IN THE SUPERIOR COURT OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

FEDERAL INSURANCE COMPANY,	)	
	)	
Plaintiff,	)	
	)	
v.	)	C.A. No. 06-02-248 (JRJ)
	)	
HILCO CAPITAL, LP and CONGRESS FINANCIAL CORPORATION,	)	
	)	
Defendants.	)	

Date Submitted: April 3, 2008
Date Decided: June 6, 2008, 2008
Dated Amended: August 5, 2008

Upon Plaintiff/Counterclaim Defendant Federal Insurance Company's Motion for Summary Judgment. **GRANTED IN PART, DENIED IN PART.**

Upon Defendant/Counterclaim Plaintiff Hilco Capital LP and Congress Financial Corp.'s Motion for Summary Judgment. **DENIED.**

AMENDED MEMORANDUM OPINION

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I. INTRODUCTION

Presently before the Court are cross-motions for summary judgment. Hilco Capital LP and Congress Financial Corporation (collectively referred to as "Hilco")[1] have moved for summary judgment seeking coverage for the *Barron* Litigation[2] settlement under an excess Directors and Officers policy issued by Federal Insurance Company ("Federal") to Payless Cashways, Inc. ("Payless").[3] Federal has cross-moved for summary judgment seeking a declaration that coverage for the settlement is barred under the applicable excess policy because the directors and officers of Payless ("the Insureds") materially breached their obligations under the policy. The Parties agree that Missouri law applies. The Court heard argument on these motions on April 3, 2008. For the reasons set forth below, the Court grants in part and denies in part Federal's motion and denies Hilco's motion.

II. BACKGROUND

A. The Policies

The Insureds maintained $30 million in Directors, Officers and Corporate Liability Insurance coverage consisting of three separate $10

[1] The Court will refer collectively to Hilco Capital LP and Congress Financial Corporation as "Hilco" since their interests are essentially allied in these motions, unless the context requires particular identification.
[2] The "*Barron"* Litigation was an action filed by the Hilco Parties against the directors and officers of Payless Cashways Inc. A detailed procedural history of this litigation is set forth in Federal's Opening Br. in Supp. of its Mot. for Summ.J. ("Federal Opening Br.") at 3-4, Docket Item ("D.I.") 81.
[3] Pursuant to the *Barron* Litigation settlement, the Insureds assigned their rights under the excess policy issued by Federal to the Hilco Parties.

million policies.[4] National Union Fire Insurance Company of Pittsburgh, PA. ("National Union") issued Policy No. 857-35-63 ("Primary Policy") that provided the first layer of $10 million coverage.[5] Federal issued Policy No. 8151-47-72 ("Federal Policy") that provided the second layer of $10 million coverage and Twin City Fire Insurance Company ("Twin City") provided the second excess policy which provided the third layer of $10 million coverage.[6]

The Federal Policy relies for its terms on the Primary Policy that "sits" below it. The Primary Policy provides and, in turn, the Federal Policy provides that:

> The Insureds shall not admit or assume any liability, enter into any settlement agreement, stipulate to any judgment, or incur any Defense Costs without the prior written consent of the Insurer. Only those settlements, stipulated judgments and Defense Costs which have been consented to by the Insurer shall be recoverable as Loss under the terms of the Policy. The Insurer's consent shall not be unreasonably withheld, provided that the Insurer shall be entitled to effectively associate in the defense and the negotiation of any settlement of any Claim.[7]

In addition to the incorporated terms of the Primary Policy, the Federal Policy further provides that "[n]o change in, modification of, or assignment of interest under this policy shall be effective except when made

[4] Cohen Aff., Exs. 1-3.
[5] The $10 million coverage limit of the Primary Policy has been exhausted through the payment of defense costs and costs in the *Barron* Litigation settlement. *Id.* at 1.
[6] *Id.* at 2-3.
[7] Cohen Aff., Ex. 1 at 10.

by written endorsement to this policy which is signed by an authorized representative of the Company."[8]

B. The Underlying Lawsuit – The "*Barron*" Litigation

1. Introduction

The Hilco Parties are financial institutions that provided financing to Payless based on and secured by the amount of inventory that Payless certified to the lenders. On May 6, 2003, Hilco filed a Complaint against Payless' directors and officers (the Insureds) for breach of fiduciary duty, negligent and intentional misrepresentation and common law fraud.[9] Essentially, Hilco claims that Payless manipulated and overstated inventory certifications and thereby induced Hilco to make loan advances that it would not have otherwise made. Hilco claims that the misrepresentations ultimately led to Payless' financial ruin and inability to repay its indebtedness.[10] On April 6, 2004, Hilco filed an Amended Complaint that added a claim of intentional interference with contracts.[11] In the Amended Complaint, Hilco alleged that David Stout, a lower-level Payless employee, made improper journal entries in the general ledger which led to the

[8] Cohen Aff., Ex. 2 at ¶11.
[9] Cohen Aff., Ex. 4 at ¶¶91-101.
[10] *Id.* at ¶1.
[11] Cohen Aff., Ex. 6.

overstated inventory certifications. Because Stout was not a director or officer of Payless, he was not a party to the lawsuit.

2. The October 15, 2003 Kansas City Mediation

On October 15, 2003, Hilco and the Insureds participated in a mediation before a retired Tenth Circuit judge in Kansas City.[12] At this time, the Insureds, represented by defense counsel David Shay, Esq. ("Shay"), and National Union viewed the settlement value to be between $3 and $5 million. Because the settlement range did not implicate the Federal Policy or Twin City Policy, neither excess insurer attended the mediation.[13] The mediation lasted only one day and was unsuccessful. The Parties subsequently engaged in extensive deposition and document discovery which ended in October 2004 with Hilco and the Insureds filing cross-motions for summary judgment. The Court scheduled a settlement conference to be held on January 5, 2005 before a magistrate judge. If that conference proved unsuccessful, trial was scheduled to begin on January 24, 2005.[14]

[12] Shay Aff., at ¶6.
[13] *Id.*
[14] Thum Aff., Ex. 8.

3. The December 7, 2004 San Francisco Mediation and the Handwritten Memorandum of Understanding ("MOU")

Prior to the January 5, 2005 settlement conference, Hilco and the Insureds again attempted to mediate, this time with a private and mutually agreed upon mediator. The mediation was scheduled for December 7, 2004 in San Francisco. Although Federal was notified of the San Francisco mediation, the Insureds, National Union and Federal all agreed Federal should not attend the mediation for tactical reasons.[15]

At that mediation, the mediator proposed a single-issue arbitration with a high-low restriction on damages. Under this approach, National Union would pay $3.8 million to Hilco up front and unconditionally. Any further obligation to provide coverage would be determined by the outcome of a single-issue arbitration to be held before a neutral arbitrator. If the Insureds prevailed on the single issue, Hilco would retain the $3.8 million paid by National Union and the Underlying Action would be dismissed with prejudice. If Hilco prevailed on the single issue, judgment would be entered against the Insureds for $15.5 million, in which case approximately $8.3

[15] According to Shay, he spoke with the representatives for National Union and Federal prior to the San Francisco mediation. He informed National Union and Federal that the Insureds had no intention of settling the case for more than $7 million. National Union agreed that it had no intention of paying the remaining limits of its policy to settle the *Barron* lawsuit. Further according to Shay, with the concurrence of the Insureds and National Union, Federal decided not to attend the mediation because the Federal Policy was not triggered until National Union paid out its limits and National Union made it clear that it would not offer its remaining limits at the mediation. Shay Aff., at ¶26.

million of the judgment would be provided by National Union thereby exhausting the remainder of its policy after payment of defense costs.

Shay informed the mediator, National Union and the Hilco Parties that the Insureds were unwilling to enter into the proposed settlement without Federal's consent because the Insureds were unwilling to assume the risk of exposure to a judgment that would not be covered by the Federal Policy.[16] According to Shay, "[the Insureds] and I understood that it would be necessary to obtain Federal's consent to the proposed settlement, because under the proposal Federal would be required to make a substantial payment under its policy if the Hilco Parties prevailed in the single issue arbitration."[17] The Hilco Parties agreed that they would not seek to recover any part of the judgment from the Insureds if they agreed to the settlement despite Federal's lack of consent.[18]

The mediator concluded the mediation by drafting by hand a copy of the proposed settlement terms (the "handwritten MOU"). There is no dispute that the terms were not complete. The handwritten MOU provided for a "low" of $5 million and an unspecified "high" that would be "limited

[16] Shay Aff., at ¶30, 32.
[17] *Id.* at ¶30.
[18] *Id.* at ¶33.

to amounts payable under the applicable excess insurance policies." [19] The single issue to be decided in arbitration was:

> Whether under the facts of this case the defendants or any of it should have known that during the period from November 2000 through March 2001 David Stout made materially false representations in the certifications of the value of merchandise inventory provided to the plaintiffs. Defendants stipulate that solely for the purposes of the arbitration the certifications referenced above contained materially false representations.[20]

The handwritten MOU expressly provided that the agreement was contingent only upon final approval from the Insureds, National Union, and the Hilco Parties, not Federal.[21]

On December 13, 2004, Shay sent Federal a copy of the handwritten MOU and asked that the proposal "be seriously considered" by Federal.[22] On January 4, 2005, Federal informed Shay and National Union that it would not consent to the settlement. Federal requested that the parties instead proceed with the settlement conference scheduled for the next day. Notwithstanding Federal's objection, the Insureds, National Union and the Hilco Parties executed the finalized Memorandum of Understanding ("MOU") embodying the terms of the single-issue arbitration and setting the

[19] Shay Aff., at ¶37.
[20] Cohen Aff., Ex. 25.
[21] *Id.*
[22] Shay Aff., at ¶41.

"high" at $15.5 million and the "low" at $3.8 million.[23] The MOU provided that if Hilco prevailed on the single issue, the Insureds would be obligated to assign their rights to coverage to Hilco. The MOU was the complete statement of the terms of the settlement.[24] Shay informed Federal that the MOU had been signed and that there was no need for Federal to attend the settlement conference.[25] Federal told Shay that, in light of the executed MOU, it would not attend the settlement conference but that it wanted the opportunity to express its objection to the MOU to the judge.[26]

The following day, the Insureds, National Union and the Hilco Parties presented the MOU to the magistrate judge at the settlement conference. The judge called Federal on the phone and Federal informed him that it would not consent to the terms of the MOU.[27] Following the settlement conference, the judge stayed the *Barron* Litigation to allow the parties to proceed with the single-issue arbitration.[28]

[23] Cohen Aff., Ex. 25.
[24] Shay Aff., at ¶46.
[25] *Id.* at ¶47.
[26] *Id.*
[27] *Id.* at ¶49.
[28] Cohen Aff., Ex. 30.

4. The March 8, 2005 Single-Issue Arbitration and Judgment

The single-issue arbitration convened on March 8, 2005. On April 15, 2005, the arbitrator issued a ruling in favor of Hilco.[29] On May 18, 2005, in accordance with the MOU, the Court entered judgment in favor of Hilco in the amount of $15.5 million.[30] National Union paid out its limits under the Primary Policy to Hilco for the *Barron* Litigation settlement and Hilco filed a Partial Satisfaction of Judgment based on the outstanding portion of the judgment; approximately $7.2 million.[31] Effective May 1, 2005, the Insureds assigned their rights to coverage against Federal for the balance of the judgment exceeding the Primary Policy limits to Hilco.[32] On February 24, 2006, Federal filed a declaratory judgment action asking the Court to declare that it is not obligated to provide coverage for the settlement.[33] On March 7, 2007, Hilco filed its motion for summary judgment.[34] On February 1, 2008, Federal filed its cross motion for summary judgment.[35] On April 3, 2008, the Court heard oral argument on the cross motions.

[29] Thum Aff., Ex. 23.
[30] *Id.* at Ex. 24.
[31] Thum Aff., at Ex. 25.
[32] *Id.*at 26.
[33] Complaint for Declaratory Judgment and Further Relief, D.I. 1.
[34] Hilco's Mot. for Summ. J., D.I. 36.
[35] Federal's Mot. for Summ. J., D.I. 81.

III. DISCUSSION

Summary judgment should be granted if the record shows that there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law.[36] The facts must be viewed in the light most favorable to the non-moving party.[37] Summary judgment may not be granted if the record indicates that a material fact is in dispute, or if it seems desirable to inquire more thoroughly into the facts in order to clarify the application of the law to the circumstances.[38] However, when the facts permit a reasonable person to draw but one inference, the question becomes one for decision as a matter of law.[39]

Federal claims that it is entitled to summary judgment for three reasons. First, it claims that the Insureds breached the "consent to settle" provision in the Primary Policy, to which the Federal Policy follows form, when they entered into the settlement without first obtaining Federal's written consent. According to Federal, because it had a reasonable basis for withholding consent, the Insureds' breach precludes coverage for the settlement. Second, Federal claims that the Insureds breached the anti-assignment provision in the Federal Policy when they assigned their rights to

[36] Super. Ct. Civ. R. 56(c).
[37] *Guy v. Judicial Nominating Comm'n*, 659 A.2d 777, 780 (Del. Super. 1995) *Figgs v. Bellevue Holding Co.*, 652 A.2d 1084, 1087 (Del. Super. 1994).
[38] *Ebersole v. Lowengrub*, 180 A.2d 467, 470 (Del. 1962).
[39] *Wooten v. Kiger*, 226 A.2d 238 (Del. 1967).

Hilco before the loss and without its written consent. Third, Federal argues that, wholly apart from the Policy provisions, the settlement was collusive and unreasonable and thus not enforceable under Missouri law.

In opposition, Hilco argues that the Insureds did not breach the Federal Policy when they entered into the settlement because Federal delegated the right to consent to National Union. According to Hilco, because National Union consented to the settlement, Federal is liable for the resulting judgment. Alternatively, Hilco argues that even if Federal had the right to consent, it could not unreasonably refuse to consent, and because Federal did not have a reasonable basis to withhold its consent, the Insureds were free to enter into the reasonable and non-collusive settlement. Hilco also argues that under Missouri law Federal had an implied duty to negotiate in good faith and that it violated that right by refusing to participate in the settlement process. As a result, Hilco claims that Federal breached its obligations to the Insureds and is liable for the judgment entered against them.

A. Federal Did Not Have an Implied Duty to Negotiate

Under Delaware law, the existence of a legal duty is a question of law to be determined by the Court.[40] Upon review of the Federal Policy and the applicable Missouri law, the Court concludes that the Participation Clause of the Federal Policy establishes, as a matter of law, that Federal did not have a an implied legal duty to negotiate with Hilco.

The Participation Clause is clear and unambiguous in regard to Federal's obligation to negotiate and therefore the parties are bound by the plain meaning.[41] It specifically provides that Federal "may, at its sole discretion, elect to participate in investigation, settlement or defense of any claim covered by the policy, even if the primary policy has not been exhausted." Based upon the plain language of the policy, the Court finds that Federal had the *option* to participate in settlement negotiations, at any time, at its *sole discretion.*

Under Missouri law, "there can be no breach of the implied promise or covenant of good faith and fair dealing where the contract expressly permits the actions being challenged, and the defendant acts in accordance with the express terms of the contract."[42] Accordingly, the Court finds that

[40] *Certain Underwriters v. Nat'l Installment Ins. Servs.* 2007 WL 4554453, at *9 (Del. Ch.) ("[t]he existence of a legal duty ordinarily is a question of law to be decided by the court.").
[41] See *AT&T Wireless Services, Inc. v. Federal Ins. Co.,* 2006 WL 267135 (Del. Super.).
[42] *City of St. Joseph v. Lake Contrary Sewer Dist.*, 2008 WL 1860307 (Mo. Ct. App.).

Federal did not have an implied duty to negotiate because the language of the Participation Clause expressly provided otherwise. The Court therefore grants summary judgment in favor of Federal on this issue.

B. Federal Had a Right to Consent to the Settlement

The Court finds that Federal did have a right to consent to the settlement. The consent to settle provision at issue provides that "[t]he Insureds shall not…enter into any settlement agreement…without the prior written consent of the Insurer."[43] Hilco argues that "[t]he Primary Policy, to which the Federal Policy follows form, states that the 'Insurer' has the right to consent and the 'Insurer' is defined as National Union . . . [therefore] . . . Federal did not preserve the right to consent to the settlement, but had delegated that right to National Union."[44]

The Court does not agree with Hilco's interpretation. It is undisputed that both the Insureds and National Union interpreted the Policy to require that the Insureds request and obtain Federal's consent for any settlement that potentially implicated the Federal Policy. Shay stated that he told the mediator, Hilco and National Union that the Insureds were unwilling to enter into the proposed settlement unless Federal consented to it because the Insureds understood that it was necessary to request and obtain Federal's

[43] Cohen Aff., Ex. 1 at ¶8.
[44] Hilco Ans. Br. at 19.

consent prior to agreeing to the settlement, and that Federal may not be liable under its excess policy for any settlement to which it did not consent.[45] Consistent with Missouri law, the mutual intent of the original contracting parties controls the construction of their contract. In *Metropolitan Nat'l Bank v. Benedict Co.,*[46] the Court held that "[t]he law will not override the will of the parties in the construction of their own contracts, for the benefit of a third party, whose interests are not affected thereby, or who acquired his interest with full knowledge of what the parties conceded and agreed was their contract." To the extent that Hilco acquired its interest in the Federal Policy with full knowledge that the Insureds and Federal understood the Policy to give Federal a right to consent, it cannot now insist on a contrary interpretation of the terms that it knowingly acquired. The Court therefore grants summary judgment in favor of Federal on this issue.

C. Genuine Issues of Material Fact Exist as to the Remaining Issues

There are significant factual disputes that preclude the Court from granting summary judgment with respect to the remaining issues. For example, although the Court has determined that Federal had a right to

[45] Shay Aff., at ¶32.
[46] 74 F. 182, 185 (8th Cir. 1896).

consent to the settlement, it is for the jury to determine whether Federal unreasonably withheld its consent. If the jury finds that Federal unreasonably withheld its consent, the jury must then determine whether the settlement was reasonable and non-collusive. Because genuine issues of material fact exist as to whether Federal or the Insureds breached the Federal Policy prior to the Insured's assignment of their rights, the Court will not dispose of that issue on summary judgment.

In light of the foregoing, Federal's Motion for Summary Judgment is **GRANTED in part** and **DENIED in part** and Hilco's Motion for Summary Judgment is **DENIED.**

IT IS SO ORDERED.

Jan. R. Jurden, Judge