

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

T.R. MCCLURE & CO., INC. : CIVIL ACTION
LIQUIDATING TRUST, : NO. 99-537
: :
Plaintiff, : :
: :
v. : :
: :
TMG ACQUISITION CO., ET AL., : :
: :
Defendants. : :

M E M O R A N D U M

EDUARDO C. ROBRENO, J.

SEPTEMBER 2, 1999

Plaintiff T.R. McClure & Co., Inc. Liquidating Trust brought this breach of contract action naming as defendants TMG Acquisition Co. ("TMG") and DIMAC Corp. ("DIMAC"). Specifically, plaintiff alleged that defendants breached their duty of good faith and fair dealing. Prior to any discovery being taken, defendants filed the instant motion for summary judgment, relying solely upon their interpretation of the contract at issue. The case originally was assigned to the Honorable Robert S. Gawthrop, III, however, due to Judge Gawthrop's unexpected and unfortunate death, the case was transferred to this court. For the following reasons, defendants' motion for summary judgment will be denied.

I. FACTS

The following facts are not in dispute or are construed in the light most favorable to the plaintiff. On September 29, 1995, defendant DIMAC and its subsidiary, defendant TMG,

purchased T.R. McClure & Co., Inc. ("Old McClure"). The parties executed the transaction pursuant to an Asset Purchase Agreement ("APA"), which included a separate Earn-Out Agreement. Under the terms of the APA, DIMAC purchased all of the assets of Old McClure for \$16 million. The new company, The McClure Group ("New McClure"), retained Old McClure's management team and is now a wholly owned subsidiary of DIMAC. Plaintiff is the successor in interest to Old McClure.

The Earn-Out Agreement provided that DIMAC would pay quarterly to plaintiff additional sums for four years (4) following the sale. The payments were to be calculated in two components -- "recaptured revenue" and "EBITDA."¹ The "recaptured revenue" provision reads, in pertinent part:

"Recaptured Revenue" shall mean revenue . . . collected . . . , in connection with work generated by clients of New McClure and brokered by New McClure to the Parent Corporation [DIMAC] or a subsidiary of the Parent Corporation after the date of this Agreement.

Earn-Out Agreement, § 1(f). The Earn-Out Agreement provides that plaintiff would receive twelve percent (12%) of all recaptured revenue. The EBITDA provision provides that plaintiff would receive approximately fifty percent (50%) of New McClure's EBITDA-based earnings over a base level of \$3 million. Earn-Out Agreement, § 1(d).

The Earn-Out Agreement specifies that DIMAC's recaptured revenue and EBITDA-based payments to plaintiff are to

¹ "EBITDA" is the acronym for "earnings before interest expense, taxes, depreciation, and amortization."

be made quarterly. If plaintiff fails to submit a written notice of objection to DIMAC's determination of the amount of the earn-out payments within twenty (20) business days after receipt of the determination, the determination is deemed final and binding. Earn-Out Agreement, § 3(a). If plaintiff does submit a notice of objection to DIMAC's determination, the parties must negotiate for fifteen (15) days to resolve the dispute, and if no resolution is reached, the dispute shall be submitted to arbitration for resolution. Earn-Out Agreement, § 3(b).

On February 24, 1998, plaintiff timely objected to DIMAC's recaptured revenue earn-out payments for the fourth quarter of 1997. On March 6, 1998, plaintiff also objected to the recaptured revenue earn-out payments for the period from October, 1995 through September, 1997. Subsequently, on April 24, 1998 and August 10, 1998, respectively, plaintiff timely objected to the recaptured revenue earn-out payments for the first and second quarters of 1998. Plaintiff's objections alleged that, in addition to work actually performed by DIMAC, the earn-out payments also should include all work brokered by New McClure to DIMAC, even if DIMAC ultimately failed to perform, as well as any work that New McClure was unable to broker to DIMAC due to DIMAC's allegedly unreasonable prices and schedules or past poor performance. In addition, on March 31, 1998, plaintiff notified DIMAC of its claim for \$97,500 for lost EBITDA-based earnings for the fourth quarter of 1997 as a result of DIMAC's failure to infuse capital into the expansion of New

McClure's telemarketing services. Pursuant to the Earn-Out Agreement, plaintiff sought arbitration of all of the objections it had asserted to DIMAC's earn-out payments.

Initially, DIMAC agreed to arbitrate only plaintiff's claims that related to the recaptured revenue earn-out payments for the fourth quarter of 1997 and first and second quarters of 1998. DIMAC, however, subsequently changed its mind and refused to submit any of plaintiff's claims to arbitration. DIMAC contended that plaintiff's claims relating to the period from October, 1995 through September, 1997 were not subject to the arbitration provision because plaintiff's objections were untimely. DIMAC also reasoned that plaintiff's timely filed claims, relevant to the fourth quarter of 1997 and the first and second quarters of 1998, were not arbitrable because "Section 3 of the Earn-Out Agreement does not contemplate arbitration of these sorts of disputes. Section 3 is addressed to the resolution of disputes regarding 'the determination of the amount of the Earn-Out Payments.'" Pl.'s Resp., Ex. S (emphasis in original). DIMAC characterized plaintiff's claims as alleging a breach of the duty of good faith and fair dealing "that go beyond the accuracy of the calculation of the amount of the Earn-Out Payment." Id. For these reasons, DIMAC concluded that plaintiff's claims were not proper matters for arbitration under the Earn-Out Agreement. As a result, plaintiff filed the instant action.

It is the theory of plaintiff's complaint that DIMAC breached its implied duty of good faith and fair dealing by failing to undertake, or by undertaking in an inadequate fashion, certain of its obligations under the Earn-Out Agreement. In essence, the complaint represents a concession by plaintiff that its prior objections to the earn-out payments due are not arbitrable under § 3(b) of the Earn-Out Agreement because the objections did not implicate the method of calculating the earn-out payments. Rather, it now acknowledges that the disagreement between the parties concerns the defendants' conduct that allegedly resulted in the determination of lower earn-out payments than would have been granted had the defendants not breached.

In response, and before the completion of any discovery in this case, DIMAC filed the instant motion for summary judgment arguing that: (1) plaintiff's claims based on the recaptured revenue earn-out payments for the period from October, 1995 through September, 1997 are barred as a matter of law because plaintiff's notices of objections were untimely; (2) plaintiff's timely claims based on the recaptured revenue earn-out payments for the fourth quarter of 1997 and first and second quarters of 1998 are barred because the Earn-Out Agreement provided that plaintiff would only receive additional payments for the revenue DIMAC actually collected for work in fact performed; and (3) plaintiff's claim for lost EBITDA-based payments are barred as a matter of law because the Earn-Out Agreement does not require

DIMAC to infuse capital into the expansion of New McClure's services. In turn, plaintiff replies that: (1) section 3 of the Earn-Out Agreement, including the 20-day notice provision and the arbitration provision, does not apply to plaintiff's claims alleging breach of the duty of good faith and fair dealing; (2) DIMAC is estopped from relying on the 20-day notice provision as a defense; and (3) DIMAC waived the use of the 20-day notice provision as a defense.

II. LEGAL STANDARD

Summary judgment is appropriate if the moving party can "show that there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c). When ruling on a motion for summary judgment, the Court must view the evidence in the light most favorable to the non-movant. See Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp., 475 U.S. 574, 587, 106 S. Ct. 1348 (1986). The Court must accept the non-movant's version of the facts as true, and resolve conflicts in the non-movant's favor. See Big Apple BMW, Inc. v. BMW of N. Amer., Inc., 974 F.2d 1358, 1363 (3d Cir. 1992), cert. denied, 507 U.S. 912, 113 S. Ct. 1262 (1993).

The moving party bears the initial burden of demonstrating the absence of genuine issues of material fact. See Celotex Corp. v. Catrett, 477 U.S. 317, 322-23, 106 S. Ct. 2548 (1986). Once the movant has done so, however, the non-moving

party cannot rest on its pleadings. See Fed. R. Civ. P. 56(e). Rather, the non-movant must then "make a showing sufficient to establish the existence of every element essential to his case, based on the affidavits or by depositions and admissions on file." Harter v. GAF Corp., 967 F.2d 846, 852 (3d Cir. 1992); see also Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 255, 106 S. Ct. 2505 (1986).

III. ANALYSIS²

A. Timeliness of Plaintiff's Objections.

Several undisputed facts are particularly relevant to an analysis of DIMAC's motion for summary judgment: (1) plaintiff submitted a timely notice of objection to the recaptured revenue earn-out payments for the fourth quarter of 1997 and first and second quarters of 1998; (2) plaintiff's notice of objection to the earn-out payments for the period from October, 1995, through September, 1997 were untimely, as defined in the Earn-Out Agreement; and (3) all of plaintiff's objections relate not to the determination of the amount of the earn-out payments, but, rather, to DIMAC's alleged breach of its duty of good faith and fair dealing.

DIMAC contended that none of plaintiff's claims were arbitrable because plaintiff's objections did not qualify as

² The parties do not dispute that, pursuant to the terms of the Earn-Out Agreement, New York law governs this action. Earn-Out Agreement, § 4(g).

"Disputed Matters" under section 3 of the Earn-Out Agreement.

Section 3 of the Earn-Out Agreement states, in part:

The determinations of the amount of the Earnout Payments shall be submitted to the Seller Group Representative within 60 days after the end of the applicable Payment Period If the Seller Group Representative does not object to the determination by the Parent Corporation of the applicable Earn-out Payment by written notice of objection (the "Notice of Objection") delivered to the Parent Corporation within 20 business days after receipt by McClure & Co. of such determination, the proposed Earn-out Payment shall be deemed final and binding.

Earn-Out Agreement, § 3(a) (emphasis added). Section 3 of the Earn-Out Agreement further provides:

If the Seller Group Representative delivers a Notice of Objection to the determination of the Earn-out Payments within the appropriate time period, [and] . . . [i]f after 15 business days following such notice (the "Negotiation Period") any of such objections have not been resolved (the "Disputed Matters"), then such Disputed Matters shall be submitted to arbitration in St. Louis, Missouri.

Id., § 3(b) (emphasis added).

Interpreting §§ 3(a) and (b), DIMAC defined "Disputed Matters" as "limited to objections to the determination of the Earn-Out Payments that have been the subject of a timely 'Notice of Objection' under Section § 3(a)." Pl.'s Resp., Ex. S (emphasis in original). As a result, DIMAC contended that plaintiff's claims were not arbitrable because plaintiff's untimely objections were barred by the 20-day notice provision, as set forth in § 3(a), and plaintiff's timely objections did not qualify as challenges to the determination of the earn-out payments, as set forth in § 3(b). DIMAC asserts that although all objections to the earn-out payments are subject to the 20-day

notice provision of § 3(a), only some claims are subject to arbitration under § 3(b), namely, claims challenging the determination of the amount of the earn-out payment.

The court disagrees. Just as the plain language of § 3(b) specifies that only objections pertaining to "the determination of the amount" (and not the conduct that underlies the mathematical determination) of the earn-out payments are subject to arbitration, § 3(a) also indicates that only those objections pertaining to "the determination" are subject to the 20-day notice provision. The contract term, "the determination of the amount," should be given the same meaning whether interpreting § 3(a), the 20-day notice provision, or § 3(b), the arbitration provision.³ See Dore v. Pierre, 226 N.Y.S.2d 949, 952 (N.Y. Sup. Ct. 1962) (citing White v. Knickerbocker Ice Co., 172 N.E. 452, 454 (N.Y. 1930)) ("A word used by the parties in one sense is to be interpreted as employed in the same sense throughout the writing in the absence of countervailing reasons."). Since it is undisputed that all of plaintiff's claims relate to DIMAC's alleged breach of the duty of good faith

³ DIMAC asserts that absent a timely notice of objection, "the plain language of section 3(a) requires that the earn-out payments be deemed final and binding regardless of the nature of the claim raised." Defs.' Reply, at 5-6. The court's determination that the 20-day notice provision of § 3(a) applies only to claims related to the determination of the amount of the earn-out payments does not, as DIMAC suggests, render the "final and binding" provision a nullity. To the contrary, if plaintiff was challenging DIMAC's determination of the amount of the recaptured revenue earn-out payments for the period from October, 1995 through September, 1997, plaintiff's claims would be barred as untimely. Under such circumstances, the determination of the amount of the earn-out payment would be final and binding.

and fair dealing, i.e., the conduct of the defendants, and not to the determination of the amount of the earn-out payments, neither the 20-day notice provision nor the arbitration provision applies.⁴ Therefore, plaintiff's claims pertaining to the earn-out payments for the period from October, 1995 through September, 1997 are not barred by the 20-day notice provision of the Earn-Out Agreement.⁵

B. Breach of the Duty of Good Faith and Fair Dealing.

In its complaint, plaintiff avers that DIMAC breached its duty of good faith and fair dealing "by refusing to take New McClure's business; by pricing New McClure's business so high that New McClure has had to send its business elsewhere or risk losing customers; by being unwilling or unable to meet New McClure's scheduling requirements so New McClure had to send its business elsewhere; and by performing New McClure's work in such a shoddy manner that customers of New McClure refused to allow DIMAC to do their work and New McClure had to send that work

⁴ The court agrees with DIMAC's assertion that plaintiff's claims alleging a breach of the duty good faith and fair dealing are not covered by § 3(b), which refers to arbitration only those disputes that challenge the determination of the amount of the earn-out payment. "Although the good faith and fair dealing claim is casually related to the computation of [the earnout payment], it is not within the scope of the arbitration clause." See Blutt v. Integrated Health Services, No. 96-3612, 1996 WL 389292, at *3 (S.D.N.Y. July 11, 1996) (holding that the arbitration provision in an earnout agreement is limited to accuracy of calculation of payment). In any event, plaintiff argues only that its claims are not barred by the 20-day notice provision. Plaintiff does not contend that its claims should be subject to arbitration.

⁵ Given the court's finding, the court need not address plaintiff's arguments concerning estoppel and waiver.

elsewhere." Pl.'s Compl., at ¶ 15. With respect to plaintiff's lost EBITDA-based payments, plaintiff alleges that "DIMAC breached the Earn-Out Agreement by failing to adequately capitalize New McClure's business operations, thereby reducing [plaintiff's] EBITDA-based earn-out payments." Id. at ¶ 19.

DIMAC asserts that it is entitled to judgment as a matter of law as to plaintiff's claims concerning the recaptured revenue earn-out payments because: (1) the Earn-Out Agreement is the complete integration of the parties' intent; (2) the implied duty of good faith and fair dealing cannot add material terms to the contract; and (3) plaintiff has produced no evidence that DIMAC breached its duty of good faith and fair dealing. DIMAC also seeks summary judgment as to plaintiff's allegations concerning alleged lost EBITDA-based payments because the Earn-Out Agreement does not require that DIMAC infuse a specific amount of capital into New McClure's operations.

Under New York law, "implicit in every contract is a covenant of good faith and fair dealing . . . which encompasses any promises that a reasonable promisee would understand to be included." New York Univ. v. Continental Ins. Co., 662 N.E.2d 763, 769 (N.Y. 1995) (citations omitted). Accordingly, "contracting parties' fields of discretion under a contract are bounded by the parties' mutual obligation to act in good faith." Cross & Cross Properties, Ltd. v. Everett Allied Co., 886 F.2d 497, 502 (2nd Cir. 1989). "[N]either party to a contract shall do anything that has the effect of destroying or injuring the

right of the other party to receive the fruits of the contract," or to violate the party's presumed or reasonable expectations. M/A-COM Sec. Corp. v. Galesi, 904 F.2d 134, 136 (2d Cir. 1990) (citations omitted).

Although it is true that the implied covenant of good faith and fair dealing cannot "create an additional benefit for which [the plaintiff] did not bargain," Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989), it also "ensures that parties to a contract perform the substantive, bargained-for terms of their agreement." Id. at 1517 (citation omitted). The duty of good faith, however, cannot add to, detract from, or alter the terms of the contract itself. See National Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 679 (S.D.N.Y. 1991) ("The parties' contractual rights and liabilities may not be varied, nor their terms eviscerated, by a claim that one party has exercised a contractual right but has failed to do so in good faith.").

The implied covenant of good faith and fair dealing "surfaces when, while the express terms [of the contract] may not have been technically breached, one party has nonetheless effectively deprived the other of those express, explicitly bargained-for benefits." Metropolitan Life, 716 F. Supp. at 1517. "The boundaries set by the duty of good faith are generally defined by the parties' intent and reasonable expectations in entering the contract." Cross & Cross Properties, 886 F.2d at 502.

In this case, the Earn-Out Agreement evidences the parties' intent to spread the balance of DIMAC's purchase of Old McClure over a five-year period. Indeed, the Earn-Out Agreement states that "payments under the Earn-Out Agreement shall be additional purchase price consideration for the Assets . . . of [Old McClure]." Earn-Out Agreement, Recital B. Although the Earn-Out Agreement does not explicitly state the amount of consideration owed by DIMAC, it does evidence the parties' intent that DIMAC would make additional earn-out payments to plaintiff premised upon performance by both New McClure and DIMAC. Thus, the Earn-Out Agreement's terms envision that DIMAC would, if feasible, act so as to generate additional purchase price consideration. It is reasonable to require that, in doing so, DIMAC act in good faith to make the parties' expectations come to fruition.⁶ Finding DIMAC liable of a breach of its contractual

⁶ Plaintiff, however, cannot argue that DIMAC was obligated to accept all of the work brokered to it by New McClure, or, for that matter, any of it. Nor can plaintiff claim that DIMAC was required to capitalize New McClure with a sum certain. To do so would be asking this court to add additional terms to the Earn-Out Agreement, which would have been included in the contract had the parties so intended. See Keene Corp. v. Bogan, No. 88-0217, 1990 WL 1864, at *11 (S.D.N.Y. Jan. 11, 1990) ("The alleged agreement[] that [plaintiff] would . . . guarantee earn-out payments [is] so related to provisions of [the Earn-Out Agreement] that a reasonable person would expect [it] to be embodied in that agreement."). Further, the Earn-Out Agreement includes an integration clause that states that the agreement "constitutes the entire agreement of the parties hereto relating to the subject matter hereof, and the parties hereto have made no agreements, representations or warranties relating to the subject matter of this Agreement that are not set forth herein." Earn-Out Agreement, § 4(f). Indeed, DIMAC could have failed to perform all of the work brokered to it by New McClure or failed to infuse capital into New McClure without breaching the contract, so long as DIMAC's conduct was undertaken in good

obligations to plaintiff if it acted in bad faith by setting unreasonable prices and unacceptable schedules, or undercapitalizing New McClure, even though the Earn-Out Agreement does not set forth any minimal requirements, would not be tantamount to rewriting the contract or adding additional terms. Rather, it would simply be enforcing DIMAC's obligation to act reasonably and in good faith in fulfilling the parties' expectations.

The record, however, is insufficiently developed so as to support a finding by the court that DIMAC is entitled to judgment as a matter of law on these claims. DIMAC argues that "[e]ven if these alleged implied obligations of DIMAC were legally cognizable, plaintiff's claims are still deficient because they have not come forward with evidence that DIMAC breached those obligations." Defs.' Reply, at 14. However, the instant motion for summary judgment was filed before discovery in this case had even begun. This ruling, however, is without prejudice to DIMAC's ability to press its argument at the close of discovery. Thus, the court will deny DIMAC's motion for summary judgment and allow the parties to proceed with discovery.

An appropriate order follows.

faith.

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ORDER

AND NOW, this **2nd** day of **September, 1999**, upon consideration of defendants' motion for summary judgment (doc. no. 11), plaintiff's reply (doc. no. 13), and defendants' response (doc. no. 14), it is hereby **ORDERED** that defendants' motion for summary judgment is **DENIED**.

AND IT IS SO ORDERED.

EDUARDO C. ROBRENO, J.