IN THE SUPERIOR COURT OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

CENDANT CORPORATION,	)	
	)	
Plaintiff,	)	
	)	
v.	)	C.A. No. 98C-10-034 HLA
	)	
COMMONWEALTH GENERAL CORPORATION,	)	
	)	
	)	
Defendant.	)	

Date Submitted: March 6, 2002
Date Decided: August 28, 2002

ORDER

UPON DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

DENIED

On this 28th day of August 2002, upon consideration of the Motion for Summary Judgment filed by Defendant, the response by Plaintiff and the oral argument, it appears to the Court that:

FACTS

On December 9, 1997, Cendant's predecessor HFS Corporation ("HFS") entered into a contract to purchase from Commonwealth General Corporation ("Commonwealth") all of the stock of the Providian Property and Casualty Insurance Companies ("Providian"). Commonwealth's Offering Memo for the sale of Providian presented a general overview of Providian's potential future policy sales, premiums and expenses; disclaimed any representations or warranties on these projections; and cautioned that future results will probably vary from the projections.[1] The Offering Memo predicted 20,000 new insurance policies to be sold in the current fiscal year ending June 30, 1998 and 27,500 in the 1998 calendar year. The Offering Memo predicted that values in the succeeding years would increase steadily, and would reach 50,000 by fiscal year 2000. As a result of the 1997 Offering Memo, HFS became interested in purchasing Providian. Biemer and Commonwealth employees reiterated and reinforced the prosperous expectations of Providian, as set forth in the Offering Memo. In reliance on

[1] Cendant Corporation ("Cendant") argues that Ed Biemer ("Biemer"), Providian's Senior Vice President of Marketing, had a $1 million incentive to sell Providian for approximately $200 million. Thus when he created the sales brochure, he stated a healthy outlook anticipating several years of prosperity and long-term growth. Further, Cendant alleges Biemer knew that 25 to 40% of the expected purchase price would be tied to expectations for future sales to new customers, as he was intricately involved in the development of a valuation model by Tillinghast Towers-Perrin, an insurance actuarial firm. Therefore, Cendant alleges fraud in the sales brochure.

Commonwealth's Offering Memo and representations, HFS[2] tendered an offer to purchase Providian which Commonwealth accepted.

On December 9, 1997 HFS and Commonwealth signed a Stock Purchase Agreement (SPA) to purchase from Commonwealth all of the stock of Providian.[3] Pursuant to section 4.16 of the SPA, Commonwealth warrants that since December 31, 1996 no event or occurrence took place which had a Material Adverse Effect on Providian. The SPA defines Material Adverse Effect as follows:

> Material Adverse Effect means an event or occurrence that has or could reasonably be expected to have a material adverse effect on permits, the business, financial condition or results of operations of the Company and the Subsidiaries taken as a whole.

Commonwealth brought this motion to have the Court declare that a failure to meet pre-contract projections cannot be construed as constituting a Material Adverse Change or Material Adverse Effect as defined by the SPA.

Cendant argues that the forward looking language of the Material Adverse Effect ("MAE") clause, which was specifically negotiated into the clause, is in fact a warranty which encompasses expectations for the future results of operations. In support Cendant

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[2] HFS is now known as Cendant Corporation.

[3] Pursuant to the SPA, New York law governs its interpretation.

argues that Commonwealth's initial draft of the SPA had an express disclaimer that projections, including those in the 1997 Offering Memo were not warranted. Cendant further contends that the disclaimer was struck from the SPA because it directly conflicted with the forward reach of the MAE definition. Commonwealth rebuts that Cendant knew and its CEO Henry Silverman ("Silverman") admitted that there was no warranty of projections. Cendant contends that Silverman merely testified that sellers normally do not like to warrant projections and posits that this MAE Clause does warrant them.

On December 17, 1997, CUC International ("CUC") and HFS merged to form Cendant Corporation ("Cendant"). In March 1998, Cendant learned there was nonrecurring income at CUC for 1997 that might reach as high as $100 million. It thus had to switch $165 million from reserves to revenue to meet its 1998 budget. By April 1998, Cendant became concerned that the earnings from CUC's receivables were falsified. Nonetheless it continued to tell investors that "fundamentals are great." On April 15, 1998 Cendant publicly announced it discovered potential accounting irregularities at its membership services unit. On April 16, its stock price fell by 46% and its credit rating was placed under review. By this time Cendant internally concluded that fraud occurred. Yet on April 28, 1998, Silverman publicly stated that Cendant believed that the only potential accounting problems which existed were those previously

discovered. He stated that Cendant remains strong, liquid and extremely profitable. This statement turned out to be erroneous. Due to the accounting irregularities, Cendant experienced a cash flow problem. At a meeting between Cendant and Commonwealth on May 18, 1998, the parties agreed to extend the June 1, 1998 closing date to September 30, 1998.

Commonwealth argues that Cendant had no intention to complete the sale after it discovered CUC's accounting fraud. According to Commonwealth the following course of events are significant. On July 14, 1998, Cendant announced that it would restate its earnings for 1995 and 1996 and amend its 1997 10-K to report a loss of $218.2 million restated from a profit of $55.4 million. Cendant further explained the widespread and systematic nature of the accounting fraud and told how it affected the accounting records of all major business units of CUC. The next day, Cendant's stock price fell again. On August 13, 1998, Cendant lowered its 1997 profits by $392 million or $0.28 per share. Due to its problems, Cendant changed from an acquirer of companies to a seller of them. It raised $4.8 billion from the sale of 18 business units and used the proceeds to purchase 165 million shares of Cendant stock and to pay down approximately $700 million in debt.

Cendant combats this argument by pointing out that the Securities & Exchange Commission found the accounting regularities were performed by CUC employees in

CUC financial records and that HFS was a victim, not a participant. In addition, Cendant contends that as of September 30, 1998 it had over $1.6 billion in available cash.

Cendant argues that Commonwealth was trying to hide the truth about Providian's finances from Cendant. According to Cendant the following facts are significant. Cendant contends that Commonwealth did not want the buyer of Providian to conduct a post-closing audit to reflect changes in the book value between the signing and the closing because of significant risks. Cendant argues that as soon as they received the 1997 year-end results of operations Cendant raised the issue of Providian failing to meet projections. They argue that a January 25, 1998 phone call to Commonwealth proves that they did not invent this problem to get out of the deal after finding out about the accounting fraud. Based on Cendant's complaints, Commonwealth set out to aggressively manage expenses in the short run without long term viability concerns. One concern of Cendant was that Commonwealth allowed Providian's telemarketing staff to fall to 40 workers when the Expense Reduction Plan in the SPA called for it to remain at 60. Commonwealth also switched from underwriting its own policies to brokering Progressive policies. Underwriting their own policies generates approximately $1150, plus a renewal each year for that amount, whereas brokering Progressive policies only generates a one time fee of $225. If one did not qualify for a Providian policy, Progressive policies were offered. Cendant contends that a failure of marketing occurred

when Commonwealth employees consistently marketed to people who did not qualify for Providian policies. After the signing of the SPA the ratio between Progressive policies and Providian policies sold was reversed although the accounting practices did not reveal this fact. Further, before Cendant complained to Commonwealth about the failure to meet projections, Commonwealth reported the sale of Progressive polices as "Other Income" which reduced acquisition costs. After signing the SPA Commonwealth began reporting this as an off-income statement deduction from expenses. Thus, Cendant contends a material change in their accounting practices occurred which the terms of the SPA forbid.

Moreover, Cendant contends that the SPA provided that if the closing date was not met either party could terminate the transaction. Cendant lists numerous reasons why the closing did not take place: (1) Commonwealth did not get regulatory approval for the name change nor were Providian policyholders notified of it, (2) Commonwealth did not get Providian's permission for Cendant to use the Providian name for a short post-closing period, and (3) the April 1998 accounting irregularities required Cendant to restate its audited financial statements and without them Cendant could not get regulatory approval. Cendant avers that it tried to arrange a meeting with Commonwealth to investigate their concerns after the extension, but Commonwealth stalled until August 1998. After this meeting, Silverman told Cendant's Board of Directors that he believed a Material

Adverse Change occurred in Providian's business and that business simply was not being run in accordance with the SPA. On October 2, 1998, Cendant's Board of Directors met with its acquisition team and outside advisors and determined not to go forward with Providian's acquisition.

On October 5, 1998, Cendant wrote to Commonwealth indicating it terminated the SPA because Commonwealth had breached various representations and warranties in the SPA. The same day, Cendant filed this lawsuit. Cendant's lawsuit seeks to determine that it was within its right to terminate the SPA.

Following the termination of the SPA, Commonwealth put Providian back on the market with a 1998 Offering Memo. Cendant alleges this memo demonstrates that a Material Adverse Change occurred; i.e., (i) the actual and projected sales deteriorated, (ii) the actual and projected cost of acquiring new customers burgeoned and (iii) Providian altered the way it sold insurance.

SUMMARY JUDGMENT

Summary judgment is appropriate when the moving party has shown that there are no genuine issues of material fact and that the moving party is entitled to judgment as a matter of law.[4] In considering such a motion, the Court must evaluate the facts in the

[4] *Moore v. Sizemore,* 405 A.2d 679 (Del. 1979).

light most favorable to the non-moving party.[5] Summary judgment will not be granted under circumstances where the record reasonably 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 law to the circumstances.[6]

ANALYSIS

Commonwealth's main argument for partial summary judgment is that their 1997 Offering Memo had a disclaimer against reliance on projections and the integrated SPA contained no warranty for them. Commonwealth asserts that absent an express warranty, the court cannot imply a warranty of future prospects. It asserts that the Material Adverse Change Clause and the SPA should be narrowly construed as the definition of Material Adverse Effect was narrowly defined. Commonwealth contends that the SPA is silent on the issue of prospects or projections and argues that Cendant is trying to get the Court to rewrite the contract via judicial construction.

Commonwealth contends that a MAC clause does not warrant prospects or projections unless specifically mentioned. Commonwealth cites *IBP, Inc. v. Tyson Foods, Inc.*[7] for the above proposition. In that case, the Delaware Chancery Court stated

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[5] *Id.*

[6] *Ebersole v. Lowengrub,* 180 A.2d 467 (Del. 1962).

[7] C.A. No. 18373, Strine, V.C. (Del. Ch. June 18, 2001).

that "practical reasons lead me to conclude that a New York Court would incline toward the view that a buyer ought to have to make a strong showing to invoke a MAE exception to its obligation to close."[8] The Court specifically stated that "a short-term hiccup in earnings should not suffice; rather the MAE should be material when viewed from the longer-term perspective of a reasonable acquiror."[9]

Commonwealth contends that since a court determined that *IBP*'s broader MAE clause did not warrant projections, the same result should be found here. However, the court in *IBP* did not hold that IBP did not or could not suffer a MAE by failing to reach projections, the court held that degree and duration of IBP's shortfall was insufficient to establish a MAC. The Court reasoned IBP's had a historical performance of cyclical falls.[10] Based on market analyst views and predictions, IBP appeared to be in sound enough shape to deliver results of operations in line with the company's recent cyclical falls, as the company was a consistently but erratically profitable company.[11] Thus, the courts underlying holding was that two quarters of down profits was not sufficient to establish a MAC. In the case *sub judice*, Providian did not meet its projections for more

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[8] *Id*. at *43.

[9] *Id*.

[10] *Id*. at *45.

[11] *Id*.

than a full year in a line of business that does not have cyclical downfalls. In addition, Commonwealth has calculated the decrease in profits to have a devastating impact for several years on Providian. Moreover, Commonwealth shows this impact in its 1998 Offering Memo which predicts substantially lower profits and sales than the 1997 Offering Memo.

Further, Commonwealth cites *Goodman Mfg. Co. v. Raytheon Co.*[12] for the proposition that MAC clauses do not warrant projections unless specifically stated. In *Goodman* a material adverse change was alleged because the washers were not ready in 1997 as projected but not until 1999. The clause in that contract stated no material adverse change of a business condition, which the contract defined as business assets or financial condition.[13] Commonwealth argues that the court ruled that since there was no mention of future prospects, they will decline to assert it into the contract. The Court stated that since the contract specifically disclaimed the existence of any warranty or representation as to "cost estimates, projections or other predictions" and agreed to take the company "as is", the breach of contract claim can not stand.[14] Commonwealth argues that the same result should occur here as Cendant acknowledges that no specific warranty

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[12] 1999 WL 681382 (S.D.N.Y. Aug. 31, 1999).

[13] *Id.* at *13.

[14] *Id.* at *13-14.

for prospects or projections exists in the SPA. Cendant combats that the contract in *Goodman* did not encompass future expectations because no forward looking language existed in that contract. It further argues that an important distinction between the two cases is that the contract in *Goodman* specifically disclaimed all "cost estimates, projections or other predictions" and the buyer agreed to take the company "as is"[15], such is not the case here.

Commonwealth also raises *Pacheco v. Cambridge Tech. Partners, Inc.*[16], a Massachusetts case, to support its aforementioned contentions. In that case, Excell and Cambridge were engaged in a stock for stock merger with no representations or warranties regarding future prospects.[17] The MAC clause, however, provided for no material change in prospects, which the contract defined as "events, conditions, facts or developments that are known to Excell and that in the reasonable course of events are expected to have an effect on future operations of the business as presently conducted by Excell."[18] The Court ruled that one quarter of failed projections was not a material

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[15] *Id.*

[16] 85 F. Supp. 2d 69, 74 (D. Mass. 2000).

[17] *Id.* at 73.

[18] *Id.*

adverse change as the warranties only ran to current operations not future operations.[19] This case differs from the instant case, as the MAC clause did not specify future expectations.

In *Pittsburgh Coke & Chem. Co. v. Bollo*[20], Pittsburgh Coke entered into a purchase agreement for Bollo's airline parts supply stores, Standard. The MAC clause warranted "no MAC in the financial condition or in the business or operations of Standard."[21] In entering into this contract, Pittsburgh Coke expected Standard to gain business based on the upcoming big jet business, this did not occur. The Court held that there was no MAC as the big jet business was non-existing and never occurred, it was due to extrinsic developments in the aviation industry that Standard's business did not increase as planned.[22] Cendant again argues that this outcome is understandable since the MAC clause contained no forward looking language, thus future expectations were not warranted.

Further, Commonwealth argues that the SPA's integration clause prevents projections from being added as warranties. Section 10.2 of the SPA states that the

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[19] *Id.* at 74.

[20] 421 F. Supp. 908 (E.D.N.Y. 1976).

[21] *Id.* at 930.

[22] *Id.*

agreement constitutes the entire understanding of the parties and no warranties exist except as specifically made in this agreement. Moreover, Commonwealth argues that a breach of contract claim can only arise from the SPA, not the 1997 Offering Memo. To support this claim, Commonwealth cites *Longwood Elastomers, Inc. v. Aeroquip Corp*.[23] In that case, the Court held that a breach of contract claim can only arise from the purchase agreement and not the Offering Memo.[24] There the Offering Memo contained future projections but disclaimed all warranties or representations, subsequently a purchase agreement between the parties ensued with no projections contained therein, then the projections were not met.[25] The difference here arises by the fact that in the case *sub judice* the warranty period of the MAC clause encompasses the time period when the 1997 Offering Memo was made, whereas in *Longwood* the warranty period was for a period post the Offering Memo.

Besides combating the above arguments by Commonwealth, Cendant asserts various own contentions to support its cause of action. Cendant challenges that the MAC clause encompasses reasonable expectations for Providian's future results of operations. It argues that Commonwealth's projections are representations about expectations for

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[23] 1995 WL 1052245 (W.D. Va. Feb. 24, 1995), *aff'd* 165 F.3d 18 (4th Cir. 1998).

[24] *Id*. at *5.

[25] *Id*. at *3.

Providian's business, financial condition or results of operations. Since the SPA's MAC clause has forward looking language, i.e. "or could reasonably be expected to have," projections should be included. Cendant alleges that practitioners commonly use language about "reasonable expectations" as a substitute for the word "prospects:"

> MAC and MAE provisions often have some forward looking language. Without explicitly referring to future prospects, many MAC/MAE provisions extend to changes, events and circumstances that can 'reasonably be expected to have a Material Adverse Effect' in the future. Such forward looking language may have much the same effect as the inclusion of 'prospects' in the definition of a MAC or MAE.[26]

In fact, *Pacheco*, the Massachusetts case cited by Commonwealth, equates expectations with prospects.[27] Further, the *Pacheco* court does cite with approval the Howard law review article that supports the above cited excerpt.[28]

In addition, Cendant contends that the drafting history confirms the plain language that the MAC clause warrants projections. In the initial draft there was no forward looking language. Cendant proposed adding the word "prospects" to the clause, which Commonwealth rejected. Cendant countered with a phrase that included the forward looking language which Commonwealth accepted. At that same time, the parties agreed

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[26] Rod J. Howard, *MAC and MAEs-Allocating the Risk of Changes Between Signing and Closing in Recent Technology M&A Agreements*, 128 2PLI/Corp. 329 (2001).

[27] 85 F. Supp. at 77.

[28] *Id*. at 74.

to strike a warranty that projections were not warranted in the SPA. Commonwealth's main response to this argument centers around the notion that since there is no mention or reference to prospects or projections in the SPA there can be no warranty for them.

Where more than one plausible construction of a contract exists or the contract is ambiguous because two or more provisions conflict, an issue of material fact arises and summary judgment must be denied. This seems to be the case here. There is no doubt that the parties rely on variant constructions of the Material Adverse Change clause. Depending on which construction the jury finds more plausible will determine how the case is resolved. There are issues of genuine fact surrounding whether the drafters intended the forward looking language off the MAC clause to include prospects, as well as whether the current future wording does include prospects. It seems that this will all boil down to whether a reasonable jury could determine, based upon the facts as it finds them to be, that the MAC clause warrants prospects.

For the aforementioned reasons, Defendant's Motion for Summary Judgment is **DENIED.**

IT IS SO ORDERED.

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ALFORD, J.

ORIGINAL: PROTHONOTARY'S OFFICE - CIVIL DIV.