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Chancery Court Clarifies When Counterclaims Are Advanceable

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Delaware Business Court Insider
June 11, 2014



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When are counterclaims prosecuted by a defendant subject to advancement? This question was addressed recently by the Delaware Court of Chancery in *Pontone v. Milso Industries*, C.A. No. 7615-VCP (Del. Ch. May 29, 2014).

Harry Pontone, a former officer and director of The York Group and its subsidiary, Milso Industries, was a defendant in an action brought by the two companies and their parent company in federal court in Pennsylvania. The Pennsylvania plaintiffs alleged that Pontone, while still employed by York and Milso, participated in a wrongful scheme to induce several of their employees and many of their customers to switch to their main competitor. They alleged that these actions violated Pontone's employment agreement, which included express noncompete and nonsolicitation covenants, as well as the common law. The Pennsylvania plaintiffs asserted numerous claims against Pontone, including claims for breach of contract, breach of fiduciary duty, tortious interference with contractual relations, unfair competition, and unjust enrichment.

In response, Pontone asserted a number of counterclaims against the Pennsylvania plaintiffs, including counts for breach of contract, breach of implied covenant of good faith and fair dealing, tortious interference with prospective economic advantage, unjust enrichment, unfair competition, misappropriation of name, image and likeness, abuse of process, intrusion on seclusion, and declaratory and injunctive relief.

York and Milso both had bylaws that provided their officers and directors with indemnification and advancement rights. Pontone brought suit in the Court of Chancery for indemnification and advancement for attorney fees and expenses he had incurred and would continue to incur in connection with the Pennsylvania action. The court had earlier granted summary judgment to Pontone, holding that he was entitled to advancement under Milso's bylaws but not York's bylaws, and appointed a special master to resolve any disputes between the parties as to the amount of fees and expenses properly subject to advancement. The matter was now before the court on Milso's exceptions to the special master's report. The primary issue was the legal standard and determination of which counterclaims were advanceable under Delaware law. The court had ruled earlier that whether the counterclaims in the Pennsylvania action were advanceable turned on whether they qualified as having been asserted "in defending" against the affirmative claims made in the Pennsylvania action. The special master applied the standard set forth by the Delaware Supreme Court in *Citadel Holding v. Roven*, 603 A.2d 818 (Del. 1992), asking whether the counterclaims were (1) "necessarily part of the same dispute" as the Pennsylvania plaintiffs' affirmative claims; and (2) "advanced to defeat, or offset" those claims.

Milso argued that the special master had applied an erroneous legal standard. First, Milso argued that the special master had applied the wrong test for determining whether a counterclaim was "necessarily part of the same dispute." The special master had looked to whether Pontone's counterclaims were intertwined with the affirmative claims in some general sense. Milso argued that in order to be "necessarily part of the same dispute" and eligible for advancement, the counterclaims had to qualify as compulsory under the traditional test used by the Delaware and federal procedural rules. Under the special master's formulation of the test, noncompulsory (or permissive) counterclaims might be subject to advancement.

The court agreed with Milso that in order for a counterclaim to be advanceable, it must qualify as a compulsory counterclaim under the prevailing Delaware and federal procedural standard. A counterclaim is compulsory under that standard if, among other requirements, it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim. According to the court, limiting advancement to compulsory counterclaims ensures the factual interrelatedness of affirmative claims and advanceable counterclaims. The court also underscored that the test is whether the counterclaim would qualify as compulsory under the traditional test used by Delaware and federal civil procedure rules, not whether it actually qualifies as compulsory under the rules of the jurisdiction where it was asserted. This refinement is necessary to provide consistency since, as the court noted, in some states all counterclaims are defined as permissive. Since the special master did not address whether the counterclaims in question were compulsory under the test used in Delaware and federal civil procedure rules, the standard he employed to determine whether the claims were necessarily part of the same dispute may have been overinclusive.

Second, Milso argued that a compulsory counterclaim can only qualify as defensive for purposes of advancement if it has the potential to fully defeat or negate an affirmative claim, so that the special master erred when he considered a counterclaim to be advanceable if it would operate "to defeat or offset" the affirmative claims. Milso based its argument on the standard actually applied in *Roven*, and a subsequent decision by the Court of Chancery in *Zaman v. Amedeo Holdings*, C.A. No. 3115-VCS (Del. Ch. May 23, 2008). In *Zaman*, the court restated the *Roven* test to require that the counterclaim be compulsory and so directly related to a claim against a corporate official such that success on the counterclaim would operate to defeat the affirmative claims against the corporate official: "In other words, a counterclaim fits within the 'in defending' language if it defends the corporate official by directly responding to and negating the affirmative claim." The *Pontone* court found the *Zaman* court's formulation—that a compulsory counterclaim must be able to defeat or respond to and negate an affirmative claim to be advanceable—to be consistent with *Roven*, but the suggestion that a compulsory counterclaim that offsets, but not defeats, an affirmative claim not be subject to advancement was inconsistent with the express language of *Roven*. Given the apparent conflict between these decisions, the court was bound to apply the test articulated by the Supreme Court in *Roven*. The court also found the result to be consistent with Delaware's public policy in favor of advancement.

The court restated the test in full as follows: A counterclaim will be considered to be "defending" and thus advanceable if it is (1) "necessarily part of the same dispute," in the sense that it qualifies as a compulsory counterclaim under the prevailing Delaware and federal procedural

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'Own Counsel' Defense Rejected in Awarding Class Counsel Fees

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May 14, 2014

Can a party that retains its own counsel be liable to pay a fee to another party's counsel or to class counsel? The answer, according to the recent Court of Chancery opinion in *Smith, Katzenstein & Jenkins v. Fidelity Management & Research*, C.A. No. 8066-VCL (Del. Ch. April 16, 2014), is a resounding yes. The court rejected the defendants' "own counsel" defense in an action to recover attorney fees and costs for benefits conferred as a result of the plaintiffs' prosecution and settlement of a class action as contrary to longstanding Delaware precedent dealing with shared causation in the award of fees and expenses when an attorney creates a common fund for, or confers a common benefit upon, a readily ascertainable group.

The plaintiffs were law firms that successfully prosecuted a class action lawsuit on behalf of the stockholders of Revlon against its controlling stockholder and board of directors. The defendants were investment funds and entities affiliated with the Fidelity financial services group that held or controlled shares constituting approximately 75 percent of the class. After the law firms began pursuing their case, but before the firms settled on behalf of the class, the Fidelity defendants settled their claims for a fixed amount per share plus a contingent payment based on any additional amount that the law firms obtained for the rest of the class. The law firms ultimately settled the claims for the rest of the class for an amount per share in excess of the Fidelity defendants' fixed payment, resulting in an additional payment to the Fidelity defendants of approximately \$4 million. After settling with Revlon, the law firms approached the Fidelity defendants seeking compensation for the benefits that they had conferred on the Fidelity defendants, but the defendants refused to pay anything. The firms then instituted suit against the Fidelity defendants. Subsequently, the court approved the class action settlement on behalf of the remainder of the class and awarded the firms fees and expenses based solely on the benefits that they had conferred on the class members other than the Fidelity defendants.

In order to obtain a fee award from the Fidelity defendants, the law firms had to show that the claims in the underlying lawsuit were meritorious at the time it was filed; the underlying lawsuit created a common fund for, or conferred an identifiable benefit on, the Fidelity defendants; and a causal connection existed between the litigation and the benefit. The court concluded that the law firms' complaints were meritorious when filed, a matter not in

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standard, and (2) "advanced to defeat, or offset" the affirmative claims.

Since there was a possibility that the special master's application of the test was overinclusive by not limiting itself to compulsory counterclaims, the court reviewed each of the counterclaims at issue to determine whether they were subject to advancement. The court found that the counts for breach of implied covenant, for tortious interference with prospective economic advantage, and for unjust enrichment were compulsory and capable of offsetting the Pennsylvania plaintiffs' affirmative claims and therefore advanceable. The counts for misappropriation of name, image and likeness, and for abuse of process were not compulsory and therefore not "necessarily part of the same dispute" as the affirmative claims and not subject to advancement.

Pontone does not make new law, but clarifies the existing standard for determining when a counterclaim may be the subject of advancement. More importantly, *Pontone* reminds us that counterclaims may be defensive and thus advanceable under the appropriate circumstances.

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