

**Penguin Group (USA) Inc. v Time/Warner Retail  
Sales & Mktg. Servs., Inc.**

2012 NY Slip Op 33543(U)

August 23, 2012

Supreme Court, New York County

Docket Number: 650214/2012

Judge: Melvin L. Schweitzer

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SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: MELVIN L. SCHWEITZER
Justice

PART 45

PENGUIN GROUP (USA) INC

INDEX NO. 650214/2012

-v-

MOTION DATE

TIME WARNER RETAIL SALES +
MARKETING SERVICES, INC.

MOTION SEQ. NO. 001
002

The following papers, numbered 1 to , were read on this motion to/for

Notice of Motion/Order to Show Cause — Affidavits — Exhibits No(s).

Answering Affidavits — Exhibits No(s).

Replying Affidavits No(s).

Upon the foregoing papers, it is ordered that this motion is by plaintiff for summary

judgment on its breach of contract claim is DENIED;

Motion by defendant to dismiss plaintiff's claims for breach of contract and breach of the implied covenant of good faith and fair dealing is GRANTED

all per the attached Decision and Order.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: August 23, 2012

Melvin L. Schweitzer, J.S.C.
MELVIN L. SCHWEITZER, J.S.C.

- 1. CHECK ONE: CASE DISPOSED (checked) NON-FINAL DISPOSITION
2. CHECK AS APPROPRIATE: MOTION IS: GRANTED (checked) DENIED GRANTED IN PART OTHER
3. CHECK IF APPROPRIATE: SETTLE ORDER SUBMIT ORDER DO NOT POST FIDUCIARY APPOINTMENT REFERENCE



Penguin and Time/Warner entered into an agreement effective January 1, 1997 (the Agreement), under which Penguin employed Time/Warner as its national distributor. The Agreement was renewed and amended several times, and the parties terminated it effective December 31, 2010. The parties dispute how they should calculate the “Finalization Payment” used to settle their accounts pursuant to ¶ 13(d) of the Agreement.

Understanding the economics of the Agreement gives context as to how the Finalization Payment should be calculated. First, a wholesaler orders a shipment of books, which Penguin delivers to the wholesaler on a fully returnable basis, meaning that the wholesaler may return books to Penguin for full credit. Under the arrangement, instead of paying Penguin, the wholesaler pays Time/Warner, sometimes on credit, who handles billing and collection for Penguin. The wholesaler then distributes the books to retailers, on a fully returnable basis, who sell the books to customers.

Penguin receives payment from Time/Warner, who pays Penguin for the shipment to wholesalers less “actual returns” by the wholesalers. 2001 Amended Agreement ¶ 12(a). A high number of returns with respect to a particular book generally indicates a low sales number and, accordingly, Penguin receives less compensation than if the book was a popular success. A low number of returns to a particular book generally indicates a high number of sales associated with a popular success. Accordingly, Penguin receives greater compensation than if the book was tepidly received.

Using returns as a measurement with respect to sales can overestimate Time/Warner’s required payment to Penguin when one of Penguin’s wholesalers ceases processing returns from retailers. This is because Time/Warner’s payment to Penguin is calculated as the cost of the

shipment less a credit for actual returns. Consequently, if the wholesaler stops processing returns from retailers such that actual returns approach zero, then Time/Warner's payment will be equal to the cost of the shipment less a sum approaching zero, or just approximately the cost of the shipment. In reality, retailers are not selling their entire stock of books, but rather the wholesaler has stopped processing their returns. In that case, Time/Warner would be overpaying Penguin for the entire shipment unless the parties adjusted the formula for calculating Time/Warner's payment to Penguin.

One reason a wholesaler might stop processing returns is because of its bankruptcy. Paragraph 16 of the Agreement originally foresaw the possibility of a wholesaler bankruptcy and/or cessation of operations and provided that in such case, "Net Sales," a defined term, would be calculated on the basis of *average* returns over a historic period and not *actual* returns. This solution avoided overestimating sales by depending on historic return numbers (which presumably would approximate actual sales) instead of actual return numbers which, quite possibly, would approach zero for the sole reason that the wholesaler stopped processing those returns.

On March 2, 2009, several book publishers filed an involuntary petition in bankruptcy against Anderson News Company, LLC (Anderson), one of Penguin's wholesalers. Anderson ceased its business operations. Although it returned to Penguin the books it had in its stock, it did not process returns of books from its retailers. Time/Warner relies on Anderson's bankruptcy and cessation of business operations to invoke Paragraph 16 of the Agreement, claiming it is entitled to calculate the number of returns to Penguin based on historic *average*

returns, not on *actual* returns, thereby reducing the amount it owes to Penguin by \$2,353,478.89, the amount in question in this litigation.

Penguin calculates shipments less returns on the basis of *actual* returns, as it argues is mandated by ¶ 13(d), the termination clause. Section 13 (d) provides that upon termination of the Agreement either “by expiration or earlier termination,” the parties settle their accounts with a “Finalization Payment,” which, like the regular payments pursuant to amended ¶ 12, is “equal to the shipments less *actual returns* of any unpaid Books less any Deductible Charges as defined in Paragraph 13(a).” Amended Agreement ¶13(d) (emphasis added).<sup>1</sup>

Time/Warner disagrees with Penguin’s understanding of ¶ 13(d), claiming that although it provides for actual returns, it also provides for adjustments based on “Deductible Charges,” one of which is “any overpayments.” Agreement ¶ 13(a)(ix). Time/Warner argues that the Finalization Payment is not a *final* payment but rather subject to ¶ 13(e), which provides that “[n]otwithstanding the Finalization Payment, the parties shall thereafter remain responsible for promptly making appropriate reimbursements for any overpayments . . .” Time/Warner argues that calculating the Finalization Payment on the basis of actual returns would be an overpayment subject to adjustment as a “Deductible Charge” under ¶ 13(d) or, alternatively, as requiring reimbursement under ¶ 13(e).

Penguin contests Time/Warner’s interpretations of the overpayment language. Penguin also argues that Time/Warner’s reliance on Paragraph 16 is misplaced because it provides a calculation for “Net Sales,” a defined term, which, due to an amendment, is no longer relevant to

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<sup>1</sup> Paragraph 13 originally provided a “Finalization Payment” based on an “estimate of returns.” On November 6, 2001, the Agreement was amended, *inter alia*, to calculate the Finalization Payment based on “shipments less *actual returns*” (emphasis added).

the calculation of the Finalization Payment. Because of the parties' disagreement over the calculation of returns and, in turn, the Finalization Payment, Penguin initiated this action.

Penguin brings two claims: (1) breach of contract and (2) breach of the implied covenant of good faith and fair dealing, both for \$2,353,478.89.

## **Discussion**

### Standard of Review

Summary judgment shall be granted if a cause of action or defense is “established sufficiently to warrant the court as a matter of law in directing judgment.” CPLR 3212(b). To prevail on a motion for summary judgment, the movant “must make a prima facie showing of entitlement to judgment as a matter of law, tendering sufficient evidence to demonstrate the absence of any material issues of fact.” *Alvarez v Prospect Hosp.*, 68 NY2d 320, 324 (1986) (citations omitted). Once this showing has been made, the burden shifts to the party opposing the motion to produce admissible evidence “sufficient to establish the existence of material issues of fact which require a trial of the action.” *Id.* at 324. The court’s inquiry in deciding whether a motion for summary judgment should be granted is “to determine if any triable issues exist.” *Sheehan v Gong*, 2 AD3d 166, 168 (1st Dept 2003).

### The breach of contract claim

The court finds Anderson’s bankruptcy and cessation of business operations triggered ¶ 16 such that Net Sales is calculated based on average, not actual, returns. Paragraph 16, “Wholesale Bankruptcy—Computation of Net Sales,” provides:

In the event that any Wholesaler voluntarily or involuntarily takes advantage of any federal or state insolvency law for relief of debtors, including reorganization, or shall cease its business operation with the effect that such Wholesaler fails to return its unsold copies of the Books, [Time/Warner] shall be entitled to compute

Net Sales applicable to the uncollected amount on a per-title basis for all unsettled titles for the period of such failure on the basis of the average Net Sales of Books reported by such Wholesaler for the twelve (12) months (or such lesser period if applicable) prior to the period of such failure. [Time/Warner] shall use all reasonable efforts to prevent the copies of Books in such Wholesaler's inventory from reentering the market in returnable condition, including the purchase by [Time/Warner] of such inventory copies if same are generally offered for sale or auction and are available to [Time/Warner] for purchase."

Penguin argues that ¶ 16 is not to be used to calculate Net Sales because the Agreement provides that the cessation of business operations must cause Anderson to "fail to return *its* unsold copies of the Books," ¶ 16 (emphasis added), and that in fact Anderson has returned all books in its warehouses. In fact, although Anderson has returned \$2.6 million worth of books in its warehouses, Anderson has failed to return "its unsold copies of the Books" because it has not processed its retailers' returns. Penguin's argument erroneously equates the books in Anderson's warehouses at the time it stopped processing retailers returns with "its unsold copies of the Books." Paragraph 16 is meant to refer to Penguin books in Anderson's warehouses or in the possession of Anderson's retailers.<sup>2</sup> Indeed, Penguin's brief states that "the failure to return *Penguin Books* is necessary for Paragraph 16 to be operative," Brief in Further Support of Summary Judgment at 17 (emphasis added), which is a more accurate position than its assertion that the failure only refers to books in Anderson's warehouses. Indeed, it is only reasonable to interpret "its unsold copies of the Books" to include the unsold copies of the Penguin books in Anderson's retailers' possession because the very purpose of ¶ 16 is to protect Time/Warner from a wholesaler's failure to process returns from retailers. Otherwise Time/Warner's payment to Penguin would be based on an inflated calculation of returns.

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<sup>2</sup> An example is illustrative: if Ford promised its customers it would repair all of "its" trucks within ten years or 100,000 miles, certainly this language does not limit Ford's promise to those trucks it still owns on its lots; rather, the language is intended to reach those trucks in the possession of Ford's customers.



The parties do not dispute that when Anderson ceased business operations, Anderson did not collect and return unsold books from retailers. Thus, Anderson having failed to return these books, one of the conditions of ¶ 16, that a Wholesaler “shall cease its business operation with the effect that such Wholesaler fails to return its unsold copies of the Books,” has been met.

Penguin next argues that the phrase “with the effect that such Wholesaler fails to return its unsold copies of the Books” modifies both clauses (a) bankruptcy and (b) the cessation of business operations, and that in interpreting Section 16 Time/Warner cannot rely solely on the undisputed fact that Anderson has entered bankruptcy in order to call into play Section 16. In support of this interpretation Penguin cites the language “for the period of such failure,” in Section 16, which defines when Net Sales shall be calculated based on averages. Penguin argues that “the period of such failure” must refer to the failure to return Penguin Books and thus the condition precedent of bankruptcy does not alone trigger ¶ 16.

Penguin’s interpretation is erroneous. If the phrase “with the effect that such Wholesaler fails to return its unsold copies of the Books” were meant to apply to both the state of bankruptcy and the cessation of business operations, then there would be a comma after the word “operation” in ¶ 16. There is no comma so it only applies to the second part of that disjunctive clause. Also, the period in which a wholesaler is in bankruptcy is itself a “failure” so that “period of such failure” is applicable if the wholesaler is in bankruptcy, without regard to the failure to return its copies.<sup>3</sup>

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<sup>3</sup> Bankruptcy is defined as a “failure to meet obligations” (*see* Black’s Law Dictionary 167 (9th Ed 2009)).

Thus both of ¶ 16's conditions, either of which standing alone would be sufficient, have been met. Paragraph 16 applies to base the calculation of Net Sales on average instead of actual returns.

Next, the court finds that the term Net Sales is applicable to the parties' Agreement and has not been effectively deleted by the 2001 amendment. Before the parties amended the Agreement, ¶ 13(d) calculated the Finalization Payment as "equal to the Net Billings of the unsettled Books less estimated Deductible Charges . . . plus [Time/Warner's] Commission on estimated returns of unsettled Books." Net Billings is defined in the Agreement as "the Wholesale Price of the Book multiplied by Net Sales, minus 'Warner's Commission.'" Agreement ¶ 9(e). Net Sales is defined in the Agreement as "the number of copies of the Book shipped . . . minus all copies returned pursuant hereto." Agreement ¶ 9(a). As such, before the 2001 amendment, the term Net Sales figured into the calculation of the Finalization Payment by affecting Net Billings. By calculating Net Sales on the basis of average instead of actual returns, ¶ 16 originally affected the Finalization Payment.

Penguin argues that although the Agreement may have originally applied Net Sales to the Finalization Payment, the 2001 amendment deleted mention of Net Billings and thus Net Sales. In essence, Penguin is arguing that the 2001 amendment to the Agreement has effectively deleted Paragraph 16. However, while the amendment indeed has deleted mention of Net Billings from the calculation of the Finalization Payment, no amendments have stricken the definitions from the Agreement. Indeed, every single amendment, including the 2001 amendment, has been accompanied with the language "[a]ll other terms and conditions as contained in the Agreement shall remain in effect."

A court in the Southern District of New York has interpreted similar language to mean that a previously included term in a contract still applies despite the parties' partial amendment of the contract. See *Fifty-Six Hope Road Music, Ltd. v UMG Recordings, Inc.*, No. 08 Civ. 6143, 2011 WL 3874861, at \*2 (SDNY 2011) (amendment, which, unlike prior agreements, contained no "incontestability provision," but which stated that "except as expressly amended hereby, all provisions of the 1990 Agreement shall remain in full force and effect," held to incorporate those prior incontestability provisions). Paragraph 16, included in "[a]ll other terms and conditions as contained in the Agreement," must therefore "remain in effect." 2001 Amendment. Penguin argues that "[i]t would do violence to Paragraph 13(d) to find that the term "Net Sales" could somehow be implanted into it" but this misconstrues Time/Warner's argument. Net Sales is not being implanted into ¶ 13(d) but rather found to have always been included and never removed.

Just as compelling is the fact that despite the deletion of the term Net Sales, the 2001 amendment provided that Net Sales would be a variable in calculating the Finalization Payment, in form if not in name. This is true because the 2001 amendment provided that the Finalization Payment is "equal to the shipments less actual returns of any unpaid Books." Amended ¶ 13(d). This is the exact calculation that would be required if the amendment had explicitly demanded a calculation of Net Sales itself because Net Sales is defined as "the number of copies of the Book shipped . . . minus all copies returned pursuant hereto." Agreement ¶ 9(a). Similarly, Net Sales originally applied explicitly to ¶ 12 (providing the payment schedule), was nominally deleted by the 2001 amendment, but in effect remained rooted in the calculation mandated by that paragraph as "shipments . . . less actual returns." Thus, the court finds that Net Sales still applies

to both ¶ 12 and to ¶ 13 and that ¶ 16 therefore has not been effectively deleted by the 2001 amendment to the Agreement.

The court finds that this conclusion is not in tension with ¶ 13(d) because that section provided an adjustment for “Deductible Charges as defined in Paragraph 13(a).” Amended Agreement ¶ 13(d). One of the Deductible Charges found in ¶ 13(a)(ix) is “any overpayments and all other proper charges, payments or other reimbursements due [Time/Warner] pursuant to the terms of this Agreement.” It would be one such overpayment to calculate the Finalization Payment on the basis of actual instead of average returns when the “terms of [the] Agreement,” ¶ 13(a)(ix), allow Time/Warner to use average returns. As such, ¶ 16 and ¶ 13 are not in conflict.<sup>4</sup>

Because Time/Warner was entitled to calculate Net Sales on the basis of average instead of actual returns due to Anderson’s bankruptcy and cessation of business operations, Penguin’s breach of contract claim against Time/Warner is dismissed.

The breach of the implied covenant of good faith and fair dealing claim

The court also dismisses Penguin’s claim for breach of the implied covenant of good faith and fair dealing.

The implied covenant of good faith and fair dealing embraces a pledge that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract. *See 511 West 232nd Owners Corp. v Jennifer Realty Co.*, 98 NY2d 144, 153 (2002). Accordingly, this doctrine applies when the spirit, if not the letter, of the contract was violated. *See In re Refco Inc. Sec. Litig.*, 2011 WL 1219265, at\* 9 (SDNY 2011).

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<sup>4</sup> Similarly, ¶ 13(e) shows that the Finalization Payment is not a final payment but rather subject to adjustment: “Notwithstanding the Finalization Payment, the parties shall thereafter remain responsible for promptly making appropriate reimbursements for any overpayments or underpayments.”

However, “[a] good faith and fair dealing claim is not an insurance policy to cover instances where there is no breach of contract.” *Horowitz v Am. Int’l Group, Inc.*, 2010 WL 3825737, at \*9 (SDNY 2010) (citations omitted).

Here, there has been no breach of contract. *See supra*. What is more, the spirit of the contract, compensating for a failure in calculating sales based on returns, allowed Time/Warner to make the very calculation premised on average returns which Time/Warner took. Time/Warner has not done anything with “the effect of destroying or injuring the right of [Penguin] to receive the fruits of the contract,” *511 West 232nd Owners Corp.*, 98 NY2d at 153, but has instead sought to preserve its rights under the contract, rights that even Penguin acknowledged existed under the Agreement.<sup>5</sup>

Thus Penguin’s claim for breach of the implied covenant of good faith and fair dealing fails to state a cause of action.

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Penguin’s own CEO acknowledged Time/Warner’s right to use average, not actual, returns in calculating the Finalization Payment. On February 27, 2009, twenty days after Anderson’s cessation of business operations, David Shanks, Penguin’s CEO, who also signed the 2001 Amendment on behalf of Penguin, wrote to Time/Warner’s President, Richard Jacobsen, acknowledging that ¶ 16 remained in effect and applied to the Anderson bankruptcy:

[Time/Warner’s] obligation under Paragraph 16 to prevent [Penguin] books from reentering the market is quid pro quo for its right under that same contract provision to impute a rate of return to unreturned [Anderson] inventory. Unless [Time/Warner] moves aggressively to redress the situation – if it is still salvageable – and remove [Penguin] books from [Anderson’s] inventory before they can reenter the market, [Penguin] will not accept chargebacks for imputed [Anderson] returns of books for which PGI only will have to pay again when returned by the buyers of the ANCO inventory.

Thus, Penguin admitted that the 2001 Amendment did not alter Time/Warner’s rights under ¶ 16. Penguin does not now allege that Time/Warner failed to prevent Penguin books from reentering the market. Thus, even if this obligation were quid pro quo for Time/Warner’s right to use average instead of actual returns, which Time/Warner contests, Penguin’s acknowledgment shows that Time/Warner would still be able to use average returns because Penguin does not argue that Time/Warner failed in its obligation.

**Conclusion**

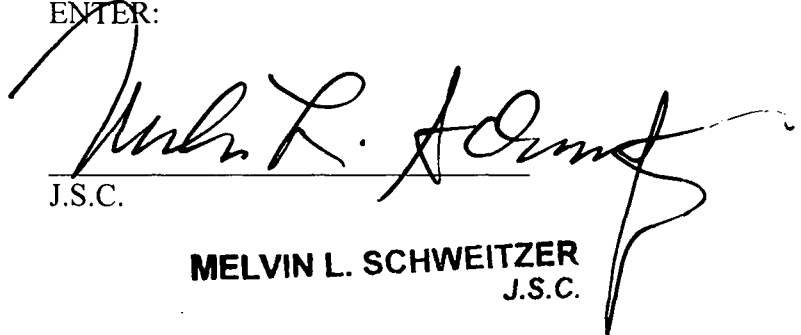
Accordingly, it is

ORDERED that Penguin's motion for summary judgment with respect to Penguin's breach of contract claim is DENIED; and it is further

ORDERED that Time/Warner's motion for summary judgment dismissing Penguin's (i) breach of contract claim, and (ii) breach of the implied covenant of good faith and fair dealing claim is GRANTED.

Dated: August 23, 2012

ENTER:



A handwritten signature in black ink, appearing to read 'Melvin L. Schweitzer', is written over a horizontal line. The signature is stylized and extends to the right of the line.

J.S.C.

**MELVIN L. SCHWEITZER**  
J.S.C.