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Case No. 2017-0178-SG

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

RCS CREDITOR TRUST, *Plaintiff*, v. NICHOLAS S. SCHORSCH, et al., *Defendants*.	C.A. No. 2017-0178-SG

PLAINTIFF'S ANSWERING BRIEF IN OPPOSITION TO THE ARC PARTIES' SUPPLEMENTAL MEMORANDUM OF LAW IN SUPPORT OF THEIR MOTION TO DISMISS THE VERIFIED COMPLAINT

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The RCS Creditor Trust (the "Trust"), by and through its attorneys, Kramer Levin Naftalis & Frankel LLP and Ashby & Geddes, respectfully submits this Opposition to the ARC Parties'[1] Supplemental Memorandum of Law in Support of Their Motion to Dismiss the Verified Complaint ("Def. Supp. Br.", addressed to the "Complaint") in response to the Court's invitation in its November 30, 2017 Memorandum Opinion (the "Opinion" or "Op.") (D.I. 61).

PRELIMINARY STATEMENT

The Opinion sustained the "core" allegation underlying this action – that Nicholas Schorsch and the Control Defendants breached their fiduciary duties when they "used their control over RCAP to cause it to enter into off-market arrangements with AR Capital" that "siphoned value away from RCAP and to AR Capital" (Op. at 27, 30) – while dismissing certain other claims.[2]

The Court did not rule on Plaintiff's claims for (i) aiding and abetting breach of fiduciary duty (Count II) and (ii) unjust enrichment/constructive trust (Count III) – claims that may or may not prove necessary depending on what discovery and trial show. The Court invited supplemental briefing on Counts II

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[1] Capitalized terms are defined as in the Complaint ("Compl.") and in the ARC Parties' Memorandum of Law in Support of Motion to Dismiss ("Def. Br.").

[2] Dismissal of Plaintiff's claim based on Defendants' performance of the off-market contracts through gross overstaffing and other excessive expenditures is the subject of Plaintiff's Motion for Limited Reargument, filed on December 7, 2017 (D.I. 62).

and III based "on the viability of these claims in light of this Memorandum Opinion." Op. at 49. In other words, the Court invited new briefing only if something in its decision gave rise to new theories or arguments. The Court did *not* invite reargument carte blanche.

Defendants have nevertheless submitted a Supplemental Memo that offers little more than a rehash of baseless and premature arguments that Plaintiff has already answered. Defendants' only new point is the observation that, to the extent the Court has dismissed breach of fiduciary duty claims based on certain transactions, the corresponding claims for aiding and abetting also cannot go forward. Def. Supp. Br. at 2. New briefing was hardly necessary to establish this unremarkable proposition. Plaintiff responds below to the other arguments that Defendants have seen fit to recycle here.

First, as Plaintiff explained in its brief opposing summary judgment ("Pl. Br."), the Complaint alleges aiding and abetting only *in the alternative* to the core breach of fiduciary duty claim, in the unlikely event that any individual Defendants "may prevail in arguing that they, as individuals, lacked a fiduciary duty to RCAP or RCS" in connection with a particular transaction. Pl. Br. at 57. Count II expressly incorporates by reference the core factual allegations preceding it in the Complaint (¶ 131) – detailed facts that the Court has held state a valid claim against the Control Defendants for breach of the duty of loyalty. Op. at 28.

Second, unjust enrichment and constructive trust provide a standard equitable remedy for disgorging ill-gotten proceeds that may or may not be needed depending on whether any judgment may be satisfied directly against the Control Defendants. There is no reason to reach Defendants' arguments unless and until Plaintiff seeks to employ the remedy. In any event, none of these arguments has gained any validity since their initial airing on the motion to dismiss:

- The unjust enrichment claim is not barred by the existence of contracts between RCS and the Advisor Defendants because, among other things, Plaintiff is not seeking to *enforce* the contracts through another means, but to recover for harm flowing from separate breaches of fiduciary duty. *See* Pl. Br. at 58-59.
- The claim is not based on a "hypothetical" flow of profits, but on actual profits received and retained by – and still flowing to – the Control Defendants through entities they owned and controlled. This is not, as Defendants argue, a "newly articulated worldview" (Def. Supp. Br. at 12) but part of the core claim alleged in the Complaint and already sustained. *See* Compl. ¶¶ 48-49, 52, 54-57, 135.
- And it is irrelevant that the Advisor Defendants performed the contractual tasks for which they received fees. The claim seeks disgorgement only of net *profits* that would have been earned instead by

an RCAP subsidiary if the underlying contracts had been negotiated by unconflicted fiduciaries – a distinction the Court recognized at oral argument. 9/29/2017 Hr'g Tr. 70:7-10. Indeed, this type of scenario has been found to support an unjust enrichment claim. *See Teachers' Ret. Sys. of La. v. Aidinoff*, 900 A.2d 654, 662-63, 671-72 (Del. Ch. 2006).

- Finally, with respect to both unjust enrichment and constructive trust, Plaintiff need not show independent misconduct or culpability by the Advisor Defendants themselves – merely that the Control Defendants knowingly breached their fiduciary duties, since their conduct and state of mind are imputed to the entities they established and controlled to receive profits under particular contracts that should have been directed to RCAP subsidiaries. *See* Pl. Br. at 60-61.

As the Court has recognized, it may not be necessary to pursue the claims embodied in Counts II and III. The defendants remaining in the case may be held liable directly as fiduciaries, rendering Count II unnecessary. And any judgment may be satisfied directly from defendants' own resources, making it unnecessary to pursue equitable remedies to disgorge ill-gotten gains that remain at the advisor entities. But Defendants cite no new facts that rule out the possible need for these remedies. Accordingly, Plaintiff respectfully requests that the Court continue to hold these claims in abeyance pending further factual development.

PROCEDURAL HISTORY

The Opinion sustained Plaintiff's "core" breach of fiduciary duty claim: that "by forcing RCAP to bear all the costs of wholesaling AR Capital's investment vehicles, the Control Defendants enriched AR Capital, in which they (together with Schorsch's wife) held a 100% economic stake, to the detriment of RCAP, in which they held only a 25% economic interest." Op. at 15. The Court held that "[t]hese allegations state a claim for breach of the duty of loyalty against the Control Defendants." *Id.* at 28.

The Court dismissed breach of fiduciary duty claims based on certain other transactions and issues and declined to rule on two additional counts: one alleged against the individual defendants and Holdings for aiding and abetting breach of fiduciary duty (Count II); and another against the Advisor Defendants, AR Capital, and AR Global for unjust enrichment and constructive trust (Count III). Compl. ¶¶ 131-39. These additional counts expressly "repeat[ed] and incorporate[d] by reference each of the allegations set forth above." *Id.* ¶¶ 131, 134. As Plaintiff has explained, "Count II is pleaded entirely in the *alternative* . . . [t]he purpose of Count II is simply to capture wrongful conduct by any of the individual Defendants who may prevail in arguing that they, as individuals, lacked a fiduciary duty to RCAP or RCS at any particular time." Pl. Br. at 57. And as Plaintiff's counsel explained at oral argument, the purpose of Count III is to

"formulate an appropriate remedy . . . not only for amounts that the defendants have received that really should have gone to RCAP but for amounts that will be received in the future." 9/29/2017 Hr'g Tr. 69:19-23.

The Opinion reserved decision on Counts II and III, noting that unjust enrichment "involves issues of fact" and further observing: "Because the core fiduciary duty claim survives Defendants' Motion to Dismiss, I find it prudent to reserve decision on the arguments for dismissing the unjust enrichment and aiding and abetting claims, pending supplemental briefing, should any party desire it, on the viability of these claims *in light of this Memorandum Opinion*." Op. at 49 (emphasis added). Thereafter, without conferring with Plaintiff's counsel as to the necessity for further briefing, Defendants filed a twenty-page brief on January 10, 2018 (D.I. 72) repeating the arguments they had already set forth at length in briefing and at oral argument, offering virtually nothing new "in light of" the Opinion. *Compare* Def. Supp. Br. at 7-18 *with* D.I. 32 at 47-58; D.I. 43 at 24-31; 9/29/2017 Hr'g Tr. 34:1-17; 85:20-86:10.

This brief responds once again to Defendants' arguments with regard to Counts II and III, mindful of the limited scope of the Court's invitation. Plaintiff respectfully submits that the Court should maintain course and, because Counts II and III are based on equitable remedies that "involve issues of fact" (Op. at 49), continue to hold those claims in abeyance until a later stage of this case.

ARGUMENT

I.

AIDING AND ABETTING IS VALIDLY PLED IN THE ALTERNATIVE FOR ALL SURVIVING BREACH OF FIDUCIARY DUTY CLAIMS

Plaintiff's Count II for aiding and abetting breach of fiduciary duty is appropriately pled in the alternative to the core claim for breach of fiduciary duty, which the Court has already sustained. Defendants do not dispute that even if a party lacks a direct fiduciary duty, he may nonetheless be liable for aiding and abetting breaches by other fiduciaries based on "knowing participation" in the breach. *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 861 (Del. 2015); Def. Br. at 48. Thus, in the unlikely event that any of the remaining defendants can establish that they lacked a direct fiduciary duty to RCAP or its subsidiaries with respect to particular transactions related to the core claim, they may still be liable under Count II for the breaches of other fiduciaries.

Defendants remarkably continue to argue, as they did on the motion to dismiss, that "the Trust does not allege a single fact that could support an inference of knowing participation by any of the defendants named in Count II" (Def. Supp. Br. at 8) and that the Complaint is "wholly conclusory," "threadbare," and "devoid of any factual allegation that any defendant knowingly participated in a breach of fiduciary duty" (*id*. at 8-9). This argument never made any sense and is even more clearly meritless in the wake of the Opinion for two separate reasons.

First, as Plaintiff has previously explained, Count II "expressly incorporates by reference all factual details set forth in the first 130 paragraphs of the Complaint" (Pl. Br. at 57) – allegations that the Court has already sustained as legally sufficient. Op. at 28 ("These [core] allegations state a claim for breach of the duty of loyalty against the Control Defendants.") The Court explained the course of conduct showing knowing participation in the core breach of fiduciary duty:

> In addition to serving as officers or directors of RCAP, [the Control Defendants] exercised effective control over the Company through their collective ownership of Holdings . . . [d]espite their role as fiduciaries for RCAP's public stockholders, the Control Defendants engineered a series of transactions between RCAP and AR Capital that allegedly siphoned value away from RCAP and to AR Capital . . . [N]one of the transactions . . . were approved by a majority of disinterested and independent directors. Instead, every one of RCS' business deals with RCAP was negotiated . . . on both sides by the Control Defendants . . . [who] were therefore squarely on both sides of the challenged wholesaling agreements between AR Capital and RCAP. That invokes entire fairness review, which in turn precludes dismissal of the core claim on a Rule 12(b)(6) motion.

Op. at 30-31 (internal quotations and alterations omitted).

Far from being "devoid of any factual allegation that any defendant knowingly participated in a breach of fiduciary duty" (Def. Supp. Br. at 9), the Opinion's holding that these facts support a primary claim for breach of fiduciary duty establishes *a fortiori* sufficient knowing involvement to support a claim for aiding and abetting. *See Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d

1096, 1125 (Del. Ch. 2008) (finding knowing participation and denying motion to dismiss claim for aiding and abetting breach of fiduciary duty where plaintiff "has pleaded a set of facts that, if true, leads to a reasonable inference that the [defendant] breached its fiduciary duties").

Second, Defendants ignore that Count II is expressly, and permissibly, pled in the alternative to the core breach of fiduciary duty claim. *See In re Nine Sys. Corp. S'holders. Litig.*, Consol. CA. No. 3940-VCN, 2014 WL 4383127, at *48 (Del. Ch. Sept. 4, 2014) (sustaining aiding and abetting claim alleged in the alternative to breach of fiduciary duty claim and explaining that "Plaintiffs are limited to one recovery – breach of fiduciary duty or aiding and abetting"). Which claim applies will depend on the facts proved at trial, because the "relationship" between allegations of breach of fiduciary duty and a claim of aiding a abetting is "a distinction more readily and carefully addressed after fact finding rather than by pre-trial dispositive motion." *Wallace ex. rel. Cencom Cable Income Partners II, L.P. v. Wood*, 752 A.2d 1175, 1184 n.39 (Del. Ch. 1999) (declining to "dismiss plaintiffs' aiding and abetting claim as I may later decide, after discovery or at trial, that plaintiffs cannot prove the pleaded requisite control necessary to establish the existence of a fiduciary relationship"). Here, similarly, Count II exists "to capture wrongful conduct by any individual Defendants who may prevail

in arguing that they, as individuals, lacked a fiduciary duty to RCAP or RCS at any particular time." Pl. Br. at 57. The Court should decline to dismiss Count II.

II.

UNJUST ENRICHMENT AND CONSTRUCTIVE TRUST ARE VALID REMEDIES THAT PREVENT SHELTERING OF ILL-GOTTEN GAINS

As with aiding and abetting, Defendants' arguments with respect to unjust enrichment and constructive trust add nothing to the prior briefing and fail to explain how the "viability of these claims" is altered "in light of" the Opinion. Op. at 49. Count III merely sets forth traditional remedies to disgorge ill-gotten gains that Plaintiff may or may not need to invoke, but there is no reason to reach the merits of these remedies until appropriate fact finding determines whether Plaintiff can obtain a full recovery directly from Mr. Schorsch and the other Control Defendants. If the Control Defendants are found liable but succeed in sheltering their personal assets, Plaintiff may be forced to rely on these alternative remedies to seek recovery from entities wholly owned and controlled by the Control Defendants that were literally created for the purpose of receiving profits siphoned away from RCAP. Accordingly, the Court should continue to hold Count III in abeyance pending further factual development.

A. The Complaint States a Claim for Unjust Enrichment

The unjust enrichment claim follows directly from the breach of fiduciary duty claim that the Court has already sustained. The Complaint alleges

in detail how "the Control Defendants engineered a series of transactions between RCAP and AR Capital" to rob RCAP of value it properly should have earned but for those fiduciary breaches. Op. at 30. The Court held that "[i]t is reasonably conceivable that the transactions on which the core claim is premised were not the product of fair dealing, since they were engineered and approved by conflicted fiduciaries. And I can infer unfair price from the Complaint's detailed allegations about the off-market nature of the arrangements between AR Capital and RCAP." *Id*. at 31 n.159 (internal citation omitted).

In the transactions underlying this claim, AR Capital caused lucrative management business to be directed to its own wholly owned subsidiaries – the Advisor Defendants – rather than entities owned and controlled by RCAP. *See* Compl. ¶¶ 48-49, 52, 54-57, 135. The quantifiable profits flowing from these specific contracts should have gone to RCAP but ended up, instead, in entities that were in essence the extended pockets of the Control Defendants. This sets the stage for a classic unjust enrichment disgorgement claim, should Plaintiff ultimately be required to go that route to achieve a full recovery for the Control Defendants' breach of fiduciary duty.

Offering nothing new in light of the Opinion, Defendants simply recycle their original arguments that the unjust enrichment claim fails because (1) it is based on conduct governed by contracts (Def. Supp. Br. at 11-12); (2) it is

supposedly based only on a "hypothetical" stream of profits (*id.* at 12); (3) the Advisor Defendants rightfully "earned" the fees they received (*id*. at 12-13); and (4) the absence of specific allegations of wrongdoing *by* the Advisor Defendants means that their retention of the siphoned profits cannot be said to be against "fundamental principles of justice or equity and good conscience" (*id*. at 13-14) (internal citation omitted). None of these points has gained any power through repetition.

1. The Unjust Enrichment Claim Is Based on Pre-Existing Fiduciary Duties and Is Not Precluded By Contracts That Themselves Resulted from a Breach of Duty

Defendants persist in arguing that the unjust enrichment claim is barred by the existence of contracts governing the wholesaling function – the very contracts evidencing Defendants' breach of fiduciary duty towards RCAP. Leaving aside that these contracts were with RCS, not RCAP, Defendants simply ignore, yet again, why the authority they cite is irrelevant here. Cases like *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872, 891 (Del. Ch. 2009), stand for the proposition that an unjust enrichment claim cannot be *based* on the same contract a plaintiff is suing to enforce – *i.e.*, that unjust enrichment is subsumed in a related contract claim. *See* Pl. Br. at 58 (citing cases). But that authority does not apply where the plaintiff is suing not to enforce the contract, but rather to obtain a remedy for the breach of independent fiduciary duties. *See id.* at 59 (citing cases).

Here, the fiduciary duty claim does not arise out of the contract; rather, the unfair contract is the result of the breach of pre-existing duties.

Defendants inexplicably argue that RCAP and RCS may not "retain" the "benefits" of the wholesaling contracts "and claim the contracts are supposedly invalid" because a party "is not entitled to make directly contradictory factual allegations." Def. Supp. Br. at 11-12. But of course, these contracts did not *benefit* RCAP – they were the abusive fruit of Defendants' breach of fiduciary duty. In any event, this action does not seek to set aside these contracts, but rather to recover damages – including, if necessary, by disgorging profits that unjustly enriched entities owned and controlled by Defendants – for the breaches of fiduciary duty described in the already sustained core claim.

2. The Unjust Enrichment Claim is Based on Quantifiable Profits Under Specific Contracts

Defendants next seek to sow confusion by accusing Plaintiff of creating a web of "hypotheticals" requiring "leaps of faith," based on a "newly articulated worldview" supposedly designed to overcome flaws in the unjust enrichment pleading. Def. Supp. Br. at 12. None of this makes any sense. The unjust enrichment claim is not based on "hypotheticals," but rather on a real and quantifiable flow of profits under actual contracts – profits diverted from RCAP by Defendants' breach of duty.

At oral argument, the Court did discuss "hypothetically" how future profits might be captured under an unjust enrichment theory, suggesting that "you could impose a constructive trust on RCAP that would measure its liability by what runs into those entities." 9/29/2017 Hr'g Tr. 72:11-13. But that hardly makes the diverted profits – millions already received by Defendant-controlled entities and millions more still being paid – "hypothetical" in any way.

Nor is this theory "newly articulated." It is, to the contrary, the heart of the breach of fiduciary duty claim already sustained: that the conflicted Control Defendants caused RCS to enter into contracts to provide unprofitable wholesaling services without simultaneously bargaining for RCAP (through another subsidiary) to receive a customary and economically rational 20-25 percent share of the management economics. *See* Compl. ¶¶ 48-49, 52, 54-57, 135.

3. It Matters Not Whether the Advisor Defendants "Earned" their Fees; Plaintiff Seeks Ill-Obtained *Profits*

Defendants seek to claim the equitable high ground by repeatedly arguing that the Advisor Defendants rather than RCAP performed the advisory work associated with the disputed contracts – stressing no less than eleven times that the Advisor Defendants supposedly "earned" their fees. *See* Def. Supp. Br. at 3, 8, 12, 13, 15, 18. But as Plaintiff has previously explained, "[t]he argument is not that RCS (or rather, an appropriate RCAP entity) did advisory work but was never paid for it, but rather that unconflicted fiduciaries for RCAP would have

insisted on obtaining the more lucrative work as a condition of agreeing to take on the less profitable wholesaling obligations." Pl. Br. at 59. That is why Plaintiff does not seek to disgorge the gross fees paid to the Advisor Defendants under the management contracts, but rather only the net *profits* that would have flowed to RCAP had Defendants had not breached their fiduciary duty. Plaintiff's counsel emphasized this point at oral argument. 9/29/2017 Hr'g Tr. at 70:7-10.

That the Advisor Defendants actually performed the highly profitable work diverted to them does not bar an unjust enrichment claim. The injustice does not lie in the Advisor Defendants' own behavior, but in the breach of duty by their controlling owners, who kept for themselves lucrative business that should have been shared with RCAP. This is similar to what happened in *Teachers' Ret. Sys. of La. v. Aidinoff*, 900 A.2d 654 (Del. Ch. 2006), which sustained a potential unjust enrichment claim based on the allegation that the victimized company "could have performed the same function as [the unjust enrichment defendant] in-house, using many of the same personnel, and thereby captured more of the profit for itself." *Id.* at 662-63.

4. Principles of Justice and Equity Support the Unjust Enrichment Claim

Finally, Defendants continue to misleadingly suggest that Plaintiff must show wrongdoing *by* the Advisor Defendants to sustain a claim for unjust enrichment. They argue that these defendants merely "retained fees they earned"

and thus "fundamental principles of justice or equity and good conscience" bar any unjust enrichment claim. Def. Supp. Br. at 13-14. This is simply wrong: The relevant wrongdoing was committed by the Control Defendants, whose knowledge and actions are *imputed* to the entities they created to receive siphoned profits. *See Nash v. Schock*, No. 14721-NC, 1998 WL 474161, at *2 (Del. Ch. July 23, 1998) ("Restitution is permitted even when the defendant retaining the benefit is not a wrongdoer"); *see also* 9/29/2017 Hr'g Tr. 70:11-16 (acknowledging this principle).

Contrary to Defendants' misleading citation of *Aidinoff* as requiring an unjust enrichment claim to be predicated on the target entity's "wrongful conduct" (Def. Supp. Br. at 14), then-Vice Chancellor Strine in that case sustained such a claim (as well as an unpleaded aiding and abetting claim) based on the allegation that the target entity was "fairly charged with the knowledge and conduct of its controlling persons," who in that case "intentionally enriched" the target entity to the detriment of plaintiff. 900 A.2d at 671.

Here, the pleading of the core claim against the Control Defendants has been sustained. If it is proved at trial that they intentionally diverted profits from RCAP to the Advisor Defendants, principles of justice and equity may well support a finding of unjust enrichment. The Court's instinct to hold that question in abeyance was sound. The renewed motion to dismiss this claim should be denied pending further factual development.

B. Constructive Trust is a Valid and Appropriate Remedy

Defendants' renewed arguments in favor of dismissing the claim for constructive trust merely echo the points already refuted above with respect to unjust enrichment. If unjust enrichment is established, constructive trust may well be the appropriate remedy, because "constructive trusts are regularly imposed by courts of equity to remedy unjust enrichment." *Nash*, 1998 WL 474161 at *2.

Defendants' argument that the party against which a constructive trust is sought must be the same party that owed, and breached, a duty to the plaintiff (Def. Supp. Br. at 16-17) is incorrect. While Defendants cite two cases in which the wrongdoer was also the target of the constructive trust, they cite no authority holding that such identity is required. To the contrary, as the Court observed in *Aidinoff*, such a requirement would "undercut much of the utility of the unjust enrichment cause of action" in recovering ill-gotten gains from entities acting without scienter but aligned with or controlled by wrongdoers. 900 A.2d at 673 n.25 (summarizing case law and treatises recognizing that constructive trusts may be imposed against innocent third parties).

This is not a hard case, like an innocent relative receiving property with no notice of wrongdoing. The Advisor Defendants are wholly owned subsidiaries that were set up by the Control Defendants specifically to receive improperly diverted profits. Imposing a constructive trust on their assets, if

sufficient wrongdoing by their masters is established, will not be a stretch. Nor should the Court take seriously the faux equitable argument that a constructive trust would "rob" these entities of "the fees they negotiated for and worked to earn." Def. Supp. Br. at 18. The negotiations in question were tainted by fiduciary violations; all of the "work" was performed by AR Capital employees; and the ultimate owners and beneficiaries of these purported "earnings" are the Control Defendants themselves. Pl. Br. at 59-60.

Finally, it is premature to conclude that Plaintiff will be unable to identify "specific property or identifiable proceeds" sufficient to support a constructive trust. Def. Supp. Br. at 17. As the Court concluded based on similar facts in *Aidinoff*, "it would be inappropriate to deny [Plaintiff] the opportunity to make the appropriate showing that specific funds remain in [defendant's] hands that are attributable to excessive payments from [the victimized company]." 900 A.2d at 673. Indeed, the Court recognized that "a constructive trust can be entered against a defendant even if the defendant no longer possesses the property improperly taken from the plaintiff, on the grounds that the trust originally arose at the time the defendant improperly received the plaintiff's funds." *Id.* Ultimately, "equity has a kitbag full of remedies" and thus "the mere dissipation of the proceeds received from the plaintiff by the defendant does not render the defendant safe from an equitable remedy requiring economic restitution to the plaintiff." *Id.*

In short, the Court should maintain the potential for a constructive trust as an appropriate remedy for disgorgement of ill-gotten proceeds, in the event that this remedy proves necessary to provide the Trust with a full recovery on any judgment against the Control Defendants.

CONCLUSION

For the foregoing reasons and those stated in Plaintiff's prior submissions and at oral argument, the Defendants' Motion to Dismiss Count II and Count III should be denied.

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