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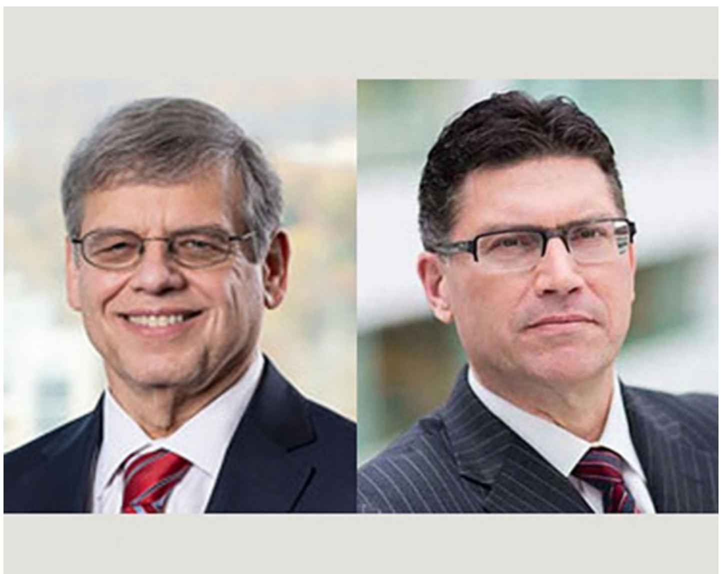
COMMENTARY

The Requirements of Equitable Fraud as a Basis for Chancery Court Jurisdiction

The distinction between legal and equitable fraud is not always clearly drawn, yet subject matter jurisdiction in the Delaware Court of Chancery can depend on it.

By Barry M. Klayman and Mark E. Felger | November 09, 2022



Barry M. Klayman, left, and Mark E. Felger, right.

The distinction between legal and equitable fraud is not always clearly drawn, yet subject matter jurisdiction in the Delaware Court of Chancery can depend on it. That was the case in *Trust Robin v. Tissue Analytics,* C.A. No. 2021-0806-SG, 2022 WL 4545174 (Del. Ch. Sept. 29, 2022), in which the jurisdiction of the Court of Chancery depended on whether the plaintiff had adequately pleaded a cause of action for equitable fraud. Vice Chancellor Sam Glasscock found that the complaint, taking into account all plaintiff-friendly inferences, stated a claim for equitable fraud; that a case at law absent such a count might be insufficient; and that the equitable fraud cause of action was more than a makeweight version of the legal torts also alleged. In light of the equitable fraud claim, the Court of Chancery had jurisdiction over the subject-matter of the lawsuit.

Plaintiff Trust Robin, a Canadian corporation, was hoping to bring the first user-friendly digital wound technology and education platform to market. It sought the assistance of the defendant Tissue Analytics, a Delaware corporation that specialized in developing artificial intelligencepowered software for the healthcare sector. The two companies entered into a memorandum of understanding outlining their plan to work together to develop and market Trust Robin's "iWound" application and integrate it into Tissue Analytic's software platform. The MOU was followed by a work order, pursuant to which Tissue Analytics agreed to develop and maintain Trust Robbin's software in exchange for a monthly fee, and a Master License & Services Agreement, which provided a more comprehensive legal framework for the work orders.

While Tissue Analytics was negotiating the master license agreement with Trust Robin, it was in the process of being acquired by defendant Net Health Systems. Trust Robin did not learn of the acquisition until it was publicly announced, but the former Tissue Analytics representatives, now employed at Net Health, assured Trust Robin that Net Health was committed to the development of the iWound app and might even consider purchasing Trust Robin. Relying on these representations, Trust Robin continued to supply the defendants with licensing fees and its intellectual property, business plans and lists of potential customers. Meanwhile, according to Trust Robin, the defendants capitalized on delays in the development of the iWound application and the information provided by Trust Robin to develop their own competing app and beat Trust Robin to market.

Trust Robin brought suit in the Court of Chancery against both Tissue Analytics and Net Health, alleging counts for common law fraud, fraudulent concealment, fraudulent inducement, equitable fraud, breach of contract, tortious interference with contract, tortious interference with prospective economic advantage, unjust enrichment, civil conspiracy, and breach of the implied covenant of good faith and fair dealing. The majority of the claims were legal in nature.

The only arguably equitable claim was the count sounding in equitable fraud.

The defendants moved to dismiss the complaint. At the argument on the motion, Vice Chancellor Glasscock raised sua sponte the issue of subject matter jurisdiction, since the complaint alleged breach of contract and fraud in connection with a services agreement that sounded largely in tort and contract. As a court of limited jurisdiction, the Court of Chancery is limited to hearing equitable causes of action and cases requiring equitable relief as well as those matters assigned to Chancery by statute. He asked the parties to provide supplemental briefing on the issue.

Trust Robin argued that the Court of Chancery had subject matter jurisdiction because of the claim for equitable fraud, while the defendants argued that the complaint failed to state a claim for equitable fraud. In his opinion, the vice chancellor discussed the distinction between legal and equitable fraud. Legal fraud requires a plaintiff to show a false representation, the defendant's knowledge of or belief in its falsity or the defendant's reckless indifference to its truth, the defendant's intention to induce action based on the representation, reasonable reliance by the plaintiff on the representation, and causally related damages. The gravamen of legal fraud is the scienter requirement—the defendant's knowledge of the falsity of its statements or reckless indifference to its truth. In contrast, equitable fraud, a creature of equity, does away with the scienter requirement. But the touchstone of equitable fraud is the equitable relationship between the parties. Only where a special relationship exists, rather than a purely contractual one, will the court find actionable equitable fraud.

In the case before him, Glasscock found that Trust Robin pleaded facts that could infer the existence of a special relationship necessary to invoke equity jurisdiction, although it was a close call. The relationship between Trust Robin and Tissue Analytics was originally commercial in nature. In order to effectuate the parties' joint purpose, the relationship required the defendants to control intellectual property and proprietary information belonging to Trust Robin. The defendants leveraged the control of Trust Robin's property to its detriment and their advantage. This was sufficient to imply a special relationship that went beyond a mere "quotidian commercial relationship." Further support for a special relationship was found in Trust Robin's description of its relationship with Tissue Analytics as a "partnership," even though the master license agreement provided that the parties were independent contractors and not partners.

The vice chancellor also found a meaningful distinction between the equitable action and its legal fraud analog as pleaded. It was conceivable that an equitable fraud claim might lie against Tissue Analytics whereas a legal fraud claim might not be sustainable based on the differing requirements of the two causes of action. Thus, the equitable fraud claim was not simply a makeweight, but had independent significance as a separate, equitable claim. As the vice chancellor commented, "This jurisdictional piton … is but shallowly driven into the rock of equity; nonetheless it holds."

The key to the court's finding that the plaintiff had pleaded a claim for equitable fraud was its ability to infer the existence of a special relationship between Trust Robin and the defendant Tissue Analytics. That required the court to determine where to draw the line between an ordinary commercial relationship and a relationship where the parties owed each other something more. In this case, the vice chancellor seized upon the defendants' control over the plaintiff's property to effectuate their joint purpose. It found further support in the plaintiff's description of their relationship in several instances as a "partnership," which implied the existence of fiduciary obligations between them. Still, the court will be reluctant to posit a special relationship in every commercial relationship, otherwise the distinction between law and equity, upon which the Court of Chancery's limited jurisdiction depends, would disappear. In Glasscock's words, the court's limited jurisdiction may be an anachronism, but it is "a beneficent anachronism" with perceived advantages for present day litigants.

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