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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-VCG

THE ARC PARTIES' SUPPLEMENTAL MEMORANDUM OF LAW IN SUPPORT OF THEIR MOTION TO DISMISS

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The ARC Parties respectfully submit this supplemental memorandum of law in support of their motion to dismiss the Complaint in this action, in response to the Court's invitation for supplemental briefing in its Memorandum Opinion, issued November 30, 2017.[1]

PRELIMINARY STATEMENT

On November 30, 2017, the Court granted in part the ARC Parties' partial motion to dismiss the Complaint, dismissing several allegations underlying the Trust's purported breach of fiduciary duty claim while sustaining the "core" theory of that claim. The Court reserved decision, however, on the Trust's (i) aiding and abetting breach of fiduciary duty claim (Count II) and (ii) unjust enrichment/constructive trust claims (Count III), and invited supplemental briefing on those claims in light of the Court's rulings on the balance of the ARC Parties' motion. The ARC Parties submit that the Trust has failed to plead necessary elements of both claims, and thus that the Court should now dismiss those claims as well. Dismissal of these claims at this time will promote judicial efficiency by limiting the issues in the case to those that the Court has otherwise found adequately pleaded, and will narrow the scope of discovery.

[1] Unless otherwise indicated, capitalized terms have the same meaning as in the ARC Parties' opening brief in support of their motion to dismiss. (D.I. 32.)

The Court should dismiss the Trust's claim for aiding and abetting breach of fiduciary duty because the Complaint does not plead *any* facts supporting a requisite element of that claim—specifically, that any of the Control Defendants or Holdings (the defendants named in Count II) "knowingly participated" in any alleged underlying breach of fiduciary duty. Instead, the Complaint makes only the most conclusory assertions of knowing participation, simply including the conclusory term "knowing participation." That threadbare recital of an element of a claim is plainly insufficient as a matter of law. In addition, the aiding and abetting claim is largely premised on allegations the Court dismissed in its decision, and thus the aiding and abetting claim should, at the least, be dismissed to the extent it relies on any such now-dismissed allegations.

As to the Trust's unjust enrichment claim, it fails for several reasons, none of which involve disputed factual issues:

First, the claim fails because there exist binding contracts that govern the relationships among the Advisor Defendants, the AR Capital-sponsored REITs, and RCAP's subsidiary, RCS, which precludes any unjust enrichment claim.

Second, the claim is based upon some hypothetical "stream" of advisory fees that supposedly would have flowed to RCAP *if* some hypothetical RCAP advisory entities had existed that had entered into different hypothetical contracts with AR Capital-sponsored REITs. But unjust enrichment claims do not

apply to hypothetical payments that might have been received under agreements that never existed.

Third, in fact, the Trust concedes that the Advisor Defendants fully performed the services required under their existing contracts, and thus fully earned all of the fees they received. The Trust further concedes that RCAP (and/or RCS) did no work to earn those fees. Thus, the advisory fees paid to the Advisor Defendants cannot possibly be construed as a "benefit" the Advisor Defendants unjustly received.

Finally, the Trust's unjust enrichment claim does not comport with "fundamental principles of justice or equity and good conscience." Rather, as just noted, that claim attempts to deny fees earned by entities that fully performed their contractual obligations and, instead, to shift those fees to an entity that did nothing whatsoever to earn them. Adding to the inequity of the Trust's theory, the Trust readily admits that the Advisor Defendants are merely in the case for the Trust's "convenience"; and that it can recover any alleged loss from other defendants who supposedly prevented RCAP from entering into the hypothetical contracts to which the Trust claims RCAP was entitled. The Trust's purported "convenience" is no substitute for the demands of equity.

In addition, because the Trust's unjust enrichment claim fails, so too must its request for a constructive trust. That proposed "remedy" is further

unwarranted given that the Trust does not allege that any of the Count III defendants owed, let alone breached, any duty to RCAP—a necessary requirement for a constructive trust. Nor does the Trust allege, as it must, the existence of specific property or identifiable proceeds of specific property over which a constructive trust could be imposed. Lastly, a constructive trust would again lead to a decidedly inequitable result: it would rob the Advisor Defendants of fees they negotiated and earned, and give them to a party that did neither.

For all of these reasons, and those set out below and in the ARC Parties' motion to dismiss, Counts II and III of the Complaint should now be dismissed.

PROCEDURAL BACKGROUND

On March 8, 2017, the Trust initiated this action by filing a Complaint (D.I. 1), asserting three purported causes of action: (1) a claim against the Control Defendants, Louisa Quarto and Holdings for breach of fiduciary duty; (2) a claim against the Control Defendants, Louisa Quarto and Holdings for aiding and abetting alleged breach of fiduciary duty; and (3) a claim against Advisor Defendants, AR Capital and AR Global for unjust enrichment and constructive trust.

The ARC Parties filed a partial motion to dismiss on May 26, 2017 (D.I. 31), which Mr. Block subsequently joined on May 30, 2017 (D.I. 33). In

their motion, the ARC Parties sought dismissal of almost all of Count I, and all of Counts II and III.[2] In particular, the ARC Parties argued that the Trust failed to plead the necessary elements of an aiding and abetting claim (Count II) against any defendant, particularly the element of knowing participation. As to the claim for unjust enrichment and constructive trust, the ARC Parties noted, among other things, that the Trust had failed to explain why the Advisor Defendants, AR Capital and AR Global should not be allowed to retain payments for work that even the Trust conceded they had fully performed under existing contractual arrangements.

The Court heard oral argument on the defendants' motion on September 29, 2017. During the argument, the Court stated that it "d[id]n't quite understand" the Trust's unjust enrichment claim against the Advisor Defendants, AR Capital and AR Global. (9/29/2017 Hr'g Tr. 34:20.) The Court asked the Trust's counsel to explain how "the fees that were earned [by the Advisor Defendants] were really the property of [RCAP]." (*Id.* 69:9-10.) In response, the Trust's counsel stated that the claim against the Advisor Defendants (and presumably AR Capital and AR Global) was included in the Complaint

[2] The ARC Parties moved to dismiss Count I of the Complaint except as to the Trust's allegations concerning the Cole and Apollo Transactions. The ARC Parties will demonstrate at the appropriate time that those transactions cannot support the Trust's purported breach of fiduciary duty claims.

"because . . . if liability is found, we [*i.e.*, the Trust] need to be able to formulate an appropriate remedy." (*Id.* 69:15-19.) The Court then asked the Trust's counsel, "you have to show that these funds really in equity are the property of RCS or RCAP, these particular funds, not just similar funds, don't you?" (*Id.* 70:16-19.) The Trust's counsel agreed. (*Id.* 70:20-21.)

The Court also asked the Trust's counsel whether the relief sought by the Trust's unjust enrichment claim could not instead be secured by way of a damages award against the other defendants, that is, those who had supposedly prevented RCAP and/or RCS from entering into hypothetical advisory agreements with AR Capital-sponsored REITs. (*Id.* 71:11-21; *id.* 72:11-15.) The Trust's counsel again agreed with the Court, stating, "I don't think it's essential to have [the Advisor Defendants]" in order to obtain relief. (*Id.* 72:11-17.)

On November 30, 2017, the Court issued a Memorandum Opinion (D.I. 61) (the "Opinion") that ruled on the defendants' motions to dismiss. As is relevant here, the Court declined to dismiss what it (and the parties) referred to as the "core claim" underlying the Trust's fiduciary duty claim, namely "the allegation that the Control Defendants used their control over RCAP to cause it to enter into off-market arrangements with AR Capital." (Op. at 27.) But the Court granted the motion as to the remaining allegations underlying the Trust's breach of fiduciary duty claim, including the Trust's claims that the Control Defendants and

Holdings breached their fiduciary duties by: (i) facilitating "proxy fraud" (*id.* at 38-40); (ii) causing RCAP to acquire certain unrelated entities (*id.* at 40-45); and (iii) causing "overstaffing" at RCS (*id.*). The Court also held that the Trust had failed to plead a claim against Louisa Quarto, and dismissed her from the action. (*Id.* at 45-47.)

In its Opinion, the Court reserved decision on the Trust's purported claims for (i) aiding and abetting breach of fiduciary duty (Count II) and (ii) unjust enrichment and constructive trust (Count III), and invited supplemental briefing from the parties as to those claims in light of the Court's ruling. (*See id.* at 49.)

This supplemental memorandum responds to the Court's invitation. In particular, and as discussed both in the ARC Parties' moving papers and below, even accepting the Court's rulings as to the "core" breach of fiduciary duty theory, the Trust has failed to state a claim for either (i) aiding and abetting breach of fiduciary duty or (ii) unjust enrichment and constructive trust.

ARGUMENT

I.
THE TRUST HAS NOT STATED A CLAIM FOR AIDING AND ABETTING BREACH OF FIDUCIARY DUTY

Count II of the Complaint, which asserts a claim for aiding and abetting breach of fiduciary duty against the Control Defendants and Holdings, should be dismissed because the Trust has failed to plead "knowing participation"

by *any* of the defendants named in that claim in connection with any alleged breach of fiduciary duty. As the defendants explained in their moving papers, "knowing participation" is a necessary element of any aiding and abetting breach of fiduciary duty claim, *see RBC Capital Mkts., LLC* v. *Jervis*, 129 A.3d 816, 861 (Del. 2015) (citation omitted), and a plaintiff's failure to plead this element requires dismissal of its claim, *see, e.g.*, *In re Novell, Inc. S'holder Litig.*, 2013 WL 322560, at *17-18 (Del. Ch. Jan. 3, 2013); *In re Telecomms., Inc. S'holders Litig.*, 2003 WL 21543427, at *2-4 (Del. Ch. July 7, 2003).

To allege knowing participation adequately for purposes of an aiding and abetting breach of fiduciary duty claim, a plaintiff must allege that "[t]he aider and abettor . . . act[ed] knowingly, intentionally, or with reckless indifference; that is, with an illicit state of mind." *RBC Capital Mkts., LLC*, 129 A.3d at 862 (citations, internal quotations & alterations omitted). In addition, a plaintiff must allege that a defendant had "knowledge that the conduct advocated or assisted constitute[d] . . . a [fiduciary] breach." *Malpiede* v. *Townson*, 780 A.2d 1075, 1097 (Del. 2001) (citation omitted).

The Trust's Complaint does not satisfy these pleading requirements. Indeed, 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. Rather, the Complaint merely asserts in wholly conclusory fashion that those defendants

"knowingly participated in breaches of fiduciary duty by other defendants and thus [are] liable for aiding and abetting such breaches." (Compl. ¶ 132.) These threadbare assertions—unaccompanied by any facts—are insufficient as a matter of settled Delaware law. *See Price* v. *E.I. DuPont De Nemours & Co.*, 26 A.3d 162, 166 (Del. 2011) ("We decline . . . to accept conclusory allegations unsupported by specific facts.") (citation omitted); *see Spring Real Estate, LLC* v. *Echo/RT Holdings, LLC*, 2013 WL 6916277, at *7 (Del. Ch. Dec. 31, 2013) ("The Complaint does not state a claim . . . because the[] allegations are conclusory and mere recitations of the . . . statute.") (citation omitted).

Thus, because the Complaint is devoid of any factual allegation that any defendant knowingly participated in a breach of fiduciary duty, Count II should be dismissed.

At the least, to the extent the Trust's aiding and abetting claim is premised on any alleged breach of fiduciary duty that the Court dismissed in its Opinion, such claim is improper because a "legally sufficient underlying claim for breach of fiduciary duty" is a prerequisite for any claim for aiding and abetting breach of fiduciary duty. *Madison Realty Partners 7, LLC* v. *AG ISA, LLC*, 2001 WL 406268, at *6 n.19 (Del. Ch. Apr. 17, 2001); *accord In re Crimson Expl. Inc. Stockholder Litig.*, 2014 WL 5449419, at *27 (Del. Ch. Oct. 24, 2014).

Specifically, the Court dismissed the Trust's fiduciary duty allegations concerning (1) a supposed "proxy fraud" (Op. at 38-40); (2) RCAP's acquisition of certain entities unrelated to the defendants (*id.* at 40-45); and (3) the purported "overstaffing" of RCS (*id.*). Thus, none of those allegations can support the Trust's mirror-image aiding and abetting claim, which should likewise be dismissed to the same extent as the breach of fiduciary duty claim.

II.
THE TRUST'S COMPLAINT CANNOT SUPPORT ITS CLAIMS FOR UNJUST ENRICHMENT AND CONSTRUCTIVE TRUST

Even though the Court declined to dismiss the "core" breach of fiduciary duty claim, the Trust's unjust enrichment and constructive trust claims are independently defective and should be dismissed.

A. The Trust's Unjust Enrichment Claim Should Be Dismissed

Under Delaware law, unjust enrichment requires "the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience." *Fleer Corp.* v. *Topps Chewing Gum, Inc.*, 539 A.2d 1060, 1062 (Del. 1988) (citation & internal quotations omitted). The Trust's unjust enrichment claim against the Advisor Defendants, AR Capital and AR Global does not allege any facts that—under the standards applicable on a motion to dismiss—remotely meet those standards.

First, the Trust appears to allege that the source of the supposed unjust enrichment is the Advisor Defendants' receipt of fees pursuant to their advisory contracts. If so, the Trust is foreclosed as a matter of law from bringing an unjust enrichment claim based on conduct that is indisputably governed by those contracts. *See BAE Sys. Info. & Elec. Sys. Integration, Inc.* v. *Lockheed Martin Corp.*, 2009 WL 264088, at *7 (Del. Ch. Feb. 3, 2009) (the "threshold inquiry" for an unjust enrichment claim is "whether a contract already governs the relevant relationship between the parties") (citation omitted).

In a transparent but misguided attempt to circumvent this established legal bar to its unjust enrichment claim, the Trust, in its opposition brief, took pains to argue that: (i) RCAP is not a party to the advisory contracts (even though its wholesaler subsidiary, RCS, is); and (ii) the contracts are themselves supposedly invalid because they are the result of a breach of fiduciary duty. (Answering Br. (D.I. 36) at 58-59.) These arguments in no way salvage the Trust's unjust enrichment claim.

As to the first point, the Trust cannot deny that RCAP's subsidiary RCS was a party to these agreements, or that RCAP received the benefit of these contracts as a parent of RCS. RCAP (and RCS) cannot both retain these benefits and claim the contracts are supposedly invalid. Under longstanding Delaware law, the Trust may have the right to plead alternative theories of relief, but it is not

entitled to make directly contradictory factual allegations. *See Miller* v. *Loft, Inc.*, 153 A. 861, 863 (Del. Ch. 1931) ("While relief may be sought in the alternative, yet the alternatives presented by it must rest if not on an identical at least on a consistent state of facts.").

Second, perhaps recognizing these problems, at oral argument, the Trust tried to take a slightly different, but equally incoherent, tack. There, the Trust argued that, "but for the defendants' fiduciary misconduct, RCAP would have been receiving 20 to 25 percent of the ongoing stream of advisory -- of management economics." (9/29/2017 Hr'g. Tr. 70:21-24.) In other words, under the Trust's newly articulated worldview, but for the Control Defendants' alleged breach of fiduciary duties, a hypothetical RCAP advisor entity would have been created, and a hypothetical contract would have been executed pursuant to which the hypothetical RCAP entity would have received some hypothetical (but unknown) amount of advisory fees.

Even assuming any of these hypotheticals to be true—which would require no shortage of leaps of faith—the Trust's unjust enrichment theory fails. The Advisor Defendants concededly received the advisory fees that they negotiated for, and earned, under the advisory contracts they entered into with the REITs and RCS. In other words, the "stream" of management economics imagined by the Trust at oral argument is by definition *not* real, identifiable

property actually belonging to RCAP on which the Trust can properly base an unjust enrichment claim (or constructive trust remedy), but rather a purely hypothetical payment stream. In that situation, no unjust enrichment can exist.

Third, for similar reasons, none of the defendants named in Count III could possibly have obtained some "benefit" to which it was not entitled. In fact, the Trust has admitted that the Advisor Defendants *earned* the fees owed to them for work performed pursuant to binding advisory contracts. (*See* Answering Br. at 59-60.) The Trust also essentially conceded that RCAP did *none* of the advisory work for which the Advisor Defendants were duly paid. (*See id.* at 59 ("The argument is not that . . . an appropriate RCAP entity[] did advisory work . . .").) Thus, it is not reasonably conceivable that any Advisor Defendant obtained any "benefit" that was actually owed to RCAP with respect to the advisory fees. The same is true for AR Capital and AR Global, which, as affiliates of the Advisor Defendants, at most could have indirectly earned money from the Advisor Defendants as a result of the Advisor Defendants' receipt of fees pursuant to those entities' advisory contracts.

Finally, by retaining the fees they earned for the work they performed, the Advisor Defendants in no way engaged in conduct that could be said to be against "fundamental principles of justice or equity and good conscience." *Fleer Corp.*, 539 A.2d at 1062 (citation & internal quotations omitted). The fact that the

Trust fails to allege that any of the Advisor Defendants, AR Capital, or AR Global engaged in *any* wrongdoing of any kind certainly must be factored into any analysis of the equities. *Cf. Teachers' Ret. Sys. of La.* v. *Aidinoff*, 900 A.2d 654, 671 (Del. Ch. 2006) (allowing unjust enrichment claim to proceed because plaintiff explicitly argued that the target of its unjust enrichment claim was responsible for the wrongdoing committed by that entity's controlling persons and explicitly set forth that entity's allegedly wrongful conduct).

The Complaint's total lack of allegations of any culpability on the part of the Advisor Defendants is particularly significant given the Trust's acknowledgment at oral argument that: (i) the actual alleged wrongdoers (*i.e.*, the *other* defendants) can compensate the Trust if any of them is found liable for denying RCAP a hypothetical set of advisory agreements and fees; and (ii) there is absolutely no need to have the Advisor Defendants in the case for the Trust to obtain the remedy it is seeking. (9/29/2017 Hr'g Tr. 72:11-17.) Indeed, in the Trust's own words, the Advisory Defendants are merely a "convenient"—though not a necessary—source for collecting damages associated with the theoretical advisory fees that the Trust claims RCAP might have received for work it might have done through a hypothetical subsidiary. (*See id.* 69:15-72:17.) The supposed convenience to the Trust of dragging in multiple defendants to essentially provide

an alternative source for a damages award, however, is not a valid basis to sustain the Trust's unjust enrichment claim.

* * * *

In short, the Court's rulings kept alive the Trust's theory that other defendants may have breached fiduciary duties in connection with the agreements to pay advisory fees to the Advisor Defendants. But the Court's ruling does not mean that the Trust should also have a claim for unjust enrichment against the Advisor Defendants, who merely complied with their commercial obligations and concededly earned the fees they were paid.

B. The Trust's Constructive Trust Claim Should Be Dismissed

The Trust's purported claim for imposition of a constructive trust on the Advisor Defendants, AR Capital and AR Global is equally defective and should also be dismissed.

To justify the imposition of a constructive trust, a plaintiff must show that a defendant "unjustly enriched itself at the expense of another to whom it owes some duty as the result of fraudulent or unfair and unconscionable conduct." *Nash* v. *Schock*, 1997 WL 770706, at *6 (Del. Ch. Dec. 3, 1997) (citation omitted), *aff'd*, 732 A.2d 217 (Del. 1999). Moreover, a "constructive trust is a remedy that relates to specific property or identifiable proceeds of specific property." *Hogg* v. *Walker*, 622 A.2d 648, 652 (Del. 1993) (citations omitted). In the rare instances where a

constructive trust is applied to the recovery of money, "there will be either an identifiable fund to which plaintiff claims equitable ownership through tracing or the legal remedy will be inadequate for another reason—such as the distinctively equitable nature of the right asserted." *McMahon* v. *New Castle Assocs.*, 532 A.2d 601, 608 (Del. Ch. 1987).

The Trust cannot satisfy any of these requirements.

First, for the reasons described above, the Trust has not stated an unjust enrichment claim. Its claim for a constructive trust thus necessarily fails as a matter of law. *See VTB Bank* v. *Navitron Projects Corp.*, 2014 WL 1691250, at *6 (Del. Ch. Apr. 28, 2014) (constructive trust is a remedy "secondary to, and derivative of, [an] underlying unjust enrichment claim").

Second, none of the Count III defendants are alleged to have owed, much less breached, any fiduciary duty to RCAP. In its brief in opposition to the defendants' motion, the Trust argued, in reliance on speculative dicta contained in the *Aidinoff* decision, that neither wrongdoing nor a fiduciary relationship is necessary to support the imposition of a constructive trust. (*See* Answering Br. at 61 (citing *Aidinoff*, 900 A.2d. at 673 n.25).) But decisions both pre- and post-dating the *Aidinoff* decision on which the Trust so heavily relies in an attempt to support its position hold to the contrary. *See, e.g.*, *Nash*, 1997 WL 770706, at *6 ("A constructive trust is available to a plaintiff only where a defendant *has unjustly*

enriched itself at the expense of another to whom it owes some duty as the result of fraudulent or unfair and unconscionable conduct.") (emphasis added, citation & internal quotation marks omitted); *Vanderbilt Mortg. & Fin., Inc.* v. *Thomas*, 2014 WL 5489338, at *4 (Del. Ch. Oct. 30, 2014) ("In order to be entitled to the imposition of a constructive trust, a plaintiff must show that *defendant's fraudulent, unfair, or unconscionable conduct* causes him to be unjustly enriched at the expense of another." (emphasis added, citation & internal quotation marks omitted)).

Third, in any event, as previously noted (*supra* pp. 12-13), there is no specific property or identifiable proceeds of specific property underlying the Trust's claims against the Advisor Defendants, AR Capital and AR Global. Rather, the Trust's claims assume that the Trust is entitled to a theoretical (and as yet unidentified) "share" of the funds these defendants received. For that reason too, a constructive trust is legally unavailable. *See McMahon*, 532 A.2d at 608-09 ("[E]ven when a constructive trust is viewed as a remedial not a substantive institution, it remains primarily a proprietary one; that is, a remedy relating to specific property or identifiable proceeds of specific property.") (citation &internal quotation marks omitted).

Finally, for reasons largely described above, there is nothing remotely equitable about the relief the Trust seeks, and thus there is no basis for a

constructive trust. In fact, the remedy the Trust proposes would have perverse results. A constructive trust would rob the Advisor Defendants of the fees they negotiated for and worked to earn. And, it would effectively impose an indenture under which the Advisor Defendants would continue to be responsible for performing 100% of the advisory work associated with the daily operation of the relevant REITs, but would receive only some fractional percentage of the agreed-upon fees throughout the term of the contract. (*See* 9/29/2017 Hr'g Tr. 70:20-71:3; 71:22-72:10.) Compounding this patently unfair result—and the resulting disincentives for the Advisor Defendants to fully perform under their agreements—under the Trust's theory, RCAP, which did absolutely nothing and, at this point, cannot do anything to assist in managing the REITs, would obtain the remaining percentage. For obvious reasons, no authority cited by the Trust or known to the ARC Parties supports such an inequitable outcome.

CONCLUSION

For all of the reasons set forth above, as well as those set forth in the ARC Parties' motion to dismiss and stated at oral argument, the Trust's aiding and abetting breach of fiduciary duty (Count II) and unjust enrichment and constructive trust (Count III) claims should be dismissed.

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Dated: January 10, 2018

CERTIFICATE OF SERVICE

I hereby certify that on January 10, 2018, the foregoing was caused to be served upon the following counsel of record via File & Serve*Xpress*:

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