

ORIGINAL

342

COURT OF CHANCERY
OF THE
STATE OF DELAWARE

LEO E. STRINE, JR.
VICE-CHANCELLOR

COURT HOUSE
WILMINGTON, DELAWARE 19801

September 27, 2000

Edward M. McNally, Esquire
Morris, James, Hitchens & Williams
222 Delaware Avenue
Wilmington, DE 19899

Elizabeth M. McGeever, Esquire
Prickett, Jones & Elliott
13 10 King Street
Wilmington, DE 19899

Michael D. Goldman, Esquire
Potter Anderson & Corroon
Hercules Plaza, 6th Floor
Wilmington, DE 19899

Re: Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., et. al.,
C.A. No 15754-NC

Dear Counsel:

Plaintiff Gotham Partners, L.P. has brought a motion for partial summary judgment seeking a declaration that it has no conflict of interest that precludes it from serving as a derivative plaintiff on behalf of nominal defendant Hallwood Realty Partners, L.P. (the "Partnership") and that the unclean hands doctrine does not bar its right to assert its claims. In this opinion, I conclude that even if Gotham engaged in the improper behavior of which it is accused, that behavior neither disqualifies it as a derivative plaintiff nor constitutes unclean hands justifying a refusal to hear its claims. Rather, I find that if Gotham did engage in the inappropriate behavior, that

factor may be taken into account in determining whether to award attorneys' fees for or against Gotham.

1. The Questions To Be Decided

Gotham filed this action in June 1997. Its complaint challenges three transactions (the "Challenged Transactions" or "Transactions") entered into by the Partnership: 1) a March 1995 reverse unit split (the "Split"); 2) a March, 1995 stock option plan (the "Stock Option Plan"); and 3) a June 1995 odd-lot tender offer ("Odd-Lot Offer"). The units that were purchased by the Limited Partnership in connection with the Split and the Odd-Lot Offer were in turn sold by the Partnership to defendant Hallwood Group Incorporated ("HGI"), the sole owner of the Partnership's general partner, defendant Hallwood Realty Corporation ("the General Partner"). Meanwhile, the Stock Option Plan granted options to officers who owed their careers and loyalties to HGI.

Gotham alleges that the sale of the units and the issuance of the options occurred on economic terms that were unfair to the Partnership and unduly favorable to HGI. Furthermore, Gotham claims that the Challenged Transactions were designed to secure HGI's control over the Partnership and not to benefit the Partnership. The Split and Odd-Lot Offer allegedly did so

by increasing HGI's equity interest in the Partnership from 5.15% to 24.7%.

When the unit options issued to HGI insiders are added, HGI and its affiliates controlled 29.4% of the Partnership's Units. This increase was sufficient to have an entrenching effect, argues Gotham, because the partnership agreement states that a two-thirds vote of the limited partners is necessary to replace the General Partner.

The defendants in this action have filed a motion for summary judgment on the merits of Gotham's attack on the Challenged Transactions. That motion is addressed in a separate opinion.

This opinion focusses solely on two questions relating Gotham's status as a plaintiff. First, is Gotham entitled to an award of summary judgment declaring it a proper, non-conflicted plaintiff with standing to pursue this derivative action on behalf of the Partnership? Second, is Gotham entitled to an award of summary judgment concluding that the doctrine of unclean hands does not bar its right to seek the relief it requests?

These questions arise because of a simple factual allegation that I must accept as true for purposes of this motion. According to the defendants, Gotham's principals expressed a willingness not to pursue this action if Gotham was given a fee-generating role to pursue a financial

restructuring on behalf of the Partnership. Only when told by the General Partner that no such role would be offered did Gotham pursue this lawsuit.’

Put simply, the defendants assert that Gotham attempted to coerce the Partnership into paying it a fee to avoid this lawsuit. Because this tactic is both inequitable and selfish, the defendants argue that Gotham should not be permitted the chance to pursue its claims and certainly not on behalf of others.

II. Legal Analysis

A.. Is Gotham Entitled To Summary Judgment On The Defendants’ Affirmative Defense That Gotham Is Not A Proner Derivative Plaintiff!

Although this case involves a derivative suit brought on behalf of a limited partnership rather than a corporation, the parties agree that this distinction is immaterial for purposes of articulating the standard by which to evaluate the defendants’ disqualification claim. They concede that the relevant standard requires a “show[ing] that a serious conflict of interest exists, by virtue of one factor or a combination of factors, and that the

¹ Gotham does not concede that this allegation is true except for purposes of this motion. Even the record evidence cited by the defendants does not rule out the possibility that it was the refusal of the defendants to commit to pursue a value-maximizing restructuring that would potentially correct any harm from the Challenged Transactions, and not the defendants’ failure to hire Gotham for that purpose, that was the predominant factor in Gotham s decision to litigate.

plaintiff cannot be expected, to act in the interests of others because doing so would harm his other interests. In effect, the defendani [s] must show a substantial likelihood that the derivative suit is not being maintained for the benefit of the [partners of the Partnership].”²

This court recently honed in on the central focus of this inquiry: “Put simply . . . , the Court must ensure that the other potential beneficiaries of this suit will not be ill-affected by [the plaintiffs] continued participation as representative.”³

Here, even assuming that the defendants’ factual accusations are correct, I conclude that there is no triable issue of fact raised regarding Gotham’s adequacy as a derivative plaintiff. By this action, Gotham seeks relief that would be of benefit to all the unitholders of the Partnership, other than HGI.

Assume that Gotham prevails on its claims at trial. If the Challenged Transactions are rescinded and the shares and options sold to HGI and its insiders are restored to the Partnership in exchange for it returning the sale

² *In re Dairy Mart Convenience Stores, Inc.*, Del. Ch., Cons. C.A. No. 14713, mem. op. at 21, Chandler, C. (May 24, 1999) (quoting *Emerald Partners v. Berlin*, Del. Ch., 654 A.2d 670,674 (1989)).

³ *Id.* at 23-24.

proceeds plus interest, then all of the unitholders other than HGI will benefit because their proportionate interest in the Partnership will be increased and any economic harm to the Partnership from the Challenged Transactions will be undone. Such rescissory relief will also increase the ability of the limited partners to choose another General Partner.

Likewise, if Gotham obtains an order of monetary damages requiring the defendants to pay the difference between what HGI and the insiders paid in 1995 and what they were contractually or fiduciarily obligated to pay, then that damage award will redound to the ultimate benefit of all unitholders of the Partnership other than HGI.

Therefore, when the focus is on this action itself; there is no economic antagonism between Gotham and the other unitholders. While this suit may have its origins in unseemly behavior, there is nothing in Gotham's litigation strategy to date that suggests that the -prior behavior has infected its ability to prosecute this action in a manner that is in harmony with the interests of the other unitholders.

Indeed, it is also worth noting that the unseemly behavior was in part premised on a request that was not at face value adverse to the interests of the unitholders other than HGI. It is conceded that Gotham was interested in

helping the Partnership accomplish a financial restructuring that might well have benefited the unitholders in a material way. It is only the fact that Gotham allegedly (and for -purposes of this motion, did) ask for a fee-earning role in seeking such a transaction in exchange for not pressing this suit that provides any legal or moral force to the defendants' disqualification argument. But without any evidence that Gotham's prior conduct has caused it to litigate this action in a manner adverse to t'he non-HGI unitholders, the fact is too insubstantial to buttress a conclusion that Gotham is not a proper derivative representative.

And certainly the mere fact that Gotham may wish to obtain relief that permits it a better opportunity to convince the other unitholders to sell their units to it or to replace Gotham as general partner presents no conflict. This court concluded in the *Dairy Mart* litigation that it would be inappropriately paternalistic to assume that security holders must be protected from receiving a legal remedy that might enable them to exercise greater influence through the ballot box — and thus obtain a greater possibility of receiving tender offers for their securities from the representative plaintiff or other

parties.⁴ When capitalists (such as the defendants) assert that other capitalists (such as the other unitholders) must be protected from themselves, it is always worthwhile for the court to inquire whether the argument is more self-interested than selfless. Here, if the defendants' motion is successful, the defendants will avoid the merits of a lawsuit that could compromise their interests and benefit the other unitholders.

B. Is Gotham Entitled To Summary Judgment On The Defendants' Unclean Hands Affirmative Defense?

The defendants' affirmative defense raises an interesting question of law. They cannot claim that Gotham's behavior in any way influenced the manner in which the Challenged Transactions were effected or that Gotham's behavior induced the consummation of those Transactions. Rather, the defendants argue that they would not be facing a challenge to those Transactions if they had acceded to Gotham's request that Gotham be paid to advise the Partnership in searching for a strategic transaction.

Having been confronted with what they regard as an extortionate overture by Gotham, the denial of which proximately resulted in the filing of this lawsuit, the defendants contend that Gotham's "inequitable conduct . . .

⁴ *In re Dairy Mart*, mem. op. at 26-27.

[had] an ‘immediate and necessary’ relation to the claims under which relief is sought.”⁵ Indeed, they argue that nothing could be more necessarily related to this case than a wrongful demand that the defendants buy off Gotham with Partnership funds in order to buy litigation peace.

In response, Gotham argues that the doctrine of unclean hands does not bar relief because the connection between its own alleged wrongdoing and this lawsuit is too attenuated. Put more directly, Gotham argues that because the Challenged Transactions were already consummated by the time of Gotham’s allegedly wrongful conduct, that wrongful conduct should not operate as a bar to relief for Gotham.

In resolving this motion, I am mindful that any unclean hands defense must be evaluated carefully to determine whether the public policy that under-girds the defense’s existence is implicated.’ Here, I conclude that even if the facts are as the defendants say they are, there is not a public policy justification for denying Gotham the ability to press its claims.

⁵ *Nakahara v. NS 1991 American Trust*, Del. Ch., 718 A.2d 518, 523 (1998) (quoting *Kousi v. Sugahara*, Del. Ch., C.A. No. 1156, mem. op., 1991 WL 248408, at *3, Jacobs, V.C. (Nov. 21, 1991)).

⁶ *Skoglund v. Ormand Industries, Inc.*, Del. Ch., 372 A.2d 204; *Nakahara*, 718 A.2d at 523.

The reality is that the Challenged Transactions were either proper or improper. Gotham's allegedly wrongful conduct has no effect on that analysis. That being the case, why would it make public policy sense to deny relief that would benefit other unitholders of the Partnership simply because Gotham had expressed a willingness not to pursue valid claims if granted a fee-earning role? Such a denial now might well have the **practical** effect of exculpating wrongful conduct by the defendants simply because of improper behavior by one unitholder.

Furthermore, such a rigid approach is not necessary to protect the defendants from any harm they have suffered as a result of Gotham's wrongful conduct. Rather, such harm can be dealt with in an alternative manner.

At trial, I will allow the defendants to present evidence regarding the alleged wrongful conduct supporting their unclean hands defense. Such evidence can be relevant in at least two ways. If the defendants prevail on the merits of Gotham's claims and if they convince me that Gotham tried to extract a fee-paying contract in exchange for not bringing suit, they may well have a basis for requiring that Gotham pay all of the fees and expenses incurred in defending these actions. Likewise, if the defendants lose on the

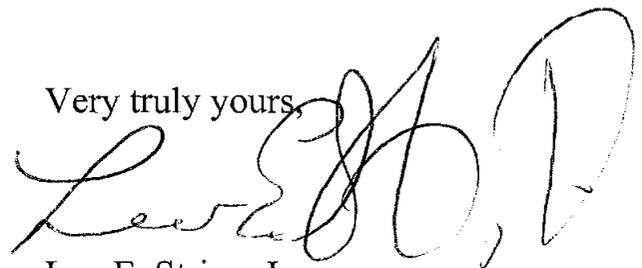
merits but Gotham is found to have engaged in wrongful conduct, the latter finding might be relevant to any consideration of a claim for fees and expenses made by Gotham.

Evaluation of the defendants defense in this more nuanced manner will serve to vindicate the legitimate interests of the defendants but without injuring other unitholders who might have been harmed by the Challenged Transactions.

III. Conclusion

For the foregoing reasons, Gotham's motion for summary judgment is GRANTED. IT IS SO ORDERED.

Very truly yours,

A handwritten signature in black ink, appearing to read "Leo E. Strine, Jr.", written over a large, stylized circular flourish.

Leo E. Strine, Jr.

oc: Register in Chancery