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Re: *Di Loreto v. Tiber Holding Corp.*
C.A. No. 16564

Dear Counsel:

Having reviewed the briefs, and given my familiarity with this case, I do not believe oral argument would be helpful. Accordingly, this is my decision on plaintiffs' exceptions to the Special Master's November 15, 2000 Final Report.

This case involves a mandatory buyback provision contained in the bylaws of defendant Tiber Holding Corporation ("Tibet-"), a closely-held Di Loreto family business. This provision requires Tiber to buy plaintiffs Michael and Andrew Di

Loreto's Class B common shares at their book value. In its 1999 decision,[1] this Court awarded plaintiffs specific performance of the mandatory buyback provision, subject to Tiber's potential setoff against certain judgments in favor of Tiber and against plaintiffs. The Court instructed the parties to calculate the per-share book value of the DiLoreto brothers' Class B shares and the amount of any setoff, but noted that if the parties were unable to provide the Court with these figures, a special master would be appointed to determine the issues. A Special Master[2] was appointed after the parties failed to provide these figures and he issued his Final Report on November 15, 2000. His conclusions are summarized below.

(1) The Special Master determined what price Tiber is required to pay for plaintiffs' Class B common shares under Tiber's bylaws. Article VI, Section 4 of Tiber's bylaws provides:

> The purchase price for such shares shall be determined by dividing the number of Class B shares then issued and outstanding by the dollar amount of the "stockholders' equity," as shown on the year-end financial statement of the corporation for the year immediately preceding the year in which the shares are offered for purchase.

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[1] *Di Loreto v. Tiber Holding Corp.,* Del. Ch., C.A. No. 16564, Chandler, C. (June 29, 1999), mem. op. See *also* Eric A. Chiappinelli, *Stories From Camp Automotive: Communicating the Importance of Family Dynamics to Corporation Law Students, 34* Ga. L. Rev. 699, 706-708 *(2000)* (using the *Di Loreto* case as an example of how family law dynamics influence corporate law principles).

[2] The Court, with the parties' consent, appointed William Lafferty, Esquire, as the Special Master.

The parties disagree on the meaning of "year-end financial statement." Plaintiffs contend that the term is ambiguous, must be construed against the drafter (Tiber), and must be found to refer to the 1997 "end of year" balance sheet attached as an exhibit to Tiber's 1997 federal tax return. This would result in a valuation of 158,060.86 per share of Class B common stock.[3] Tiber contends that the phrase "year end financial statement" is unambiguous and refers to Tiber's consolidated financial statements, dated as of December 3 1, 1997, which were audited by the certified public accounting firm of Buecler, Kerry & Irwin, Ltd. It is undisputed that these statements conclude that total shareholders' equity as of December 31, 1997, was $2,749,333 resulting in a $27,493.33 valuation per share of Class B common stock."

The Special Master found that the provision contained at Article IV, Section 4 of Tiber's bylaws unambiguously refers to Tiber's consolidated financial statements. The Special Master stated that "[a]lthough Article IV, Section 4 of Tiber's bylaws uses the term 'financial statement' in the singular, the only document that 'reasonably and fairly' meets this description, in my view, is Tiber's

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[3] This is the dollar amount of stockholders' equity, $15,806,086, divided by the number of Class B shares outstanding, 100. Since each plaintiff owns 23 shares of Class B common stock, each would be entitled to $3,635,399.78 ($158,060.86 x 23). These shares were a gift to the DiLoreto brothers from their parents, who own and control Tiber.

[4] Thus, each plaintiff would be entitled, under this view, to $632,346.59 (23 shares x $27,493.33).

consolidated financial statements, dated as of December 3 1, 1 997."[5] The Special Master gave three other reasons to support his conclusion. First, he noted that "it is common for corporations to prepare financial statements at the end of the fiscal year."' Second, he concluded that, "since 'book value' and 'stockholders' equity' are accounting terms, an objectively reasonable person would expect the financial statement referred to in Article IV, Section 4 of Tiber's bylaws to refer to a financial statement prepared in accordance with generally accepted accounting procedures ('GAAP')."[7] The consolidated financial statements were prepared in accordance with GAAP, but the balance sheet was not because it excluded one of Tiber's subsidiaries. Third, the Special Master concluded that "an objectively reasonable person would reasonably expect the financial statement referred to in Article IV, Section 4 of Tiber's bylaws to refer to a financial statement that does not effectively 'double-count' certain assets and liabilities."[8] The balance sheet did not make the same elimination as the consolidated financial statements and, thus, the balance sheet effectively *inflated* stockholders' equity.

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[5] Special Master's Final Report, at 6. The Special Master notes that the Supreme Court of Delaware has defined a contract as ambiguous "only when the provisions in controversy are reasonably or fairly susceptible to different interpretations or may have two or more different meanings." Special Master's Final Report, at 5 (citing *Rhone-Poulenc Basic Chemicals, Inc. v. American Motorists Ins.* Co., Del. Supr., 616 A.2d 1192, 1196 (1992)).

[6] Special Master's Final Report, at 7.

'Id. at 8.

[8] *Id.* at 9.

The Special Master also found that even if Article IV, Section 4 is ambiguous, which, for the reasons stated above, he believes it is not, a reasonable stockholder would expect the value of his or her shares to be determined by reference to audited financial statements prepared according to GAAP. He added that plaintiffs are entitled to prejudgment interest at the legal rate of ten percent simple interest accruing from March 16, 1998.

(2) The Special Master next discussed the issue of setoff, concluding that Tiber is entitled to setoff against its obligation to plaintiffs certain judgments totaling approx-imately $3 million that Tiber and certain of its subsidiaries have against plaintiffs. The Special Master relied on the Delaware Supreme Court's decision in *Pettinaro Construction Co. v. Lindh*[9] in his analysis of this issue. In that case, the Supreme Court stated that setoff, as a doctrine of equity, "should be allowed only when, in view of all the circumstances, equity and good conscience require it to be made, substantial justice will be promoted thereby, and the rights and interests of third persons will not be infringed."[10]

First, the Special Master dismissed plaintiffs' argument that Tiber is precluded from. seeking setoff because Tiber made false representations to plaintiffs when it negotiated the buyback provision and, thus, came to this Court

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'Del. Supr., 428 A.2d 1161 (1981).
[10] *Id.* at 1164.

with unclean hands. Plaintiffs compare their situation to that at issue in *Nakahara v. NS 1991 American Trust*,[11] where this Court denied the advancement of litigation expenses because of egregious conduct by the requesting party. The Special Master found that such egregious conduct did not occur here. Accordingly, he recommended that Tiber not be precluded from seeking setoff.

Second, the Special Master discussed plaintiffs' argument that setoff is not appropriate because there is no mutuality of debt. The plaintiffs argue that setoff would be inappropriate because the judgments in question did not involve identical parties. The Special Master notes that since "there is little or no Delaware law regarding the mutuality requirement for purposes of setoff, let alone controlling authority," the Court should use its equitable discretion in accordance with the standard of *Pettinaro*.[12] In the Special Master's view, mutuality is satisfied despite the fact that the judgments that Tiber has against plaintiffs also were entered in the full amount in favor of Tiber's subsidiaries. The Special Master notes that "it is inconceivable that any court would permit one or more of Tiber's subsidiaries to recover on that same amount in some hypothetical future proceeding once it is

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[11] Del. Ch., 718 A.2d 518 (1998).
[12] Special Master's Final Report at 19.

established that Tiber already received partial payment of the judgments by way of setoff in this action."[13]

(3) The Special Master also addressed plaintiffs' argument that the setoff should be limited because of plaintiffs' anticipated obligations to pay taxes and attorneys' fees. The Special Master concluded that Tiber's right to setoff should not be limited for either reason. With regard to their anticipated tax obligations, plaintiffs assert that they will owe long term capital gains taxes on the repurchase price and will also owe taxes on the interest portion of the judgment. They argue that the interests of the IRS, an innocent third party, should not be placed before Tiber. The Special Master rejected this argument, noting that none of these tax obligations have accrued, that the IRS is not a "creditor," and that there is no equitable reason to limit setoff on the basis of plaintiffs' tax obligations.

With regard to attorneys' fees, plaintiffs argue that their attorneys have a "charging lien" against any judgment that is obtained in this action up to the amount of their agreed upon contingent fee plus expenses. Plaintiffs insist that such a lien takes priority over the claims of other judgment creditors and, specifically, takes priority over any setoff awarded in this action. Tiber recognizes the validity of an attorney charging lien, but contends that such a lien is

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[13] Id. at 20.

inappropriate in light of the parties' Contingent Fee Agreement and, even if it is appropriate, should not take priority over the setoff of a preexisting judgment.

The Special Master noted that, as an initial matter, Delaware has no statute regarding attorney charging liens, although several cases have allowed them. The Master did not discuss at length why such a lien is appropriate in these circumstances. He merely noted that the Delaware cases establish that charging liens are valid, but that none of these cases discuss their priority *vis-a-vis* a setoff. He then moved to a discussion of whether the charging lien in this case (which he assumed to exist) should be accorded priority over any setoff. Initially, he concluded, contrary to plaintiffs' assertions, that there is no general rule recognized either in Delaware or throughout the United States, that attorney charging liens should be given priority over setoffs. Next, relying upon cases decided outside Delaware, he fashioned a flexible rule that the Court might use to determine the priority of the charging lien. Based on the particular facts of this case, the Special Master recommended that Tiber's right to seto:ff should prevail over the attorneys' charging lien. One important reason the Special Master cited for this conclusion is the fact that plaintiffs' attorneys entered the Contingent Fee Agreement with the knowledge that their ability to collect was uncertain, and that they might have to collect some or all of their contingent fee and expenses from plaintiffs' other assets.

I now turn to my review of the Special Master's findings in consideration of plaintiffs' exceptions to his report. The standard of review for a master's findings – both factual and legal – is de novo.[14] "De novo review generally means a new trial on questions of fact,"[15] but this is not necessary in all cases. "Only where exceptions raise a bona fide issue as to dispositive credibility determinations will a new hearing be inevitable.“” The exceptions at issue in this matter do not require a hearing and I will proceed in this letter opinion to resolve the legal arguments presented by counsel.

First, after careful review of the Master's Report and the plaintiffs' exceptions, I find that the Master correctly concluded that Article IV, Section 4 of Tiber's bylaws is an unambiguous provision For the reasons outlined by the Special Master and noted above, I also find that the term "year-end financial statement" contained in that provision reasonably and fairly refers to Tiber's consolidated financial statements, dated December 3 1, 1997, and audited by Buecler, Kerry & Irwin, Ltd. In addition, I find that even if the term were ambiguous, which I do not believe it is, any reasonable and objective third party

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[14] *DiGiacobbe v. Sestak*, Del. Supr., 743 A.2d 180, 184 (1999).
[15] *Id.*
[16] *Id.*

would assume that it refers to the consolidated financial statements, as these are the only relevant documents prepared and audited in accordance with GAAP.

Plaintiffs maintain in their exceptions that the provision is ambiguous and that "the applicable inquiry is what an 'objective person in the position of the parties' would have thought it meant, rather than a disinterested 'third party' as the Special Master suggested."[17] Even if plaintiffs may be correct in their distinction, it is of no importance, because this Court is satisfied that both a disinterested third party and an objective selling shareholder would assume the disputed provision referred to the consolidated financial statements.

Plaintiffs also assert that the *contra proferentem* doctrine should apply. As I stated above, however, the provision is unambiguous and, therefore, this doctrine is not implicated. Moreover, even if it were ambiguous, the ambiguity would be "cured" by the fact that any third party, including Tiber shareholders, would assume that it could only refer to the consolidated financial statements.

Next, I find that setoff is appropriate in this case. I reject plaintiffs' argument that Tiber has acted inequitably and that their "unclean hands in connection with the buyback that is the subject of this suit are a defense to Tiber's

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[17] Pls.' Exceptions at 6 (quoting *Kaiser Aluminum Corp.* v. *Matheson*, Del. Supr., 681 A.2d 392, 395 (1996)).

setoff counterclaim.”[18] I agree with the Special Master that Tiber did not act in such a way as would give rise to this defense. Moreover, I find that setoff is appropriate because there is mutuality of judgment. Contrary to plaintiffs' assertions, exact identity is not required under Delaware law and the fact that the judgments that Tiber has against plaintiffs also were entered in the full amount in favor of Tiber's subsidiaries does not defeat mutuality. The Special Master was clearly correct when he concluded that “it is inconceivable that any court would permit one or more of Tiber's subsidiaries to recover on that same amount in some hypothetical future proceeding once it is established that Tiber already received partial payment of the judgments by way of setoff in this action.““”

Lastly, plaintiffs argue that, if setoff is granted, it should only be partial setoff. Plaintiffs assert that taxes and attorneys' fees they owe in connection with the settlement should be excluded. I disagree. First, with regard to the taxes, I agree with the Special Master that plaintiffs' tax obligations have not yet accrued and that the IRS is not a “creditor.” Second, there is no equitable reason to limit setoff on the basis of potential tax obligations.

The attorneys' fees issue is somewhat more complicated. Plaintiffs assert that they have a valid attorney charging lien and that that lien must be given

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[18] Pls.' Exceptions at 16.
[19] Special Master's Final Report at 20.

priority over the setoff. They state that, if the Court were to follow the recommendation of the Special Master and not prioritize this lien over the setoff, "the Court will make it impossible for people with meritorious claims to obtain contingent representation if they have judgments against them."[20]

Although no statute in Delaware recognizes or authorizes attorney charging liens, Delaware courts have on three occasions recognized their validity.[21] The most important of these cases is also the earliest-Chancellor Wolcott's decision in *Royal Ins. Co. v. Simon.*[22] In that case, Chancellor Wolcott held that a charging lien existed. He defined a charging lien as "'the right of an attorney at law to recover compensation for his services from a fund recovered by his aid, and also the right to be protected by the court to the end that such recovery might be effected.'"[23] The Chancellor explicitly approved of such a lien, noting that "the prevalence of so many statutes in which the lien is recognized and its enforcement regulated is rather strong and convincing evidence of the justice and equity which underlie it."[24]

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[20] Pls.' Exceptions at 23.
[21] *See Royal Ins. Co. v. Simon,* Del. Ch., 174 A. 444 (1934); *Polin* v. *Delmarva Poultry Coup.,* Del. Super., 188 A.2d 364 (1963); *Pinder v. Cummings,* Del. Super., C.A. No. 85C-MR-11, Poppiti, J. (Feb. 21, 1990).
[22] Del. Ch., 174 A. 444 (1934).
[23] *Id.* at 446 (quoting 2 Thornton, Attorney at Law, § 578).
[24] *Id.* at 446.

The Chancellor next determined that the charging lien should be prioritized over two attachments that *postdated* it. In reaching that conclusion, he relied on the equitable doctrine of priorities which dictates that "a prior equitable interest prevails over a later legal one, unless the latter can borrow a superior status from the absence of notice of the existence of the former, accompanied with the element of a valuable consideration or in lieu thereof perhaps some other equitable interest."[25] *Royal* Insurance provides the basis for how this Court must prioritize competing claims. Simply put, first in time equals first in line. Thus, if an attorney and his client agree that that attorney will obtain his fee from a portion of the recovery, later in time claimants may only take against that fund after the attorney has been paid his fee. This was exactly what happened in *Royal Insurance*. The attorney in that case was allowed to recover his fee before the two subsequent in time creditors were paid. There is an exception to this general rule, however. When a second in time claimant has no *notice* of the preceding claim on the fund, that second in time claimant may claim priority over the preceding claimant.

In accordance with this framework, I must decide whether an attorney's charging lien involving the plaintiffs and their counsel should be given priority

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[25] *Id.* at *447.*

over the setoff that is the result of judgments outstanding against these same plaintiffs.[26] As an initial matter, it is unclear whether Tiber's claim, derived from the judgments, is, as plaintiffs stress, second in time to plaintiffs' attorneys' claim due to the fact that the judgments were *on appeal* when the Contingent Fee Agreement was signed.[27] Though the judgments were on appeal, they did come into being *before* the Fee Agreement and Tiber correctly points out that, absent a stay pending appeal, it had the right to execute on the Pennsylvania judgments when they were entered in April 1998, *before* the Fee Agreement was signed in July 1998. For these reasons, I agree that the judgments are in fact the first in time and, in accordance with the rule in *Royal Insurance,* should be first in line.

Even if I were persuaded that the attorney charging lien was in fact the first in time due to the fact that an appeal of the judgments was pending, the exception to the general rule of Royal *Insurance* would most likely apply and Tiber would still be first in line. In other words, Tiber, which, in this situation would be second in line, could claim priority over the technically first in time charging lien because it appears from the record that Tiber had no knowledge or notice of the Fee

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[26] This analysis assumes that the plaintiffs' attorneys have asserted a valid charging lien. I do not need to address the question whether this lien is indeed validly asserted, since, ultimately, I do not prioritize it over the setoff.

[27] The judgments against plaintiffs were entered *before* the Contingent Fee Agreement between plaintiffs and their attorneys in this action was signed in July 1998.

Agreement between plaintiffs and their attorneys before the appeals of the judgments were finalized.

Regardless of the technicalities of which party asserted the first valid claim, the result can be reached simply by examining the reasons why this Court allows attorney charging liens in lieu of statutory authority to do so. The rationale for allowing attorneys to assert a charging lien is, according to Chancellor Wolcott, to promote justice and equity. Plaintiffs' attorneys entered their contingent fee agreement with full knowledge of the potential for setoff against the judgments in favor of Tiber. Granting priority to their claimed charging lien in these circumstances is certainly not the equitable result, given this knowledge. Thus, for all of these reasons, any charging lien plaintiffs' attorneys may have successfully asserted should not, in these circumstances, be given priority over the setoff.

For the reasons stated in full above, plaintiffs are entitled to receive $27,493.33 for each share of Class B Common stock plus pre-judgment interest at the legal rate of ten percent simple interest from March 16, 1998 until the date judgment is entered. Thus, each plaintiff shall receive $632,346.59 plus interest as above described. The total amount of the awards to each plaintiff, $2,739,333 plus interest, will be setoff against plaintiffs' obligations to pay Tiber in connection with the judgments Tiber holds against plaintiffs.

Counsel shall confer and submit a form of implementing Order, on notice if they are unable to agree.

Very truly yours,

William B. Chandler III

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