COURT OF CHANCERY OF THE STATE OF DELAWARE

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January 21, 2010 Revised February 18, 2010

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Re: Public Service Commission of the State of Delaware v. Utility Systems, Inc., et al. C.A. No. 2036-VCN

Date Submitted: April 14, 2009

Dear Counsel:

On December 21, 2004, Defendant Utility Systems, Inc. ("USI") sold three lots in a residential subdivision, known as The Woods at Herring Creek ("Herring Creek"), in Sussex County, Delaware to Defendant Carbaugh Property Management, LLC ("CPM"). CPM is owned by H. Clark Carbaugh, then-president and principal stockholder of USI, and his wife. At that time USI was a failing public utility company that had provided wastewater treatment services to the residents of Herring

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Creek. Numerous regulatory claims against USI came before Plaintiff Public Service

Commission of the State of Delaware (the "PSC"). One of those claims was that the

transfer of the lots from USI to CPM violated 26 Del. C. § 215(a)(1) because PSC

approval had not been obtained for the transfer of the lots which were deemed an

"essential part . . . of the . . . plant . . . or other property, necessary or useful in the

performance of [USI's] duty to the public." The PSC concluded that the transfer

violated utility law and should be rescinded. It ordered USI to reacquire the lots from

CPM. By then, however, USI was on the verge of bankruptcy and without funds to

repurchase the lots. The PSC now seeks an order from this Court requiring CPM to

return the lots to USI or an order voiding the initial sale to CPM.

Both the PSC and CPM have moved for summary judgment.²

* * *

Beginning in 1985, USI, in accordance with permits issued by the Delaware

Department of Natural Resources and Environmental Control ("DNREC") operated a

¹ By 26 Del. C. § 215(a)(1), "[n]o public utility, without first having obtained the approval of the [PSC], shall: (1) . . . sell . . . or otherwise dispose of or encumber any essential part of its . . . plant, equipment or other property, necessary or useful in the performance of its duty to the public;"

² USI has not appeared in this action.

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wastewater treatment system at Herring Creek. USI's facilities were not on land that

it owned in fee simple but, instead, were located within easement areas dedicated by

the developer. In the mid-to-late 1990s, the treatment beds, essential to USI's spray

irrigation treatment of the community's wastewater, began to fail.³ USI considered

the acquisition of additional lands, known as Lots 5, 6, and 7 of Herring Creek (the

"Lots"), which were adjacent to some of the existing treatment beds, to allow for an

upgrade and expansion of the system. While USI was considering improvements in

its treatment system, it also was discussing a sale to a larger public utility company.

That other utility company, through a subsidiary, purchased the Lots in 1999. The

anticipated acquisition of USI, however, could not be accomplished and, in 2001, USI

purchased the Lots for the same price as had been paid by the other utility company.

The purchase price was \$111,950, paid in part by an \$84,000 mortgage.⁴

DNREC approved the design for the upgrades proposed by USI. Lots 6 and a

portion of Lot 7 were essential to the upgrades; no portion of Lot 5 was involved.

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³ Aff. of H. Clark Carbaugh ("Carbaugh Aff.") ¶¶ 5-7.

⁴ Carbaugh Aff. ¶ 8; App. to PSC's Answering Br. in Opp'n to CPM's Mot. for Summ. J. Ex. 3.

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How to pay the cost of the upgrades was problematic. USI lacked the

necessary funds. Its contract to provide wastewater services might expire soon, and

that was an impediment to regular commercial lending. Although the contract could

be extended with homeowner acquiescence, the failing treatment beds were creating

major controversy with the residents of Herring Creek. USI sought special funding

from a government loan program, but the necessary cooperation from the Herring

Creek homeowners was not forthcoming.⁵

After having grown frustrated with USI's operational problems, the members

of the Herring Creek Homeowners Association (the "Association") decided to take

over the wastewater treatment system and to refrain from making payments to USI.6

By legislation effective in early July 2004, the PSC acquired jurisdiction over certain

private wastewater treatment system operators, including USI. It became necessary

for USI to obtain from the PSC a Certificate of Public Convenience and Necessity

("CPCN") by early December 2004. Both USI and the Association sought a CPCN

to operate the wastewater treatment system at Herring Creek. By the summer of

⁵ Carbaugh Aff. ¶¶ 11-12.

⁶ Carbaugh Aff. ¶¶ 13-14.

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2004, if not earlier, the "treatment" of wastewater at Herring Creek by USI had been

relegated to pumping and hauling the wastewater for off-site treatment, instead of on-

site treatment. In light of its deteriorating relationship with the residents of Herring

Creek and with the costs of pumping, hauling, and off-site treatment ongoing, USI

decided to discontinue its services. It advised the regulatory authorities that it would

cease operations at Herring Creek and would relinquish whatever permits it had. It

also withdrew its application for a CPCN.⁷

Thus, by mid-December 2004, USI had effectively abandoned its operations at

Herring Creek and, because it had no further need for the Lots, it determined to sell

them in order to pay off the mortgage of approximately \$84,000 owed to a local bank.

CPM purchased the Lots for \$120,000.8 By this time, it was reasonably clear that

spray irrigation, the technology used by USI, would no longer suffice at Herring

Creek and, instead, that connection to the public sewer system, operated by Sussex

County, would be necessary.

⁷ Carbaugh Aff. ¶ 22.

⁸ Carbaugh Aff. ¶ 22. CPM now reports that had an easement been necessary over the Lots to support a new treatment modality, it would have provided one to the successor treatment operator on reasonable terms.

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In September 2005, a PSC hearing examiner issued a report chastising USI for abandoning its operations at Herring Creek and for selling the Lots without the PSC's

prior approval.9 Fines of almost \$500,000 were recommended. The PSC adopted the

report in November 2005 by Order No. 6783 (the "Order"). The PSC confirmed

that the sale of the Lots to CPM was improper and should be rescinded, and it ordered

USI to reacquire the Lots from CPM.¹¹ USI appealed to the Superior Court, but that

appeal was dismissed on March 2, 2007, for lack of prosecution.

USI had continued to operate its other community wastewater treatment

systems, but despite its efforts, no buyer had been forthcoming and the burdens

associated with the litigation surrounding the events at Herring Creek, as well as

The December 2004 transfer and sale of three parcels of land (described as lots 5, 6, and 7) located at "The Woods on Herring Creek" development from Utility Systems, Inc., to Carbaugh Property Management, LLC, having been done without Commission approval, is declared to be in violation of 26 Del. C. §215(a)(1). Therefore the transaction conveying the three lots is found to have been illegal. Utility Systems, Inc., shall take appropriate actions to have the title and possession of such parcels returned to the utility plant of Utility Systems, Inc., within ninety days from the date of this Order.

⁹ App. to PSC's Opening Br. in Supp. of its Mot. for Summ. J. ("PSC App.") Ex. 1 (Findings and Recommendations of the Hearing Examiner (the "Findings")).

¹⁰ PSC App. Ex. 2.

¹¹ The Order (\P 3(b) (A99)) provides in part:

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problems with other operations, induced USI in May 2006 to file a Chapter 7

bankruptcy proceeding.

The bankruptcy trustee eventually abandoned as worthless all of USI's

wastewater treatment systems. PSC also has a judgment against USI for fines and

related charges approaching \$1 million. 12 USI has never reacquired the Lots.

* * *

The PSC contends that the Court should give collateral estoppel or res judicata

effect to the PSC's determination that the Lots were sold in violation of 26 Del. C.

§ 215. Although that conclusion was reached in an administrative hearing, it was

within the scope of the agency's exclusive jurisdiction to assess whether the Lots

were necessary or useful for the public utility function. Moreover, even though CPM

was not a party to the administrative proceedings before the PSC, the similar

ownership of USI and CPM warrants application of the efficiency-based doctrine of

collateral estoppel and res judicata to preclude relitigation of an already fully-vetted

issue.

¹² Carbaugh Aff. ¶ 35.

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On the other hand, CPM argues that the PSC's determination that the Lots were

needed for utility purposes was manifestly erroneous.¹³ It further asserts that it would

be fundamentally unfair to burden it with the outcome of the administrative

proceedings because, as a consequence of USI's insolvency, it was unable to continue

with its appeal in the Superior Court.

* * *

Summary judgment is appropriate when "there is no genuine issue as to any

material fact and . . . the moving party is entitled to a judgment as a matter of law." ¹⁴

Because both CPM and the PSC have moved for summary judgment, the Court

ordinarily would be free to treat the motions as "the equivalent of a stipulation for

decision on the merits based on the record submitted with the motions." In this

¹³ Briefly, two of the Lots would have been used if USI had been able to implement its planned system enhancements. It is not so clear that fee simple ownership of them would have been necessary if the Herring Creek wastewater collection system were connected to the public sewer system. The remaining Lot evidently was not shown on any plans; this, according to CPM, amply demonstrates that it was not necessary or useful to the public utility function. Carbaugh Aff. \P 7; see also Carbaugh Aff. \P 32.

¹⁴ Ct. Ch. R. 56(c).

¹⁵ Ct. Ch. R. 56(h).

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instance, however, the parties have disputed many facts.¹⁶ Although there may be numerous facts about which the PSC and CPM disagree, the facts material to the resolution of this action are not in dispute.¹⁷

* * *

"Essentially, *res judicata* bars a court or administrative agency from reconsidering conclusions of law previously adjudicated while collateral estoppel bars relitigation of issues of fact previously adjudicated." In determining whether to apply a bar to relitigating issues previously adjudicated, a court must resolve whether:

(1) the issue previously decided is identical with the one presented in the action in question, (2) the prior action has been finally adjudicated on the merits, (3) the party against whom the doctrine is invoked was a party or in privity with the party to the prior adjudication, and (4) the party

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 $^{^{16}}$ See Supp. Aff. of H. Clark Carbaugh ¶¶ 13-15; PSC's Answering Br. in Opp'n to CPM's Mot. for Summ. J. at 2.

¹⁷ The parties disagree in particular over whether the Lots were necessary or useful to the public utility function. As a mixed question of law and fact, this debate might preclude summary judgment if the debate were dispositive. The issue before the Court, however, as will be seen, is the effect to be given to the PSC's determination that the Lots were necessary or useful to the public utility function and, as to the proceedings before the PSC, there are no material facts in dispute.

¹⁸ Betts v. Townsends, Inc., 765 A.2d 531, 534 (Del. 2000). These doctrines may extend to decisions of both courts and administrative agencies. Id.; see also Messick v. Star Enter., 655 A.2d 1205, 1211 (Del. 1995) ("Collateral estoppel extends not only to issues decided by Courts, but also to issues decided by administrative agencies acting in a judicial capacity where the parties had an opportunity to litigate.").

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against whom the doctrine is raised had a full and fair opportunity to litigate the issue in the prior action.¹⁹

* * *

The PSC, with the jurisdiction conferred by § 215, determined that the Lots were transferred in violation of law.²⁰ USI appealed that decision to the Superior Court; the appeal was dismissed and, thus, the litigation as to USI was concluded. USI had a full and fair opportunity to litigate the question of the propriety of the transfer both before the PSC and the Superior Court.²¹ It lost, and it is bound by the result. The Court would likely give preclusive effect to the administrative order as it binds USI.

¹⁹ Betts, 765 A.2d at 535 (quoting State v. Machin, 642 A.2d 1235, 1239 (Del. Super. 1993)).

Order ¶ 17 (A95-A96). The Hearing Examiner, whose conclusions were adopted by the PSC, concluded that "[the Lots] were essential to the wastewater improvements project that DNREC permitted . . . , as the [Lots] were to serve as the area for additional treatment beds. . . . Accordingly, they were also either 'necessary or useful in the performance of its duty' to the Herring Creek community, under § 215(a)(1)." Findings ¶ 154 (A78). Thus, the Hearing Examiner also found that "USI [had] violated § 215(a)(1). *Id.* ¶ 155 (A78). The propriety of the transfer, both as a matter of fact and as a matter of law as adjudicated by the PSC is the same question presented in this litigation. Ultimately, the only "new" question in this action is the appropriate remedy.

²¹ CPM argues that USI's financial condition deprived USI of a fair opportunity to press its appeal. No reasons have been offered, however, for why CPM, or its principals, could not have funded (and, in fact, did not fund) the cost of the appeal. That a party does not pursue an appeal which is ultimately dismissed because the party is unable to pursue the appeal for financial reasons does not preclude treating the outcome of that process as final or as fair.

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Of course, USI does not own the Lots. The question, instead, is whether CPM is bound by the final order resolving USI's rights and obligations. CPM was not a party to the PSC process involving the Lots, and the Order, by its terms, does not purport to bind CPM.

There are, however, instances in which a nonparty may be bound by an earlier judgment because of conduct that should justly preclude that opportunity to relitigate matters that have previously been fully litigated.²² For example, under proper circumstances, a prior judgment against a corporation may bind the entity's owners.²³

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²² Kohls v. Kenetech Corp., 791 A.2d 763, 769 (Del. Ch. 2000), appeal refused, 765 A.2d 950 (Del. 2000), aff'd, 794 A.2d 1160 (Del. 2002).

See, e.g., Peterson Novelties, Inc. v. City of Berkley, 305 F.3d 386, 395 n.2 (6th Cir. 2002), abrogated on other grounds by Coles v. Granville, 448 F.3d 853, 859 n.1 (6th Cir. 2006); see also Restatement (Second) of Judgments § 59(3) (1982) ("The judgment in an action by or against [a closely held] corporation is conclusive upon the holder of its ownership if he actively participated in the action on behalf of the corporation, unless his interests and those of the corporation are so different that he should have opportunity to relitigate the issue."); Thomas & Agnes Carvel Found. v. Carvel, 2008 WL 4482703, at *5 n.51 (Del. Ch. Sept. 30, 2008) ("The Delaware courts regularly cite the Restatement (Second) of Judgments with approval."). But see In re Kaplan, 143 F.3d 807, 814 n.14 (3d Cir. 1998) (discussing Pennsylvania's reservations about the position taken in the Restatement (Second) of Judgments that a judgment against a closely held corporation is conclusive against the corporation's stockholders).

Cf. Orloff v. Shulman, 2005 WL 3272355, at *7-8 (Del. Ch. Nov. 23, 2005). In Orloff, this Court applied res judicata to bar derivative claims brought on behalf of a closely held corporation by a minority shareholder group. The representative plaintiffs had previously litigated these issues directly in another jurisdiction. Because the "nexus of interest between the derivative action and the individual action [was] likely to be especially close," the Court reasoned that allowing the

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In this matter, USI and CPM were owned by the same family. Mr. Carbaugh

was USI's President and controlling shareholder. Mr. Carbaugh also was the

Managing Member of CPM and a 50% owner. The remaining ownership interests in

both entities were held by his spouse or offspring.²⁴ Mr. Carbaugh and a son both

actively participated in the proceedings before the PSC—although, of course,

formally on behalf of USI. Thus, CPM is charged with notice of the PSC proceeding

and, particularly, the PSC's goal of restoring to USI title to the Lots. CPM, as USI's

grantee of the Lots, was "in privity" with USI.²⁵ Its interests were consistent with

those of USI. CPM has not suggested that it would have defended the PSC

proceeding in any way materially different from the manner of USI's defense. At

least in part, that is because CPM and USI were controlled by the same individual.

Indeed, CPM did not attempt to intervene in the PSC proceeding.

derivative suit to proceed "would be to cut the heart out of the previous adjudication, conducted at great length and expense in New York." Citing public policy and judicial efficiency, it held that "Courts have no duty to allow such laborious re-litigations by identical parties, and [it] declines to sanction one now." Id. at *8.

²⁴ PSC App. Ex. 3 at A111-12, A245-48.

²⁵ Whether CPM's status as grantee would alone have supported the conclusion regarding "in privity" for these purposes is a question the Court does not address.

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In short, the sum of all these various factors leads to the conclusion that CPM

is bound by the PSC's final order and is not entitled to relitigate the question of

whether some or all of the Lots were necessary or useful for USI's public utility

function.

Accordingly, the PSC is entitled to summary judgment declaring and

confirming that the transfer of the Lots to CPM was in violation of 26 Del. C.

§ 215(a)(1). Conversely, CPM's motion for summary judgment is denied.

* * *

That leaves the question of remedy. The PSC concedes that it lacks the power

to require CPM to reconvey the Lots to USI. Thus, it has come to this Court to seek

injunctive assistance. The Lots were transferred in violation of law. Ordering that

transfer to be set aside is an obvious solution.

The problem is that USI, an insolvent entity, the assets and interests of which

have been abandoned by a bankruptcy trustee, lacks the necessary financial

wherewithal to enable the Court to place the parties in roughly the same positions

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before the transfer: that is, USI had the Lots, subject to mortgage, and CPM had what

it paid as the purchase price.²⁶

The PSC asserts that the Lots must be restored to USI and that CPM would

fundamentally and functionally become a creditor of an insolvent entity. In brief,

USI, and, thus, the PSC would obtain the benefit of the value of the Lots; CPM would

be left with nothing from reconveyance of the Lots.²⁷

The relief to which the PSC is entitled is committed to the discretion of the

Court. CPM paid \$120,000 for the Lots; those proceeds were applied either to USI's

expenses or to the USI mortgage.²⁸ The PSC's preferred remedy is punitive in nature

and would result in a windfall at the expense of CPM. If the Lots had not been

transferred to CPM, they would have remained subject to the mortgage, a first lien.

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²⁶ The objective of the remedy of rescission is to place the parties in the same position as they were in before the challenged transaction. *See, e.g., Hegarty v. Am. Commonwealths Power Corp.*, 163 A. 616, 619 (Del. Ch. 1932).

²⁷ Because of penalties assessed by the PSC, the PSC has a judgment that would reach any property that might come into the possession of USI.

²⁸ Carbaugh Aff. ¶ 25. It is likely that the Lots were, and are, worth some amount more than the purchase price. The record does not support any precise determination.

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The PSC now seeks to recover the Lots free of any such lien. Accordingly, the remedy sponsored by the PSC would be fundamentally inequitable.²⁹

The exchange of consideration necessary for rescission can be accomplished in different ways. Return of CPM's payment—mirroring the initial transaction—would be the simplest, but that is not possible in this instance. Another approach, and one that reasonably puts the parties in the same position as they were before the transaction, would be to secure the purchase price paid by CPM with a valid first mortgage lien against the Lots that would bind them upon the transfer back to USI. The Court concludes, in the exercise of its discretion, that this is the fairest remedy available.

²⁹ The PSC has also suggested that the transfer of the Lots was void *ab initio*. The statutory language does not fairly support such a draconian reading; moreover, the question of whether property is "necessary or useful" to the utility function is not necessarily an easy one. Declaring a conveyance void from the outset should not be premised upon such a technical, fact-intensive inquiry.

Furthermore, it may be appropriate to note a question neither before the Court nor decided by the Court. This case involves a transfer between related parties, one of which was subject to PSC jurisdiction. This is not a case involving an acquisition by an unrelated third party. Thus, the Court expresses no view as to the application of 26 Del. C. § 215(a)(1) to an unrelated third-party conveyance.

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Because the parties have not had an opportunity to address the specific

provisions of any such resolution and because of the evolving nature of the roles of

the PSC, USI, the Association, and Sussex County, in terms of providing wastewater

treatment services to the residents of Herring Creek, the Court is reluctant to define

the terms of any such obligation at this time.

Accordingly, counsel shall confer and advise the Court of their views within

thirty days of the date of this letter opinion. An implementing order will be deferred

pending those submittals.

Very truly yours,

/s/ John W. Noble

JWN/cap

cc:

Register in Chancery-K