Y. 1972)....19

Portnoy v. Cryo-Cell Int'l Inc., 940 A.2d 43 (Del. Ch. 2008)....20

Poskin v. TD Banknorth, N.A., 687 F. Supp. 2d 530 (W.D. Pa. 2009)....19

Precision Instrument Mfg. Co. v. Automotive Maint. Mach. Co., 324 U.S. 806 (1945)....21, 25, 26

SmithKline Beecham Pharm. Co. v. Merck, 766 A.2d 442 (Del. 2000)....23, 25, 26, 30

Sutter Opportunity Fund 2 LLC v. Cede & Co., 838 A.2d 1123 (Del. Ch. 2003)....24

TIFD III-X LLC v. Fruehauf Production Co., LLC, 883 A.2d 854 (Del. Ch. 2004)....19, 20

Transfer My Timeshare, LLC v. Selway, 2009 WL 3271326 (D.N.H. Oct. 9, 2009)....19

Turchi v. Salaman, 1990 WL 27531 (Del. Ch. March 14, 1990)....24, 25

Turner v. State, 957 A.2d 565 (Del. 2008)....18

Treatises

80 C.J.S. *Set-off and Counterclaim* § 2 (2000)....19

Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate & Commercial Practice in the Del. Ct. of Chancery* § 11.07[b] (2013)....24

Pomeroy, *Equity Jurisprudence* § 400....25

NATURE OF PROCEEDINGS

This case comes before this Honorable Court on appeal by Charles R. Goldstein, Trustee, as the Trustee for the bankruptcy estate of consolidated debtors inclusive of 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, (collectively the "**SPEs**") and UNIVERSAL DELAWARE, INC. ("**UDI**") and as the assignee of Daniel Singh a/k/a/ Daminder S. Batra ("**Batra**") and UNIVERSAL ENTERPRISE GROUP, L.P. ("**UEG**"), plaintiffs below (collectively referred to as "**Universal**"), from the opinions of the Delaware Court of Chancery allowing Robert M. Duncan, defendant below, to rely on the equitable defense of recoupment to reduce the July 1, 2013 judgment in the amount of $1,497,429 that the Chancery Court previously granted to Universal ("**Universal's Judgment**"), thereby negating entirely any affirmative recovery by Universal on its breach of contract claim, as stated in Vice

Chancellor Laster's Memorandum Order dated July 1, 2013 and Final Order and Judgment dated September 10, 2013, in case number 4948-VCL.

This case arises out of a transaction in which Robert M. Duncan ("**Duncan**") and his wholly owned company, DUNCAN PETROLEUM CORP. ("**Duncan Petroleum**") willfully and deliberately misrepresented and withheld information regarding compliance violations and equipment problems at nineteen (19) gas station properties located in Delaware and Maryland in order to quickly divest themselves of the problematic properties. Based on their misrepresentations, Universal agreed to purchase the properties for a total purchase price of Sixteen Million Dollars ($16,000,000.00). After the expiration of the due diligence period (during which Duncan continued to withhold information), Universal completed the purchase of the properties. Duncan partially financed the transaction by providing an $8,000,000 loan, which was personally guaranteed by Batra.

On October 5, 2009, Universal filed a Verified Complaint against Duncan and Duncan Petroleum for fraudulent inducement, fraudulent concealment and equitable fraud. Thereafter, the Complaint was amended to add Batra as a plaintiff, to state additional claims against Duncan and Duncan Petroleum (declaratory judgment, rescission, and breach of contract) and to add DELTA

ENVIRONMENTAL CONSULTANTS, INC. ("**Delta**")[1] as a defendant for breach of contract, breach of warranty and negligence. As is relevant to this appeal, Duncan in response asserted counterclaims for non-payment of the balance of the $8,000,000 loan note.

Trial was held on December 3-5, 2012, and, after a brief planned hiatus, concluded on December 19, 2012. The trial court issued its Memorandum Opinion ("**Opinion**") on July 1, 2013 and entered the Final Order and Judgment on September 10, 2013 ("**Order**").

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[1] As noted in the trial court's July 1, 2013 Memorandum Opinion, Delta reached a settlement with Universal during the third day of trial. A001088.

SUMMARY OF ARGUMENT

The argument before this Court on appeal is that the trial court erred, first, by not properly applying Delaware law for allowing the equitable relief of recoupment; and, second, by determining that Duncan can rely on recoupment—despite its determination that Duncan *engaged in inequitable conduct*, to reduce Universal's recovery (*i.e.*, Universal's Judgment of $1,497,429) to a final judgment entered in favor of Universal in the amount of $0.

Under Delaware law

1. The Chancery Court must determine whether the party seeking the equitable defense of recoupment comes with clean hands before applying the equitable defense of recoupment.
2. Having expressly found inequitable conduct by the party seeking the equitable defense of recoupment, the Chancery Court should have denied the equitable defense of recoupment.

STATEMENT OF FACTS

A. The Parties

Batra controlled a network of related entities that owned and operated gas stations and convenience stores in Pennsylvania, Delaware and New Jersey. A001072.

Duncan owned and operated gasoline service stations and convenience stores. A001063. By 2007, he had formed and served as President and sole stockholder of Duncan Petroleum and had assembled a portfolio of nineteen gas stations and associated real estate located in Delaware and the eastern shore of Maryland (“**Properties**”). A001063-A001064. Because the Properties were used as gasoline service stations with underground storage tanks (“**USTs**”), the Properties were heavily regulated. A001064. The eight Delaware Properties had to comply with the Delaware Regulations Governing Underground Storage Tanks, which were enforceable by both the Delaware Department of Natural Resources and Environmental Control (“**DNREC**”) and the U.S. Environmental Protection Agency (“**EPA**”). A001064. The eleven Maryland Properties had to comply with similar Maryland regulations, which were enforceable by both the Maryland Department of the Environment (“**MDE**”) and the EPA. A001064.

B. Underlying Transaction

In the spring of 2007, Batra was exploring various opportunities to grow his gas station and convenience store business and learned of the availability of the Properties. A001072. Following negotiations, on July 31, 2007, Universal (as "Buyer") and Duncan and Duncan Petroleum (as "Seller") entered into an agreement for the sale of the Properties for a total price of $16 million ("**Sale Agreement**"). A001073. Under the terms of the Sale Agreement, Universal paid $500,000 in earnest money at signing and would pay another $7.5 million in cash at closing, to be financed through a loan from TD Bank. A001073. Universal would acquire each Property through a separate special purpose entity ("**SPE**") and each SPE would sign a promissory note in favor of Duncan for its allocated portion of the outstanding $8 million balance (collectively the "**Notes**"). A001073. On November 15, 2007, the transaction closed. A001086.

C. Due Diligence and Environmental Representations

The Sale Agreement provided Universal a sixty-day due diligence period during which Universal would have the opportunity to conduct a comprehensive investigation of the Properties. A001074. To facilitate Universal's due diligence, Duncan agreed that "[i]n response to Buyer's reasonable request, Seller shall supply such documentation as Seller has or can readily obtain from third parties, to permit Buyer to complete such inspections and review in a timely manner."

A001074. Duncan further committed to provide Universal with his environmental files and disclosed a consent agreement with EPA (the "Seller Files Covenant"):

> (d) *Copies of Seller's Files*. In connection with the preparation of any environmental assessment report desired by Buyer, during the sixty (60) day Due Diligence Period, Seller shall allow the Buyer, its employees, consultants or agents to inspect the Seller's environmental books and records and make available copies of the same.
>
> (1) Seller shall supply Buyer with a copy of previously completed phase II reports, analyses or studies of any of the subject Properties. ...
>
> (2) Seller hereby discloses unto the Buyer that on or about February 14, 2006 Duncan Petroleum Corp. entered into a consent agreement [(the "Consent Agreement and Final Order" or "CAFO")] with the [EPA] resolving an administrative enforcement matter and in regard thereto paid a $65,000.00 fine.

A001074.

In addition, Duncan represented that—except as disclosed in documents provided pursuant to the Seller Files Covenant—the following statement (the "Environmental Compliance Representation") was true:

> To the best of the Seller's knowledge, the Seller has received no notice as of the Effective Date of the Agreement from DNREC or MDE requiring the Seller to undertake environmental corrective or remedial actions ... and to the best of the Seller's actual knowledge, the Property is in compliance with all applicable Environmental Laws.

A001075. While the Sale Agreement acknowledged that the Properties had been for many years used as retail motor fuel and convenience store facilities with underground petroleum storage systems, Duncan nevertheless represented that to his knowledge, except as shown in the documents he would provide to Universal, the Properties were "in compliance with all applicable Environmental Laws." A001075-A001076. Duncan also represented the absence of any investigation or litigation affecting any portion of the Property and stated that the Properties were operated and maintained in compliance with the law. A001076.

The Sale Agreement backstopped Duncan's specific representations by warranting that his representations were true and not materially misleading as follows:

> Section 11(t): To the best of the Seller's knowledge, information and belief, neither this Agreement … or any other information, report or statement furnished or delivered to Buyer by Seller contains any untrue statement or omits to state a material fact necessary to make the statements herein or therein not misleading. Seller has disclosed all material facts which are known to the Seller relating to ownership, operation and maintenance of the Property.
>
> Section 11(ii): No representation or warranty by Seller contained in this Agreement … or other instrument furnished or to be furnished to Buyer … shall contain, any untrue statement of material fact to the best of the Seller's knowledge, information and belief.

A001077.

D. Duncan's Regulatory Problems

As the trial court found, contrary to Duncan's representations as stated in the Sale Agreement (*see above* Section III.C), Duncan had managed his regulatory responsibilities poorly and the Properties had received numerous citations and adverse reports from DNREC and MDE. A001064-A001069. The violations were pervasive and ran the gamut of problems from lack of maintenance records to malfunctioning equipment and release detection systems. A001065-A001069. Indeed, Duncan's compliance with regulatory requirements was so lacking as to cause the MDE to note:

> This site does not perform proper leak detection records. The Federal EPA [is] also involved with the owner, Mr. Bob Duncan. Mr. Duncan ignores the regulations and does what he feels like doing. Duncan Petroleum should not be allowed to operate in the State of Maryland due to the large number of violations at his facilities.

A001065.

Furthermore, the trial court also found that in the months before the Sale Agreement, Duncan had received numerous notices of noncompliance from the EPA and had been warned of civil penalties of up to $32,500 per day of continued noncompliance. A001069-A001071. Rather than comply with EPA requirements, the trial court found that the Duncan had misrepresented to the EPA that:

- he had hired Coastal Pump and Tank to perform tightness testing, when in fact, he never conducted tightness testing for any of the required tanks, as he later admitted;

- tightness testing was physically and economically impossible, when in fact, he admitted to having such tests performed at one of the other Properties; and
- he had arranged for the Properties to be certified by INCON, a petroleum monitoring systems provider, when in fact, none of the Properties were certified, as he again later admitted.

A001070. The trial court also found that when the EPA began to investigate twelve other Properties as a result of Duncan's inadequate compliance with the CAFO and requested information about numerous violations and equipment problems found during inspections, Duncan gave cursory answers and did not provide the requested documentary support. A001070-A001071.

E. Universal's Suit against Duncan and Duncan Petroleum

On October 5, 2009, Universal filed a Verified Complaint against Duncan and Duncan Petroleum for fraudulent inducement, fraudulent concealment and equitable fraud. Thereafter, the Complaint was amended to add Batra as a plaintiff, to state additional claims against Duncan and Duncan Petroleum (declaratory judgment, rescission, and breach of contract). A000086-A000568. Duncan and Duncan Petroleum filed their Answer and Counterclaims against Universal for non-payment of the balance of the $8,000,000 Note. A000569-A001005. Subsequently Universal filed its Answer to Duncan's Counterclaims, denying the allegations and asserting affirmative defenses, including the defense of

unclean hands. *See* Answer to Duncan's Counterclaim, Affirmative Defense ¶ 3, A001055-A001056.

F. Bankruptcy

In July 2009, Universal Marketing, Inc., an entity related to Universal, filed for bankruptcy ("UMI Bankruptcy") and Universal stopped making payments on the Notes. A001088, A001791-A001802. The bankruptcy was converted into a liquidation, and Charles R. Goldstein became trustee. A001088. Thereafter, in 2010, Universal was consolidated into the UMI Bankruptcy. A001803-A001827. The trustee entered into a settlement with Batra, who assigned to the trustee his interest in Universal and any claims against Duncan. A001088.

G. The Trial Court Found that Duncan Knowingly Made False Representations to Induce Universal to Purchase the Properties

Following trial of the matter, the trial court issued its Memorandum Opinion dated July 1, 2013 in which it found that:

- Duncan knowingly made a series of false representation in the Sale Agreement, including (i) both the Environmental Compliance Representation and the more general representations about compliance with laws, (ii) the absence of litigation, and (iii) the providing of all material information. A001090.
- Duncan received multiple notices from the EPA, DNREC, and MDE demonstrating his noncompliance and requiring him to undertake environmental corrective or remedial actions at the Properties. A001090.

- Duncan knew about the multiple notices from the EPA, DNREC, and MDE and about the ongoing environmental violations at the Properties. A001091.

- The existence of the notices and violations rendered the Environmental Compliance Representation false unless Duncan provided Universal with documents relating to the issues. A001091.

- At trial, Duncan admitted that during due diligence, he did not provide Universal with multiple documents reflecting his history of problems with DNREC and MDE, including violations that those agencies identified just months before the sale. A001091.

- Other than disclosing the CAFO in the Sale Agreement, Duncan did not provide Universal with any documents or information relating to the CAFO or their history of interaction with the EPA. A001091.

The trial court determined that Duncan had made these false representations and failed to provide records or otherwise inform Universal about the condition of the Properties because he wanted to induce Universal to buy the Properties. A001092. Duncan's decision to sell the Properties and retire from the petroleum industry was contemporaneous with the increasing regulatory interest in his business. A001071. By early 2007, Duncan was under substantial pressure from environmental regulators and he wanted to retire and leave the petroleum industry. A001092. For example, at one Maryland Property, during 2006 and 2007, MDE cited the Property on multiple occasions for improperly abandoning two USTs. A001066. MDE declined to pursue the violations against Duncan only after Duncan agreed to sell the Property. A001066. While Duncan was willing to be "very flexible" as to the structure of a transaction—whether it be a sale, a long-

term lease of certain Properties, or seller financing—he was not willing to retain any aspect of the business involving environmental oversight. A001072. In fact, the prospectus for the Properties stated: "Under all circumstances, any lease or purchase offer should include a provision in which the Buyer/Tenant will purchase all of the existing petroleum dispensing and underground tank storage equipment at each location." A001072. Duncan wanted to obtain the best price possible for the business that he had built over thirty years and knew that if he did not represent that the Properties complied with all environmental regulations and revealed his extensive record of violations, then either Universal would decline to buy or the price he negotiated would be jeopardized. A001092.

As the trial court found that Universal did not rely on Duncan's misrepresentations in a manner sufficient to support common law fraud, it therefore entered judgment in favor of Duncan on Universal's fraud claim. A001095-A001096. Nonetheless, because reliance upon Duncan's misrepresentation is not necessary for a breach of contract claim, the trial court proceeded to find that 1) Duncan breached the Sale Agreement and 2) Universal sustained actual damages in the amount of $1,497,429. A001099, A1106-A1107.

H. The Trial Court's Ruling on Duncan's Equitable Recoupment Defense

Although the trial court found that Duncan breached the Sale Agreement, the trial court stayed enforcement of Universal's Judgment pending resolution of

Duncan's counterclaims[2], through which Duncan had argued that any damages owed to Universal should offset the unpaid balance of the Notes. A001107. The trial court ordered supplemental briefing on the impact of Universal's pending bankruptcy on the trial court's power to grant Duncan's request to offset the damages. A001107.

Following the parties' simultaneous submission of supplemental briefing, the trial court entered its Final Order and Judgment finding that Duncan could rely on the equitable doctrine of recoupment to reduce Universal's recovery on the breach of contract claim. A001789- A001790. In the Order, the trial court revealed for the first time and held that the issue of recoupment was tried with *implied consent* and that because Duncan's request for recoupment involved the same litigants, the same transaction, and similar nature of relief (money), he was therefore entitled to rely on recoupment. A001788- A001789. The trial court did not, however, consider the equitable nature of the defense of recoupment and granted recoupment *without consideration of Duncan's unclean hands*, which Universal had asserted in its defense to Duncan's counterclaims. By failing to consider the impact of Duncan's unclean hands on the availability of the equitable

[2] Universal's consolidation with the UMI Bankruptcy automatically stayed Duncan's counterclaims. Consequently, the trial court's consideration of Duncan's counterclaims was limited to Duncan's defense of recoupment.

remedy of recoupment, the trial court erred in reducing Universal's recovery and only entering judgment in favor of Universal in the amount of $0.

ARGUMENT

In this case, the fundamental question is whether Duncan—who not only made misrepresentations to the EPA regarding his compliance with the CAFO, but also made a series of misrepresentations regarding compliance with laws, condition of the equipment and the absence of litigation and failed to provide all material information, all in order to divest himself of problematic Properties by inducing Universal to purchase the Properties at the best possible price—should be permitted to rely on the equitable defense of recoupment to reduce Universal's breach of contract damages, all of which were incurred to address and remedy problems at the Properties that Duncan had knowingly denied and concealed from Universal.

Although, as an equitable doctrine, recoupment was subject to equitable defenses, like the doctrine of unclean hands, the trial court erred by finding that Duncan engaged in inequitable conduct, but then simply disregarded that same inequitable conduct to permit Duncan to rely on recoupment despite his unclean hands.

A. The Trial Court Erred, First, By Not Applying the Proper Standard for Allowing the Equitable Defense of Recoupment and, Second, By Determining That Duncan Can Rely on the Defense of Recoupment Despite His Unclean Hands

1. Question Presented

Whether the trial court erred, first, when it did not apply the proper standard for allowing the equitable defense of recoupment and, second, when it determined that Duncan can rely on the defense of recoupment despite his unclean hands.

In the trial court's Memorandum Opinion, the trial court ordered supplemental briefing on the impact of Universal's pending bankruptcy on the trial court's power to grant Duncan's request to offset the damages. A001107. Universal submitted its Supplemental Brief Addressing Setoff Issues Raised in the Court's Memorandum Opinion Dated July 1, 2013 ("Universal's Supplemental Brief"), in which Universal argued, among others, that Duncan's inequitable conduct barred the relief of setoff. A001108-A001764. At the same time, Duncan submitted a Supplemental Post-Trial Brief of Defendants Duncan Petroleum Corporation & Robert M. Duncan ("Duncan's Supplemental Brief"), in which Duncan argued, for the first time, that Duncan was entitled to a setoff based on the equitable defense of recoupment.[3] A001765-A001785. Thereafter, the trial court

[3] Incidentally, Duncan never used the words "recoup" and "recoupment" during the trial of the matter and did not preserve the issue. Even during the course of discovery, recoupment was

issued its Final Order and Judgment holding that Duncan had asserted in his counterclaim the issue of whether he could defend or reduce a money judgment and therefore recoupment was tried with "implied consent." A001786-A001789. In doing so, the trial court treated Duncan's request for setoff as equivalent to a request for recoupment. A001788-A001789. However, although Universal had asserted the affirmative defense of inequitable conduct to Duncan's counterclaim (A001055-A001056) and had argued that Duncan's inequitable conduct barred the request for setoff (A001123-A001125), the trial court did not equally apply Universal's defense of inequitable conduct to Duncan's request for recoupment. A001789-A001790.

2. Scope of Review

The trial court's formulation of the standard for allowing the defense of recoupment is a question of law, which this Court reviews *de novo*. *See General Motors Corp. v. Wolhar*, 686 A.2d 170, 172 (Del. 1996); *Turner v. State*, 957 A.2d 565, 572 (Del. 2008) (noting that a trial court's formulation and application of legal principles is subject to *de novo* review).

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referenced only twice: once in reference to whether any payments were made on the Notes (A001828-A001830) and once in reference to general recoupment on investment (A001831-A001834), neither of which concern the equitable doctrine of recoupment which is at issue here.

3. Merits of the Argument

a. Although recoupment, as an equitable doctrine, is subject to equitable defenses, including the defense of unclean hands, the trial court wholly failed to consider the applicability of the defense

"Recoupment is a common-law, equitable doctrine that permits a defendant to assert a defensive claim aimed at reducing the amount of damages recoverable by a plaintiff." *TIFD III-X LLC v. Fruehauf Production Co., LLC*, 883 A.2d 854, 859 (Del. Ch. 2004) (*quoting* 80 C.J.S. *Set-off and Counterclaim* § 2 (2000)); A001789. Because recoupment is an equitable doctrine, evidence of unclean hands can preclude the application of the defense of recoupment. *See In re American Home Mortgage Holdings, Inc.*, 401 B.R. 653, 656 (D. Del. 2009) (upholding the Bankruptcy Court's consideration of the bank's inequitable conduct in refusing to allow the bank to apply recoupment); *accord Poskin v. TD Banknorth, N.A.*, 687 F. Supp. 2d 530, 563 (W.D. Pa. 2009) ("The maxim of 'unclean hands' may apply to defendant's equitable defense of recoupment insofar as that maxim applies to all requests for equitable relief."); *Transfer My Timeshare, LLC v. Selway*, 2009 WL 3271326, at *4 (D.N.H. Oct. 9, 2009) (applying the doctrine of unclean hands to deny recoupment); *Minskoff v. U.S.*, 349 F. Supp. 1146, 1150 (S.D.N.Y. 1972) ("The doctrine of equitable recoupment being in the nature of an equitable defense, it cannot be invoked by a party who lacks 'clean hands'").

Thus, under Delaware law, in order to rely on the equitable defense of recoupment, the party seeking recoupment (1) must have clean hands[4]; and (2) must prove that the recoupment involves the same litigants, the same transaction or occurrence, similar relief sought, and is sought defensively, rather than as a basis for affirmative recovery. *See In re American Home Mortgage Holdings, Inc.*, 401 B.R. at 656 and *TIFD III-X LLC*, 883 A.2d at 859; *accord In re M&L Business Mach. Co., Inc.*, 198 B.R. 800, 811 (D. Colo. 1996) (*citing Ashland Petroleum Co. v. Appel (In re B&L Oil Co.)*, 782 F.2d 155, 157 (10th Cir. 1986)) ("in order to be entitled to the defense of recoupment, the party asserting the defense must prove (1) he or she acted in good faith, and (2) his or her claim arise from the same transaction."); *see also Gravel Express, Inc. v. Meadow Valley Contractors, Inc.*,

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[4] Courts have refused to apply the doctrine of unclean hands under certain circumstances that are not present in this case: i) where invocation of the doctrine would disturb an overarching public policy; *see Belle Isle Corp v. Corcoran*, 49 A.2d 1 (Del. 1946) (applying unclean hands to deny the requested equitable relief would have been contrary to clear statutory policy); ii) where it would inequitable to apply the doctrine; *see Portnoy v. Cryo-Cell Int'l Inc.*, 940 A.2d 43, 81 (Del. Ch. 2008) (finding that plaintiff's conduct did not rise to the level of inequity where he should be denied equitable relief and denying equitable would work an inequitable result by "denying [the company's] stockholders the right to fairly conducted election of directors, something that DGCL § 225 was enacted to ensure."); where the inequitable conduct does not relate directly to the claim presented; *see Allen v. State*, 2012 WL 1658351 (Del. 2012).

2000 WL 875319, at *2 (9th Cir. June 30, 2000) (recognizing that bad faith can negate a recoupment defense); *In re R&C Petroleum, Inc.*, 247 B.R. 203, 209 (Bankr. E.D. Tex. 2000) (holding that recoupment is an equitable doctrine and permitting recoupment where there are no allegations that the party acted in bad faith). The good faith requirement of the recoupment defense stems from the maxim—"he who comes into equity must come with clean hands"—which is a "self-imposed ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant." *In re American Sunlake Ltd. P'ship*, 109 B.R. 727, 731 (Bankr. W.D. Mich. 1989) (*citing Precision Instrument Mfg. Co. v. Automotive Maint. Mach. Co.*, 324 U.S. 806, 814 (1945)) (rejecting the defense of recoupment in light of the party's own unclean hands).

In this case, although the issue of the defense of recoupment was *not raised by the pleadings*, the trial court held that because Duncan asserted the issue of his ability to reduce a money judgment in light of his noteholdings in his counterclaim, the defense of recoupment was tried by implied consent. A001786- A001789. In that case, in analyzing the availability of the recoupment defense, the trial court should correspondingly have considered Universal's defenses to Duncan's counterclaim, including the defense of unclean hands. A001055-A001056. Even

if Universal had not asserted the defense of unclean hands, the trial court nonetheless should have invoked the unclean hands doctrine *sua sponte* to protect the integrity of the court. *See Bodley v. Jones*, 59 A.2d 463, 469 (Del. 1947) ("The Court is so jealous in guarding itself against [the delinquency, fraud or misconduct of a complainant] that it will sua sponte apply the maxim whenever it discovers the unconscionable conduct. The application of the maxim is not a matter primarily of defense. It is not applied to favor a party litigant; rather, it is a rule of public policy.")

The trial court, however, erred in allowing Duncan to rely on the defense of recoupment to preclude Universal's recovery of damage by failing to consider the equitable nature of the defense of recoupment, *i.e.*, the requirement that the party seeking recoupment have clean hands. Not only did Duncan, as the party asserting the defense, fail to prove that he had clean hands, but Universal proved, and the trial court affirmatively found, that Duncan knowingly and intentionally made a series of misrepresentations to Universal as well as to the EPA, foreclosing Duncan's ability to rely on the equitable defense of recoupment. Nowhere in the trial court's order is there any mention or discussion of the impact of the trial court's own finding of Duncan's fraudulent conduct on Duncan's ability to rely on the equitable defense of recoupment . A001789-A001790. The trial court's

complete failure to consider Duncan's fraudulent conduct in its analysis constitutes reversible error.

b. The trial court erred by failing to apply the defense of unclean hands to bar Duncan's request for the equitable relief of recoupment

The doctrine of unclean hands is based on the long-established rule that when a party, who seeks relief in the chancery court "has violated conscience or good faith or other equitable principles in his conduct, then the doors of the Court of Equity should be forever shut against him." *Bodley*, 59 A.2d at 469; *SmithKline Beecham Pharm. Co. v. Merck*, 766 A.2d 442, 449 (Del. 2000) (same); *see also Deweese v. Reinhard*, 165 U.S. 386, 390 (1897) ("[I]f the conduct of the plaintiff be offensive to the dictates of natural justice, then, whatever may be the rights he possesses, and whatever use he may make of them in a court of law, he will be held remediless in a court of equity"); *Federal United Corp. v. Havender*, 11 A.2d 331, 345 (Del. 1940) ("A court of equity moves upon considerations of conscience, good faith and reasonable diligence"); *Mfrs. and Traders Trust Co., v. Washington House Partners, LLC*, 2012 WL 1416003, at *4 (Del. Super. Ct. March 22, 2012) (holding that "[t]he maxim of Equity providing that, 'one who comes into equity must do so with clean hands,' is 'well embedded in American Jurisprudence'").

In order for the defense of unclean hands to apply, the conduct "must be so 'offensive to the integrity of the court' that the claims should be denied,

'*regardless of their merit*.'" *In re Wilbert L.*, 2010 WL 3565489, at *5 (Del. Ch. Sept. 1, 2010) (*quoting Gallagher v. Holcomb & Salter*, 1991 WL 158969, at *4 (Del. Ch. Aug. 16, 1991)) (emphasis added). Generally, the offensive conduct involves intentional conduct and parties who are found to have acted fraudulently have been denied relief regardless of the merit of their claims. *See Derickson v. Derickson*, 281 A.2d 487, 488 (Del. 1971) (finding unclean hands based on fraudulent conveyance of property to prevent creditors from reaching the property, even though he had since paid the debts); *Sutter Opportunity Fund 2 LLC v. Cede & Co.*, 838 A.2d 1123 (Del. Ch. 2003) (finding unclean hands based on plaintiff's intentional violation of the ownership cap in the partnership agreement with full knowledge of its existence, false reporting of their ownership in a series of SEC filings and refusal to provide information to defendants as required by the partnership agreement); *see also* Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate & Commercial Practice in the Del. Ct. of Chancery* § 11.07[b] at 11-84 (2013).

However, the offensive conduct need not rise to the level of fraud in order for the court to invoke the doctrine of unclean hands. In *Turchi v. Salaman*, the court denied an investor's request for the equitable relief of specific performance of an agreement because the investor came to the court with unclean hands based upon his conduct both before and after signing the agreement. *Turchi v. Salaman*,

1990 WL 27531 (Del. Ch. March 14, 1990). The court found that although the investor's misrepresentations were non-material, and therefore did not constitute fraud, the investor's "sharp practices" were sufficiently unscrupulous to deny equitable relief. *Id.* at *8-9. The court explained:

> [S]pecific performance will always be refused when the plaintiff has obtained the agreement by sharp and unscrupulous practices, by overreaching, by concealment of important facts, even though not actually fraudulent, by trickery, by taking undue advantage of his position, or by any other means which are unconscientious; and when the contract itself is unfair, one-sided, unconscionable, or affected by any other such inequitable feature... [I]t is assumed that the contract is not illegal; that no defense could be set up against it at law; and even that it possesses no features or incidents which could authorize a court of equity to set it aside and cancel it. Specific performance is refused simply because the plaintiff does not come into court with clean hands.

Id. at *8 (*quoting*, Pomeroy, *Equity Jurisprudence* § 400, pp. 100-01).

Moreover, in determining whether to invoke the defense of unclean hands, the trial court was required to focus solely on Duncan's conduct, and not on Universal's conduct. *See SmithKline Beecham Pharm.*, 766 A.2d at 449 (*quoting Precision Instrument Mfg.,* 324 U.S. 806). In *SmithKline Beecham Pharm.*, SmithKline appealed the Chancery Court's refusal to apply the defense of unclean hands to bar Merck's claims, arguing that the Chancery Court improperly applied a balancing test in determining the application of the unclean hands doctrine. *Id.* at

448-49. In rejecting the argument, this Court held that the Chancery Court set forth and applied the proper legal standard:

> To the contrary, the court twice set forth the precise legal standard, first explaining that "when a party, who seeks relief in this Court 'has violated conscience or good faith or other equitable principles in his conduct, then the doors of the Court of Equity should be shut against him.'" *E.J. Stephen, Inc. v. Ceccola*, Del. Ch. C.A. No. 7578, 1984 WL 8238, at *5, Berger, V.C. (July 9, 1984) (citing *Bodley v. Jones*, Del. Supr., 59 A.2d 463 (1947)). The court further elucidated the proper standard when it quoted from the United States Supreme Court's decision in *Precision Instrument*, stating: "It is a self-imposed ordinance that closes the doors of a court of equity of one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant." *Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co.*, 324 U.S. 806, 65 S.Ct. 993, 89 L.Ed. 1381 (1945). It is apparent that the Court of Chancery did not inappropriately apply a "balancing test" in determining the application of the unclean hands doctrine. Indeed, it appears the Court of Chancery was, as required by the case law, properly focusing on the plaintiff's conduct, just as SmithKline contends it should have done.

SmithKline Beecham Pharm., 766 A.2d at 449. Therefore, the trial court should have focused only on Duncan's inequitable conduct to determine whether the doctrine of unclean hands precludes Duncan from relying on the recoupment defense.

Here, following a four-day trial, the trial court determined that Duncan had managed his regulatory responsibilities poorly and had received numerous citations

and adverse reports such that the MDE noted that "Duncan Petroleum should not be allowed to operate in the State of Maryland due to the large number of violations at his facilities." A001064-A001065. In fact, Duncan's decision to sell the Properties and retire from the petroleum industry was contemporaneous with the increasing regulatory interest in his business. A001071. While Duncan was willing to be "very flexible" as to the structure of a transaction—whether it be a sale, a long-term lease of certain Properties, or seller financing—he was not willing to retain any aspect of the business involving environmental oversight. A001072. In fact, the prospectus for the Properties stated: "Under all circumstances, any lease or purchase offer should include a provision in which the Buyer/Tenant will purchase all of the existing petroleum dispensing and underground tank storage equipment at each location." A001072. Duncan wanted to escape the quagmire he had created for himself by handing off the Properties (and the associated scrutiny by regulatory agencies) to a third party.

Having found an interested party, the trial court concluded that Duncan "knowingly made a series of false representations" about the condition of the Properties because he i) "wanted to induce Universal to buy [the Properties]; ii) "was under substantial pressure from environmental regulators," iii) "wanted to retire and leave the petroleum industry, and he wanted to obtain the best price possible for the business that he had built over thirty years," and iv) "knew that if

he did not represent that the Properties complied with all environmental regulations and revealed his extensive record of violations, then either Universal would decline to buy or the price he negotiated would be jeopardized." A001092.

Specifically, the trial court found that contrary to his express representation that the Properties were in compliance with all applicable environmental laws and that he had received no notice requiring him to undertake environmental corrective or remedial actions, Duncan had "received multiple notices from the EPA, DNREC and MDE demonstrating Duncan's noncompliance and requiring him to undertake environmental corrective or remedial actions at the Properties." A001090. Although Duncan knew about the multiple notices and about the ongoing environmental violations at the Properties, "Duncan admitted that during due diligence, he did not provide Universal with multiple documents reflecting his history of problems with DNREC and MDE, including violations that those agencies identified just months before the sale." A001091.

Not only did Duncan make knowing and intentional misrepresentations to Universal in order to induce Universal to purchase the Properties, the trial court found that Duncan had also made misrepresentations to the EPA and had been obstructionistic. A001070-A001071. In response to the EPA's notice that Duncan Petroleum had not complied with the CAFO and that unless Duncan Petroleum take immediate measures to comply with the CAFO, Duncan Petroleum could face

civil penalties of up to $32,500 per day of continued noncompliance, Duncan had 1) told the EPA that he had hired Coastal Pump and Tank to perform the tightness testing, when in fact, he had never conducted tightness testing for any of the required tanks; 2) told the EPA that he could not perform the tightness testing because it was physically and economically impossible, when in fact, he had the same exact testing performed at one of the other Properties; and 3) told the EPA that he had arranged for the Properties to be certified by INCON, a petroleum monitoring systems provider, when in fact, he later admitted during the course of this litigation that none of the Properties were certified. A001070. The trial court also found that when the EPA began to investigate twelve other Properties as a result of Duncan's inadequate compliance with the CAFO and requested information about numerous violations and equipment problems found during inspections, Duncan gave cursory answers and did not provide the requested documentary support. A001070-A001071.

While the trial court ultimately found that Universal did not justifiably rely on Duncan's misrepresentations due to its own due diligence, the focus for purposes of determining whether the defense of unclean hands is available to Duncan is not on Universal's good faith due diligence, but rather must be on Duncan's dereliction of his obligations to manage and operate the Properties in compliance with state and federal environmental requirements, which led him to

make numerous misrepresentations to the EPA to avoid the consequences of his violations, which further led to his knowing and intentional misrepresentations and concealment of material information in order to divest himself of the problematic Properties by inducing Universal to purchase the Properties at the best price possible. *See SmithKline Beecham Pharm.*, 766 A.2d at 449 (holding that the Court of Chancery did not inappropriately apply a "balancing test" in determining the application of the unclean hands doctrine; rather the Court of Chancery properly focused on the conduct of the party requesting equitable relief).

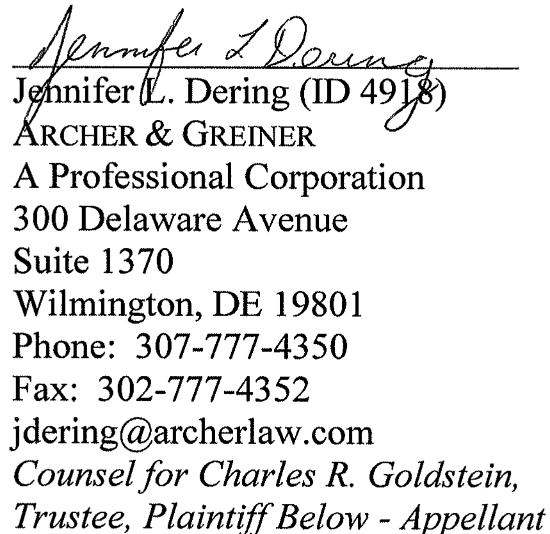
Like the investor in *Turchi* who was denied equitable relief because of his unscrupulous conduct, Duncan's 1) knowing and intentional misrepresentations and omissions of material information regarding not only the lengthy history of problems with the DNREC, the MDE and the EPA at the Properties, but also the ongoing environmental problems at the Properties, despite Universal's express request for information and despite numerous opportunities to disclose accurate information, and 2) his knowing misrepresentations to the EPA in order to avoid complying with the CAFO and the consequences for his failure to comply with the CAFO, evidence sharp practices by Duncan in connection with the sale of the Properties sufficient to warrant denial of Duncan's request for equitable relief in the form of recoupment.

Thus, the trial court erred by accepting and condoning Duncan's "sharp practices" and by granting Duncan the equitable relief of recoupment to nullify the award of $1,497,429 in contract damages that Universal sustained as a result of purchasing the Properties and addressing and remedying the problems at the Properties.

CONCLUSION

Based on the foregoing reasons, and the authority cited herein, Universal respectfully request this Court **reverse** and vacate the Order of the trial court permitting Duncan to rely on recoupment and entering judgment in favor of Universal on Count VI in the amount of $0, and **remand** this case to the trial court with instructions to deny the equitable relief of recoupment based on the doctrine of unclean hands and to enter judgment in favor of Universal in the amount of $1,497,429 on Count VI.

Date: November 21, 2013



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IN THE COURT OF CHANCERY 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 AVENUE, LLC; 505 BRIDGEVILLE HIGHWAY, LLC; 323 WEST STEIN HIGHWAY, LLC; 100 SOUTH 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,

v.

DUNCAN PETROLEUM CORPORATION and ROBERT M. DUNCAN;

Defendants.

C.A. No. 4948-VCL

FINAL ORDER AND JUDGMENT

WHEREAS the Court issued its post-trial opinion on July 1, 2013 (the "Opinion");

WHEREAS the plaintiffs submitted supplemental post-trial briefing regarding Count IV of the complaint and defendants' counterclaims on August 15, 2013 and the defendants on August 16, 2013;

NOW THEREFORE, this 10th day of September, 2013, the Court finds and orders as follows:

1. The defendants can rely on the equitable doctrine of recoupment. "When

issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings." Ct. Ch. R. 15(b). The Court can permit "[s]uch amendment of the pleadings as may be necessary to cause them to conform to the evidence." *Id.* "Before a newly raised issue can become part of the action," however, "it must be tried with the consent of the parties." 6A Charles Alan Wright, Arthur R. Miller & Mary Kay Kane, Federal Practice & Procedure § 1491 (3d ed. 2010); *accord Nixon v. Blackwell*, 626 A.2d 1366, 1374 n.5 (Del. 1993) (noting that Rule 15(b) applied where "issues were tried" by "express or implied consent" despite not appearing in the pleadings). "When appropriate, the court may direct the amendment of the pleadings on its own." Wright, Miller & Kane, *supra*, § 1493; *accord Luria Bros. & Co., v. Alliance Assur. Co.*, 780 F.2d 1082, 1088-89 (2d Cir. 1986) (observing that "failure to amend the pleadings to conform them to the evidence and raise these [new] issues does not affect the result of the trial, although the trial judge may allow such an amendment, even after judgment, either upon motion of any party, or *sua sponte*") (citations omitted); *see also Nat'l Mkt. Share, Inc. v. Sterling Nat'l Bank*, 392 F.3d 520, 527 (2d Cir. 2004) (finding that the district court's *sua sponte* consideration of an unpled issue was proper because the unpled issue was an integral part of plaintiffs' cause of action); *Walton v. Jennings Cmty. Hosp., Inc.*, 875 F.2d 1317, 1320 & n.3 (7th Cir. 1989) (finding that the pleadings were constructively amended when the district court *sua sponte* injected an unpled cause of action into the case in denying defendant's motion for summary judgment and both parties subsequently proceeded to prepare for trial on the new issue); *McDonough Marine Serv., Inc. v. M/V Royal St.*, 608 F.2d 203,

204 (5th Cir. 1979) (observing that "[i]t is clear that under Fed. R. Civ. P. 15(b) the trial court could find implied consent of the parties to the trial of the unpleaded issue" and that "the trial judge [could] only be reversed if . . . [the trial judge's] finding of fact, upon which the court conclude[d] there was implied consent, was clearly erroneous") (citation omitted).

2. Whether the defendants would be able to defend or reduce a money judgment in light of their noteholdings was a central issue in this case. Defendants asserted this issue in their answer and counterclaims, the joint pre-trial order, and their pre-trial and post-trial briefing. *See* Dkt. 32 (defendants' answer and counterclaims); Dkt. 270 (defendants' pre-trial brief); Dkt. 284 (joint pre-trial order); Dkt. 312 (defendants' post-trial answering brief). Plaintiffs likewise contested this issue by seeking rescission of defendants' noteholdings to avoid a corresponding abatement of their breach of contract and fraud damages. *See* Dkt. 21 (plaintiffs' amended complaint); Dkt. 271 (plaintiffs' pre-trial brief); Dkt. 284 (joint pre-trial order); Dkt. 306 (plaintiffs' post-trial opening brief); Dkt. 317 (plaintiffs' post-trial reply brief). The issue of whether defendants could defend, offset, or recoup a judgment based on amounts owed under their noteholdings was therefore tried with "implied consent," and the pleadings are amended to reflect the affirmative defense of recoupment. Ct. Ch. R. 15(b); *see also United States ex rel. Greenville Equip. Co. v. U.S. Cas. Co.*, 218 F. Supp. 653, 655 (D. Del. 1962) ("The term [counterclaim] is generic in nature and includes those defenses universally known as recoupment and set off."); *PNC Bank, Del. v. Turner*, 659 A.2d 222, 224 n.1 (Del. Super. 1995) (deeming that a "counterclaim would encompass the

affirmative defense of recoupment"). While Rule 15(b) does not require the Court to conduct a prejudice inquiry, *see, e.g.*, *Jeanes v. Nationwide Ins. Co.*, 1988 WL 81165, at *1 (Del. Ch. July 22, 1988) (not conducting prejudice analysis in Rule 15(b) determination), the plaintiffs have not been prejudiced because the issue of recoupment was tried and subsumed by defendants' counterclaims, which included setoff.

3. "Recoupment is a common-law, equitable doctrine that permits a defendant to assert a defensive claim aimed at reducing the amount of damages recoverable by a plaintiff." 80 C.J.S. *Set-off and Counterclaim* § 2 (2013) (footnotes omitted). "The equitable practice of recoupment serves to avoid needless delay and unnecessary litigation by permitting a court to examine all aspects of the transaction that is the subject of the action." *Id.* (footnote omitted). Recoupment is available only between the same litigants where (i) the claims arose out of the same transaction or occurrence, (ii) it is sought defensively rather than as the basis for affirmative recovery, and (iii) the nature of the relief sought is similar to the plaintiff's. *TIFD III-X LLC v. Fruehauf Prod. Co.*, 883 A.2d 854, 859 (Del. Ch. 2004). It is also limited to the extent of the plaintiff's recovery. 80 C.J.S. *Set-off and Counterclaim* § 2 (2013).

4. Based on the facts set forth in the Opinion, recoupment is available. The purchase and sale transaction, which gave rise to plaintiffs' breach of contract and fraud claims and defendants' creditor counterclaims, was the crux of this case, satisfying recoupment's requirements for the same litigants and the same transaction or occurrence. Both the claims and counterclaims sought monetary damages, making the nature of the relief sought similar. Defendants are therefore entitled to rely on recoupment as a

defense up to the amount of plaintiffs' recovery, which the Opinion found to be $1,497,429. Because plaintiffs owe defendants amounts exceeding plaintiffs' recovery under the Opinion, judgment is entered in favor of plaintiffs on Count VI in the amount of $0. The declaratory judgment entered in favor of plaintiffs on Count IV recognizes that the breach of contract led to damages of $1,497,429, albeit an amount the plaintiffs cannot recover because of recoupment.

5. Because plaintiff Batra was discharged from bankruptcy, judgment is entered in his favor on defendants' counterclaims. Because the defendants submitted themselves and their claims to the exclusive jurisdiction of the U.S. Bankruptcy Court for the Eastern District of Pennsylvania (the "Bankruptcy Court") by filing proofs of claims in *In re Universal Marketing, Inc.*, No. 09-15404-ELF (Bankr. E.D. Pa. filed July 23, 2009), the defendants' remaining counterclaims are dismissed without prejudice pending disposition of claims from the Bankruptcy Court. To the extent the defendants believe they are entitled to recover amounts from the plaintiffs, they must seek relief from the Bankruptcy Court.

/s/ J. Travis Laster
Vice Chancellor J. Travis Laster