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Case Number 164,2014

IN THE SUPREME COURT OF THE STATE OF DELAWARE

AVON ROAD PARTNERS, LP, a Delaware limited partnership, ROBERT BERMAN and DENNIS VACCO,	)	
Defendants-below/Appellants,	)	
v.	)	
CASTLEPOINT INSURANCE COMPANY, a New York insurance company, TOW SUR, LLC, a Connecticut limited liability company, REL-REM HOLDINGS, INC., a Delaware corporation, TROMBONE, LLC, a Connecticut limited liability company, JOEL ASEN and JAMES ROBERTS,	)	No. 164, 2014
Plaintiffs-below/Appellees	)	On appeal from the Court of Chancery in C.A. No. 9021-VCG
and	)	
CINIUM FINANCIAL SERVICES CORPORATION, a Delaware corporation,	)	
Nominal Defendant-below.	)	

APPELLANTS' REPLY BRIEF ON APPEAL

David L. Finger (DE Bar ID #2556)
Finger & Slanina, LLC
One Commerce Center
1201 N. Orange St., 7th floor
Wilmington, DE 19801-1186
(302) 573-2525
Attorney for Appellants Avon Road Partners, LP, Robert Berman and Dennis Vacco

Of counsel:
Joseph Bernstein
Bernstein & Bernstein
1045 Fifth Avenue
New York, NY 10028
(917) 365-3651

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Other authorities

ARGUMENT

I. INTRODUCTION.

As set forth in Appellants' opening brief, Cinium Financial Services Corporation, a Delaware corporation ("Cinium"), owns 100% of a New York insurance company, Upper Hudson National Insurance Company ("UHNIC"), and is accordingly regulated under the New York Insurance Law as a "holding company system." N.Y. Ins. Law §1501(6). Under Section 1506 of that law, no person, other than an authorized insurer, may acquire control of Cinium, whether by purchase of its securities or otherwise, unless (among other conditions) "it receives the superintendent's *prior* approval."[1] N.Y. Ins. Law §1506(a)(2) (italics added).[2]

Appellees instructed Appellants not to contact the regulating authority, the New York Department of Financial Services ("DFS"), saying that they wanted to do it themselves. However, in doing so, Appellees misled DFS by not informing it, during a telephone conversation, of the provisions of the Security Holders Agreement

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[1] "The word 'prior' is generally understood to mean 'preceding in time or in order.'" *State v. Mena-Rivera*, 791 N.W.2d 613, 619 (Neb. 2010).

[2] Delaware similarly requires approval of the Insurance Commissioner before acquisition of control of domestic insurance companies, "whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise." 18 Del. C. ch. 50 & §5001(3).

("SHA") which gave Appellees (who would have the right to place a single controlling director on the Cinium Board) the power to restrict and control the ability of the board as a whole to manage the business and affairs of the corporation.[3] By withholding that crucial information, Appellees were able to obtain an informal opinion of DFS that prior approval by DFS would not be necessary.

Appellees then informed Appellants that DFS did not require prior approval, without telling Appellants that Appellees did not in that conversation inform DFS of the existence of the SHA or its control provisions. Based on Appellees' misleading

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[3] Appellees argue that Mr. Perri did not mislead DFS, but simply exercised his professional judgment that it was not necessary to disclose the control provisions to DFS. (Appellees' Answering Brief ("AAB") at 12-13). Whether or not his actions amount to either knowing misconduct or gross negligence is not material to a resolution of this appeal. His judgment was wrong, as shown by the fact that DFS subsequently required changes to the SHA as a condition of approval. The point is that Mr. Perri was not candid in his disclosure to DFS, precluding a legitimate determination under Section 1506 at that time. Nor was Mr. Perri candid in communicating to Appellants the substance of his communication with DFS.

Appellees also insinuate that Mr. Perri's conduct was sufficient because DFS could have asked more questions if it wanted more information. (AAB 13). This is disingenuous, given Mr. Perri's selective disclosure. DFS had no reason to suspect that he was withholding crucial information. Statutes requiring applications to administrative agencies for approval presuppose a frank, candid and honest disclosure of the facts. *See Great Western Broadcasting Ass'n v. F.C.C.*, 94 F.2d 244, 247 (D.C. Cir. 1937).

representation, Appellants and other stockholders were induced into signing the SHA.[4]

As Appellees did not obtain approval from DFS prior to the execution of the SHA (which closing was fraudulently induced by Appellees' misleading representation) as mandated by New York statutory law, the conduct of CastlePoint's designated director in exercising control over Cinium thereafter violated New York's Insurance Law, rendering the SHA void prior to DFS approval.

During this litigation, Appellants asked DFS for a determination as to the validity of the SHA. On the eve of oral argument below, DFS ruled that the SHA, as executed, was not valid but would be approved subject to removal of certain control provisions. DFS did not make any ruling retroactively approving any action of Appellees prior to the amendment of the SHA.

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[4] Appellees state that Appellant Robert Berman "is not seeking to rescind the [SHA]." (AAB 17). This mis-characterizes Mr. Berman's testimony (and in any event, rescission would be beyond the scope of an action under 8 Del. C. §225). In fact, in an action filed in the Supreme Court of New York by Appellants Robert Berman and Avon Road Partners L.P. on October 18, 2013, rescission of the SHA is one of the remedies sought. Appellees filed an action in the Court of Chancery to enjoin those proceedings. *CastlePoint Insurance Company v. Cinium Financial Services, Inc.*, Del. Ch., C.A. No. 9052-VCG. On November 19, 2013, the Court of Chancery entered a stipulated order staying that action pending resolution of the present action.

At the time Avon Road issued its written consent on October 16, 2013, removing four directors, CastlePoint had not obtained "prior approval" of DFS. Therefore, the SHA was void at the time of the written consents as it violated the New York Insurance Law, and could not be interposed to defeat a written consent issued by the holder of an absolute majority of the outstanding stock of Cinium (or render such consent in violation of contract, as contended by Appellees).

II. THE COURT OF CHANCERY COMMITTED LEGAL ERROR.

Appellees claim that the court below committed no legal errors. Respectfully, it did.

A. THE COURT OF CHANCERY ERRED BY NOT DETERMINING WHETHER THE SHA CONFERRED CONTROL UPON APPELLEES IN VIOLATION OF SECTION 1506.

To determine whether the SHA was inoperative at the time of delivery of the written consent as being in violation of Section 1506, the Court of Chancery had to determine whether Section 1506 was applicable. To do that, it had to determine whether the transaction resulted in Appellees acquiring control of Cinium. It expressly elected not to do so. This failure is prejudicial to both a determination of whether Section 1506 applies, and, if so, whether that statute was clearly violated.

Appellees argue that there was no control because CastlePoint did not obtain control over at least 10% of the voting securities of Cinium, the statutory threshold

for a presumption of control. (AAB 25). However, 10% stock ownership is only the basis for a presumption of control. It is not the exclusive way of establishing control. N.Y. Ins. Law §1501(a)(2) ("control" defined as "the possession direct or indirect of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract (except a commercial contract for goods or non-management services) or otherwise…"). Appellees' argument, therefore, is a red herring.

Appellants respectfully refer the Court to pages 5-8 and 19-23 of their opening brief, in which Appellants set forth in detail the many ways in which the SHA conferred "control" and a "controlling influence" over the operations of Cinium. While Appellees attempt to justify those provisions as merely maintaining the status quo (AAB 26), the ability to do so is itself a form of control. In any event, the power conferred by the SHA goes far beyond maintaining the status quo. For example, by granting Appellee's designee to the board the power to prevent a quorum simply by not attending board meetings, Appellees have the power to coerce the other board members into compliance with their wishes by preventing any business from being addressed. Moreover, by granting the Investor Director the power to approve budgets, the Investor Director has the power to control every aspect of the operations of the company, down to the last penny.

Section 1501(a) does not distinguish between "negative" control and "positive" control. *See Nat'l American Ins. Co. v. CenTra, Inc*., 151 F.3d 780, 787 (8th Cir. 1998) (identical statute "does not support their contention that control requires active voting rights. Rather, the statute provides that: 'Control ... shall mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities ... or otherwise....'"). Blocking power is control. As the U.S. Court of Claims stated:

> Pine Products disputes the point saying that "[t]here is no reality to 'negative control' " and that the ability of one owner to block action by the other is not control of the joint venture within the meaning of the statute. We cannot accept this view. In everyday usage, control is seen both as a negative force as well as a positive one ("To exercise restraint or direction...." III *The Oxford English Dictionary* 853 (2d ed.1989) (emphasis added)) and we are offered no reason to assume that this ordinary meaning was not meant to be controlling. *See Banks v. Chicago Grain Trimmers Ass'n*, 390 U.S. 459, 465, 88 S.Ct. 1140, 1144, 20 L.Ed.2d 30 (1968) ("In the absence of persuasive reasons to the contrary," a court should "attribute to the words of a statute their ordinary meaning").

Pine Products Corp. v. U.S., 19 Cl.Ct. 691, 695-96 (Cl. Ct. 1990), *aff'd*, 945 F.2d 1555 (Fed. Cir. 1991).

The SHA, therefore, conferred upon Appellees both control and the ability to exert a controlling influence on the management of Cinium. Indeed, Avon Road has

not been able to take any action as majority shareholder due to the existence of the SHA and has totally lost all control over Cinium and UHNIC.

B. THE COURT OF CHANCERY ERRED IN FAILING TO DETERMINE WHETHER OR NOT THE GRANT AND EXERCISE OF CONTROL PRIOR TO OBTAINING REGULATORY APPROVAL VIOLATED SECTION 1506.

As control is involved, the Court of Chancery had to determine whether the failure to submit the SHA to DFS to obtain prior approval violated New York law.

Otherwise valid contracts will not be upheld where "the contract or transaction is in violation of some positive law or well settled rule of public policy." *Hannigan v. Italo Petroleum Corp. of America*, 47 A.2d 169, 172 (Del. Super. 1945) (quoting 2 *Fletcher on Corporations*, Perm. Ed., Sec. 773). *Accord Furlong v. Johnston*, 204 N.Y.S. 710, 713 (N.Y.A.D. 4 Dept.), *aff'd*, 145 N.E. 910 (N.Y. 1924) ("[a] contract made in violation of positive law, or which is contrary to public policy, is wholly void and not enforceable by any person," citations omitted).[5] The reference to both positive law and public policy appears to contemplate cases where a state's public policy is not set forth in a statute but is divined from other sources, since "the public policy of the state is to be determined by its positive laws, or in cases concerning

[5] "Positive law" refers to "enacted law," *i.e.*, statutes and regulations. *Freedman v. Adams*, 2012 WL 1345638 at *11 (Del. Ch. Mar. 30, 2012), quoting *Black's Law Dictionary* (9th ed. 2009).

matters upon which they are silent by the decisions of its courts." *Hubbard v. Hubbard*, 126 N.E. 508, 509 (N.Y. 1920). *See also Farmers Ins. Exchange v. Hurley*, 90 Cal.Rptr.2d 697, 701 (Cal. App. 1999) ("a statute necessarily reflects public policy…").

The Court of Chancery appeared to question whether New York public policy was involved. As the violation at issue was that of a statute, it was improper to question the existence of public policy or give that law lesser weight. Indeed, to the extent the Court of Chancery engaged in weighing competing policies (New York insurance law versus Delaware contract law), such endeavor was error. Where a contract is illegal under the law of the place of contracting or performance, it may not be enforced anywhere else. *In re OCA, Inc.*, 552 F.3d 413, 422 (5th Cir. 2008); *Olsen v. Celano*, 600 N.E.2d 1257, 1261-62 (Ill. App. 1992); *In re American Fuel & Power Co.*, 151 F.2d 470 (6th Cir. 1945), *aff'd*, 329 U.S. 156 (1946).

The Court of Chancery expressly stated that it was not deciding whether or not the SHA transferred "control" to Appellees "except to note that it is far from 'clear and certain' that a violation has occurred." (Ruling at 12). This is both error and misses the point. It is error because it is clear that the SHA transferred control to Appellees (for the reasons stated at pp. 5-8 & 19-23 of Appellants' opening brief) without prior regulatory approval, in clear violation of Section 1506 (which embodies

public policy). It misses the point because that conclusion is less important than the fact that it was for DFS to make a determination in the first instance before Appellees could exercise any rights under the SHA (such as the right to block the written consent). Indeed, the fact that the court below considered the matter "uncertain" emphasizes the point that it had to be submitted to DFS for prior approval, which did not occur. It is Appellee's failure to disclose the details of the SHA to DFS and seek prior approval that violated the positive law of New York. New York public policy is also manifested in the fact that a failure to obtain approval of the superintendent prior to acquiring control, as required under Sec. 1506, is a misdemeanor under N.Y. Ins. Law §109. The public policy of New York does not condone violations of law that are criminal acts.

C. THE COURT OF CHANCERY ERRED BY RELYING ON THE REGULATORY REMEDIES OF DFS.

The Court of Chancery further erred when it held that:

> Ultimately, however, I find dispositive the consideration that if DFS determined that New York public policy is implicated, and it appears, based on Mr. Lafferty's submission, that it has considered the issue and determined that the agreement does not, in fact, violate New York policy, DFS is itself in a position to remedy any violations. It does not need the assistance of this Court in that endeavor.

(Ruling at 12-13).

DFS does not have authority to determine whether a written consent issued pursuant to 8 Del. C. §228 is or is not valid. That authority lies with the Court of Chancery. 8 Del. C. §225.

Appellees argue that deeming the control provisions of the SHA void is improper, and that any remedy is limited to that provided by the regulatory scheme itself. Delaware and New York law are to the contrary. *Beeber v. Walton*, 32 A. 777, 779 (Del. Super. 1887) (contract entered into in violation of regulatory statute punishable as a misdemeanor deemed void, irrespective of absence of any statutory language declaring such contracts void); *Cook v. Pierce*, Del. Super., 7 Del. (2 Houst.) 399 (1862) (same); *Sturm v. Truby*, 282 N.Y.S. 433 (N.Y.A.D. 1935) ("[a]n integral part of the contract being illegal, the whole agreement is void and unenforceable at the hands of the one who deliberately violated the statute, and who has thereby made himself guilty of a misdemeanor"); *Frank H. Zindle, Inc. v. Friedman's Express*, 17 N.Y.S.2d 594 (N.Y.A.D. 1940) ("[t]he law is well settled that a contract made in violation of the penal statute is void and unenforceable"). Courts in other jurisdictions similarly hold that where, as here, there is a penal (misdemeanor) sanction, any contract made in violation of the statute is void, irrespective of statutory language to that effect. *E.g.*, *Roddy v. Hill Packing Co.*, 137 P.2d 215, 220 (Kan. 1943). As the Arizona Supreme Court stated:

> It is the general rule of law that where a statute expressly forbids a person from entering into a certain kind of contract until he performs some precedent act, and imposes a penalty upon such person for attempting to enter into the forbidden contract, the contract itself is absolutely void ab initio and the party penalized has no rights thereunder, and the other party to the contract, who was not required to perform any precedent act and who is not penalized by the statute, is not in pari delicto and may repudiate the agreement and stand on his rights as if no contract had ever been made.

Hunt v. Douglas Lumber Co, 17 P.2d 815, 819 (Az. 1933). *Accord Benham v. Heyde*, 221 P.2d 1078, 1082 (Colo. 1950).

Here, Appellees instructed Appellants not to contact DFS, as Appellees wanted to take charge of that obligation. (A-272-273). Appellees misled DFS as to the full nature of the transaction. (A-143-149). Appellees then compounded that error by telling Appellants that DFS said that no approval was required, without disclosing the fact that Appellants never disclosed the existence or terms of the SHA to DFS. (A-92-104). In such circumstances, Appellants are not *in pari dilecto*, and the SHA is voidable and its control and blocking provisions should be declared void prior to SHA approval, and the written consent should be declared valid.

D. THE COURT OF CHANCERY ERRED BY WEIGHING DELAWARE'S PUBLIC POLICY IN FAVOR OF FREEDOM OF CONTRACT AGAINST NEW YORK'S STATUTORY PROHIBITION AGAINST ENTERING INTO SUCH CONTROL CONTRACTS WITHOUT PRIOR REGULATORY APPROVAL.

The Court of Chancery concluded that the SHA was valid on its face and Delaware contract law outweighs New York's statute. This ignored the fact that (i) Section 1506(a) states that "no person…shall acquire control," making it a mandatory directive, and (ii) violations of the statute are punishable as misdemeanors.[6]

The Court of Chancery concluded that New York public policy as expressed in Section 1506 did not outweigh Delaware's interest in enforcing a facially valid contract. (Ruling at 11). Appellants respectfully question whether this was an appropriate weighing. Indeed, it is a false premise. Delaware's policy in favor of freedom of contract does not prevent courts from refusing to enforce them when they are invalid for some extrinsic reason. *E.g., Lincoln Nat. Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust*, 28 A.3d 436 (Del. 2011) (contract held invalid for violating public policy). Delaware has no public policy supporting enforcement of

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[6] *Beeber,* 32 A. 777-79 (contract entered into in violation of regulatory statute punishable as a misdemeanor deemed void, irrespective of absence of any statutory language declaring such contracts void); *Sturm* , 282 N.Y.S. at 437 ("[a]n integral part of the contract being illegal, the whole agreement is void and unenforceable at the hands of the one who deliberately violated the statute, and who has thereby made himself guilty of a misdemeanor").

a contract obtained through nondisclosure and violation of regulatory and penal statutes enacted to protect the public.

E. THE COURT OF CHANCERY ERRED IN INTERPRETING SUBSEQUENT DFS APPROVAL AS APPLYING RETROACTIVELY.

Finally, the Court of Chancery erred by failing to address the lack of retroactive effect of any subsequent decision of DFS. As set forth at page 25 of Appellants' opening brief, if a contract is illegal at the time of execution, any subsequent approval (subject to modifications by DFS) does not alter the fact that, at the time the consent was executed, it was illegal.

Section 1506 requires "prior approval" of DFS before a party acquires control of an insurer. This is a condition precedent to the accrual of any rights. Nothing in the language of Section 1506 permits an interpretation allowing any waiver of its mandatory requirements, or permit subsequent approval to apply retroactively.

As Appellees had not submitted the SHA to DFS for prior approval at the time the written consent was issued, there could be no contractual restriction on its effectiveness. Later approval (with modifications) by DFS could not operate retroactively to deny Appellants' rights under 8 Del. C. §228 which had already been exercised.

"[E]xisting and applicable laws from a part of every contract." *Palese v. Delaware State Lottery Office*, 2006 WL 1875915 at *4 n.46 (Del. Ch. June 29, 2006), *aff'd mem.*, 913 A.2d 570 (Del. 2006). *Accord Strauss v. Union Cent. Life Ins. Co.*, 63 N.E. 347, 356 (N.Y. 1902) ("[a]ll contracts are made subject to any law prescribing their effect, or the conditions to be observed in their performance; and hence the statute is as much a part of the contract in question as if it had been actually written into it, or made a part of the stipulations"). Nothing in the New York Insurance Law authorizes DFS to waive the explicit statutory requirement of prior approval. *See Philadelphia Suburban Water Co. v. Pennsylvania Public Utility Com'n*, 808 A.2d 1044, 1056 (Pa. Cmwlth. 2002) ("an agency cannot waive a mandate of statute..."); *City of Hartford v. Towns of Glastonbury*, 561 F.2d 1032 (2nd Cir. 1976) ("absent some overriding exigency, an administrative agency may not waive an express statutory requirement").

CONCLUSION

WHEREFORE, for the foregoing reasons, as well as the reasons stated in their opening brief, Appellants respectfully request that the Court reverse the decision of the Court of Chancery, and hold that the consent at issue in this action was lawful and effective.

Respectfully submitted,

/s/ David L. Finger

David L. Finger (DE Bar ID #2556)
Finger & Slanina, LLC
One Commerce Center
1201 N. Orange St., 7th floor
Wilmington, DE 19801-1186
(302) 573-2525
Attorney for Appellants Avon Road Partners, LP, Robert Berman and Dennis Vacco

Of counsel:

Joseph Bernstein
Bernstein & Bernstein
1045 Fifth Avenue
New York, NY 10028
(917) 365-3651

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