COURT OF CHANCERY
OF THE
STATE OF DELAWARE

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VICE CHANCELLOR

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Wilmington, Delaware 19801

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Re: Automodular Assemblies (DE), Inc., And
Automodular Assemblies, Inc., v. PNC Bank, Delaware
C. A. No. 19352

Dear Counsel:

This case arises out of a dispute between defendant PNC Bank, Delaware, as lender, and plaintiff Automodular Assemblies (DE), Inc., as borrower. Automodular is the Delaware subsidiary of a Canadian corporation and was formed to conduct the parent's U.S. operations. The parent corporation is in the business of supplying parts and components used in the manufacture of automobiles and other vehicles.

In particular, Automodular was the entity through which its parent was to perform a five-year contract to sub-assemble a variety of components of automobiles to be manufactured at a General Motors Saturn plant in Newport, Delaware. That contract was awarded in July 1998. Under the contract, Automodular was to receive a fixed monthly payment plus a variable payment of a specified amount per vehicle.

To finance its operations and in particular the cost of enabling it to perform the Saturn contract, Automodular sought a $3 million loan from PNC. After discussions between itself and PNC, a loan agreement was executed in December 1998. Importantly, that loan agreement required Automodular to deliver to PNC quarterly and annual financial statements prepared in accordance with generally accepted accounting principles in effect from time to time, and to do so on a contractually specified schedule (the “Reporting Obligations”). Both Automodular and PNC understood that the contract reference to “GAAP” was to United States GAAP.

The financial statements were the basis for measuring Automodular's compliance with certain financial covenants relating to debt service coverage and leverage. In particular, 1) beginning June 30, 1999, Automodular was to maintain a ratio of its debt to net worth (the "Leverage Ratio") of no greater than 2 to 1; and 2) beginning March 31, 2000, Automodular was to maintain a ratio of its cash flow to required debt service (the "Debt Service Coverage Ratio") of no less than 1.2 to 1.

Under the loan agreement, a violation by Automodular of the Reporting Obligations, the Leverage Ratio, or the Debt Service Coverage Ratio would constitute an event of default. Upon an event of default, PNC could declare the loan principal and accrued interest immediately due and payable.

When PNC and Automodular entered into the loan agreement, both assumed that U.S. GAAP permitted Automodular to capitalize, rather than expense, the capital investments it made in connection with starting up its Delaware facility to perform the Saturn contract. Internal PNC loan approval documents evidence that its key personnel assessed the advisability of lending to Automodular based on this assumption about the accounting treatment of the startup capital costs. In 1999, Automodular delivered PNC financial statements for the quarters ending June 30 and September 30, 1999. These statements purported to be in compliance with GAAP and to show compliance with the Leverage Ratio.

During 1999, GM's Saturn operation in Delaware — which was just starting up itself as a retooling of an existing plant that had been slated for closure — was experiencing some delays. Automodular sought some additional financing from PNC in connection with these delays and received an additional loan in January 2000 of over $700,000 with covenants identical to the earlier loan agreement.

In March 2000, two events coincided that helped trigger the current lawsuit. By this time, Automodular had learned that its assumption regarding the proper accounting treatment of its preproduction startup costs was improper. In 1998, U.S. GAAP was changed to require that such costs be expensed rather than capitalized for financial statements for periods after December 15, 1998. Automodular was unaware of this change — which differed from prior American practice and from Canadian practice. The change did not actually change Automodular's cash flows but it had a profound balance sheet impact — and caused, as we shall see, Automodular to fall out of compliance with the Leverage Ratio. Combining with this development were slowdowns in demand for the Saturn products made at GM's Newport plant, leading to reduced productions and shifts at the plant.

In an awkward coincidence for Automodular, PNC first learned of both these developments on the same day, although it had been aware of some production problems at the Saturn plant before that time. On March 16, 2000, representatives of Automodular met with PNC to explain that the financial statements they had presented previously did not comply with GAAP because of the failure to expense preproduction start up costs. As it turns out, the Wilmington News-Journal had printed an article that morning indicating that the Newport Saturn plant would be reducing production.

At the meeting, Automodular presented PNC with draft financial statements for the year ending December 31, 1999. The effect of the accounting change was major. The company's financials for the previous quarter — before the change was taken into account — showed healthy year-to-date profits and a positive net worth. The full-year financial statements reflecting the change in GAAP, however, showed a loss in excess of $2.1 million and a net worth of less than negative $1.6 million. As important, the revised financial statements resulted in Automodular having a Leverage Ratio of 2.39 to 1 — which was out of compliance. The revised financial statements also showed a Debt Service Coverage Ratio of negative 1.87 to 1.

At the meeting, Automodular asked PNC to waive the financial covenants, asserting that it had been unaware of the recent change in GAAP when it signed the loan agreements. After four days, PNC answered this request by formally declaring an event of default. The basis for the default was the Automodular had breached the Leverage Ratio and Debt Service Coverage Ratios in the loan agreements. PNC did not, however, immediately declare the loans payable. Instead, it froze certain of Automodular's funds that were on deposit, triggered certain restrictions on spending by Automodular, and otherwise reserved its rights.

During the next month or so, Automodular and PNC engaged in negotiations to work out the dispute between them. During the course of those negotiations, Automodular asserted that PNC was improvidently declaring an event of default and that, but for the slowdown at the Saturn plant, PNC would have agreed to modify the covenants. In that regard, Automodular also argued for some time that it was permissible for it to account for the startup costs through a method other than expensing that would both comply with GAAP and leave it in compliance with the Leverage Ratio.

On April 13, 2000, Automodular sent PNC a lengthy memorandum outlining the facts it had provided to possible litigation counsel to file suit against PNC. In the memorandum was a reference to the fact that PNC's declaration of a default based on the Debt Service Coverage Ratio was premature, as that Ratio did not kick in until March 31, 2000 (and impliedly could not be relied upon by PNC until April 30, 2000, when end-of-quarter financial statements had to be submitted to PNC). In the memorandum, however, the overriding argument that Automodular made was not that the Debt Service Coverage Ratio was not yet applicable. Rather, it was that — absent the unexpected need to expense the startup costs — Automodular would not be in breach of the Leverage Ratio and that any inability on Automodular's part to file GAAP-compliant financial statements resulted from a mutual mistake of both it and PNC about the proper way to account for the startup expenses. The problem with this argument — which will be touched on in more detail later — was that Automodular knew that its Debt Service Coverage Ratio as of March 31, 2000 would be revealed on April 30, 2000 to be contractually deficient, irrespective of the accounting treatment of the startup expenses. In hand-written notes on the information provided to PNC on March 16, 2000, Automodular's CFO had already calculated that the company was in breach of that Ratio regardless of the accounting treatment of the startup expenses.[1]

During the back-and-forth with PNC, Automodular sought to ensure that it could continue to service the Saturn contract. PNC, meanwhile, sought to work out the situation in a way that would result in full repayment of the outstanding loans and a release of liability to Automodular. Eventually, Automodular agreed that it would repay the principal and interest of the outstanding loans on April 28, 2000 and did so. In so doing, Automodular reserved its right to and expressed its intention to sue PNC.

[1] The notes indicated that even without applying proper GAAP treatment of startup expenses, the Debt Service Coverage Ratio would be .42 to 1. Kelleher Aff. Ex. M.

Importantly, the April 28, 2000 payment came after an April 21, 2000 letter from PNC indicating that PNC would assume that its proposal to work out the dispute was rejected and "react accordingly" if full repayment was not received by "May 5, 2000."[2] Had Automodular agreed to PNC's settlement proposal, it would have had until the end of July 2000 to pay off the loan in its entirety, but the price of accepting that proposal was releasing PNC from any liability. Automodular refused that proposal and instead fully repaid the loan on April 28, 2000, 7 days earlier than PNC demanded but only two days earlier than the April 30, 2000 date on which Automodular knew that PNC would have an indisputable right of full repayment for noncompliance with the Debt Service Coverage Ratio as of March 31, 2000.[3]

In its communications with PNC, Automodular stressed the damage that it would allegedly wrongfully suffer if it had to repay the loans in full in the time frame when it ultimately paid. As noted, it proposed a schedule that

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[2] Katzenstein Aff. Ex. 20.

[3] I assume that Automodular would have delivered financial statements on April 30, 2000. A failure to do so would in itself have been an event of default. At the latest, therefore, PNC would have been entitled to expect immediate repayment on May 1, 2000.

would have enabled it to repay the loans over a period ending in late July 2000 but refused to provide PNC with a release of liability in connection with that proposal. According to Automodular, its parent and its affiliates had taken steps to conserve cash, such as canceling a dividend and delaying a major capital project scheduled for autumn 2000. Absent a supposedly wrongful demand for full repayment, Automodular's parent would not have had to take these steps. It is clear, however, from Automodular's own submissions that these same steps would have had to be taken regardless of whether it was going to pay PNC in full on April 28, 2000 (as it voluntarily chose to do) or April 30, 2000 (as it would have been indisputably legally obligated to do).

When it paid the loans back in full, Automodular threatened to bring suit to recover those alleged damages. It waited, however, nearly two years to do so. In its amended complaint, Autmodular asserted four causes of action against PNC. They are:

- Breach of contract — This is based on the argument that PNC breached the loan agreements by declaring an event of default;

- Breach of the implied covenant of good faith and fair dealing — This claim is based on the argument that PNC breached that implied duty by declaring a default based on financial covenants when its real motive was concerns about the effect that a slowdown at the Saturn plant would have on Automodular's ability to repay the loan;

- Reformation based upon mutual mistake — This is based on the argument that the loan agreements should be reformed because the parties mutually misunderstood the GAAP requirements for accounting for the startup expenses. This claim contends that the loan contracts ought to be reformed to require that Automodular file GAAP-compliant financial statements save for the exception that the startup expenses would be capitalized and not expensed. Based on this reformed contract, Automodular claims that PNC would have had no basis to declare a default on March 20, 2000 and therefore that it should pay Automodular damages as if the contracts, as rewritten, had been in existence on that date.

- Mutual mistake based on unilateral mistake — This claim was based on the notion that Automodular made a unilateral mistake.

The parties completed full discovery and the current summary judgment motion practice ensued with each party seeking summary judgment. Automodular dropped its unilateral mistake count.

The summary judgment briefing predominantly focused on Automodular's primary complaint about its treatment at PNC's hands. That is, Automodular claimed that PNC was taking advantage of a mutual mistake by the parties about how the startup costs had to be accounted for. It was unfair, said Automodular, for PNC to seize upon a clear mistake as a pretext to declare an event of default and to put Automodular under pressure to repay the loans in full.

This promised to present an interesting question of legal doctrine. Although there is a great deal of authority that makes clear that an award of rescission may be granted when a contract is entered into on the basis of a mutual mistake about a basic assumption of fact,[4] it is far less certain that Delaware law will permit a party seeking to reform a contract on the basis of that kind of mutual mistake to claim damages incurred because it (by its own action) voluntarily terminated the contract early (by, in this case, repaying the loans in full under protest) in response to a default declared by the other party in reliance upon the plain words of the contract as written.[5] Although Automodular cited to non-Delaware cases indicating that a plaintiff may

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[4] *See, e.g.*, *Lang v. Koziarz*, 1987 WL 15554, at *5 (Del. Ch. Aug. 11, 1987) ("A contract may be rescinded by the affected party in a case of mutual mistake where: (1) both parties were mistaken as to a basic assumption; (2) the mistake materially affects the agreed upon exchange of performances; and (3) the party adversely affected did not assume the risk of the mistake.").

[5] *See* 17A AM. JUR. 2d *Contracts* § 202 ("Reformation is the appropriate remedy when the mistake is one as to expression, while voidance is the proper remedy where a mistake as to a basic assumption on which the contract was made has a material effect on the agreed exchange of performances.").

receive contractual damages if it proves a reformation claim, most of the cases it cited were cases of scrivener's errors and not the type of mutual mistake involving an erroneous assumption of fact.[6] Here, of course, there was no scrivener's error in drafting the loan agreements, there was, if Automodular's position is accepted, a mutual mistake of the parties about the requirements of U.S. GAAP that undermined a fundamental assumption upon which they were basing their decision to contract. And Automodular was unable to cite any case remotely like this one, in which the mistake did not involve a scrivener's error, the plaintiff seeking damages was allegedly injured because the other party to the contract relied upon the plain language of the agreement in seeking to end the contractual relationship, the plaintiff voluntarily gave into that demand under protest, and sought recompense for the harm it allegedly suffered as a result of that decision.

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[6] *See, e.g.*, *Diocese of Bismarck Trust v. Ramada, Inc.*, 553 N.W.2d 760 (N.D. 1996) (mutual mistake involving failure to draft provision to accurately reflect terms to which parties had specifically agreed); *Housing Auth. of College Park v. Macro Housing, Inc.*, 340 A.2d 216 (Md. 1975) (mutual mistake involving failure to delete provision that parties had agreed to delete).

This was a nice legal question that promised to be interesting to address. But the need to do so became, in my view, unnecessary and inappropriate when some other undisputed facts arose. First of all, it became clear that Automodular's argument that it could have accounted for the startup costs through a form of contract accounting that would have enabled it to comply with the Leverage Ratio was untenable. Thus, Automodular conceded that under GAAP the only proper accounting method it could use was expensing, and dropped an argument it had asserted during the workout negotiations and earlier in this litigation.

Most importantly, however, there emerged the undisputed fact that Automodular failed to meet the Debt Service Coverage Ratio on March 31, 2000, regardless of whether the startup costs were capitalized or expensed. The draft financial statements that Automodular shared with PNC bank indicated that the Debt Service Coverage Ratio would not be met on that date. Automodular shared those financial statements with PNC precisely to get PNC to negotiate with it to modify the covenants.

Automodular therefore should not have been surprised when PNC acted upon the information it was provided — that was what Automodular wanted it to do. And the reality is that Automodular cannot now and does not now dispute that on April 30, 2000, PNC would have been able to immediately demand full repayment of the principal and interest on both loans.

Why April 30, 2000? Because that was the date on which Automodular was required to produce a financial statement for the quarter ending March 31, 2000. Automodular now admits that if it had produced a financial statement that day, the statement would have shown it breaching the Debt Service Coverage Ratio regardless of whether, as it preferred, the startup costs were capitalized rather than expensed. As is now clear, Automodular would not have actually provided a financial statement for that quarter to PNC on April 30, 2000 as required, a failure that in itself would have been an event of default as a breach of Automodular's Reporting Obligations.

Because of these undisputed facts, PNC is entitled to summary judgment. There are times in life when a good theory simply does not pan out. This is one of them. If it were the case that the change in accounting treatment were the only reason for Automodular to have been in default in the key time period, then Automodular might have had a basis upon which to seek relief from PNC.

But that is not the case. Instead, it is undisputed that PNC was entitled to demand full repayment of the loans on April 30, 2000, a mere two days after Automodular voluntarily paid. Unlike Automodular, I do not find it legally or equitably significant that PNC based its declaration of default on both the Leverage and Debt Service Coverage Ratios on March 20, 2000, at a time when the Debt Service Coverage Ratio did not yet have bite.

The reality is that the Debt Service Coverage Ratio had to be met on March 31, 2000. At the March 16, 2000 meeting, Automodular intended to focus PNC on its inability to meet the Ratios. In Automodular's possession at that time was an internal calculation by its CFO indicating that regardless of the accounting treatment, it would fail to meet the Debt Service Coverage Ratio on March 31, 2000. Throughout the discussions in April, Automodular knew it would imminently reveal its own default.

At the time it was considering its financial options, therefore, Automodular was under no illusion that it had a legitimate right to sit back and wait until mid-summer or autumn to prepare to pay back the loans. It knew that, at the latest, PNC could validly demand full repayment of the loans on April 30, 2000.

Now, it is, of course, true that during the course of negotiations, Automodular pointed out (on April 13, 2000) that PNC's reliance upon the Debt Service Coverage Ratio was premature. But what it never said and could not have said was that the financial statements it had to provide to PNC on April 30, 2000 would both 1) be produced in a timely manner; and 2) show compliance with the Debt Service Coverage Ratio.

In fact, Automodular decided to pay on April 28, 2000 after receiving a letter indicating that PNC would react to any failure to pay by May 5, 2000. By May 5, 2000, of course, Automodular would have indisputably have been in default and PNC would already have been entitled to demand full repayment days earlier. Had it wished to stretch out its repayment of the loans from PNC, Automodular therefore had a viable option that it eschewed — to assent to PNC's offer to allow it until the end of July 2000 to repay and to give up its right to sue. It is Automodular's decision not to pursue this option (or some reasonable extension of that proposed schedule) that caused it any harm that it suffered, not any improper action by PNC.

As a result of these undisputed facts, Automodular is, as a matter of law, not entitled to damages for any losses it suffered. Its entire damage theory is premised on the supposed injustice it (and more accurately, its parent) suffered because it should not have had to marshal the funds necessary to repay PNC in full in the time frame that it paid off the loan. Rather, Automodular contends that it should not have been bothered with worrying about repaying PNC until sometime in late spring or early summer, at which time its parent's cash flows would have enabled it to repay PNC without having had to previously postpone capital projects and a dividend at one of its affiliates.

This argument, however, has no factual or legal basis and no equitable appeal. By its own actions on March 16, 2000, Automodular initiated a discussion about the contractual consequences of its failure to comply with GAAP and of its non-compliance with the contractual covenants if GAAP principles were used. That discussion surfaced the reality that Automodular would fail the Debt Service Coverage Ratio regardless of the accounting principles it had to use and that PNC would therefore have the right to demand full repayment of the loans on April 30, 2000, at the latest.

Knowing that reality, in the period between March 20 and April 28, the date that it paid, Automodular and its parent faced a choice with serious legal consequences. If they undertook expenditures that rendered Automodular unable to pay PNC on April 30, 2000, then Automodular and its parent would have exposed Automodular to claims for damage from PNC and to the exercise of other forms of recourse by PNC. If they prepared to meet their obligation to pay PNC, then they might have had to defer other, less pressing needs and incur some costs as a result.

Automodular, however, is in no position to make PNC the guarantor of the costs of that choice. The fact that Automodular chose to voluntarily repay the loans on April 28, 2000 before it committed an undeniable default on April 30, 2000 is not one that supports the procession of this case to trial. Loan covenants are carefully negotiated and a lender is entitled to enforce them as written, and the fact that a borrower is being exposed to objective economic risks (a slowdown at a Saturn plant) is all the more reason why a lender might legitimately enforce the covenants and not a basis for triggering an implied duty of good faith not to take enforcement measures.[7] Indeed, Automodular invited PNC to act on the information it provided on March 16, 2000 precisely because it knew that it was already in violation of the literal terms of the Reporting Obligations and the Leverage Ratio and would soon be in unavoidable violation of the Debt Service Coverage Ratio. Put

[7] Automodular's claim for breach of the implied covenant of good faith and fair dealing lacks viability independently of its own lack of compliance with the Debt Service Coverage Ratio. Putting that issue aside, Automodular either prevails or fails to prevail based on its mutual mistake claim. If there are no grounds for mutual mistake, then it could not have been in any manner wrongful for PNC to take the actions that it was permitted to take upon an event of default as set forth in the loan agreements. Lenders negotiate those provisions carefully and sophisticated borrowers like Automodular know that they must avoid them or suffer the contractual consequences. Lenders demand financial covenants precisely to address the risk of circumstances when a borrower's ability to pay may be viewed by the lender as vulnerable (e.g., when the revenues the borrower will receive from a key contract appear to be lessening). For a lender to rely upon the plain language of the contractual protections it has extracted is no violation of any implied term; to find otherwise would be to supplant the plain language of the agreement. Our law does not permit the use of the implied covenant of good faith for this purpose. *E.g.*, *First Fed. Sav. Bank v. CPM Energy Sys. Corp.*, 1993 WL 138986, at *2-*3 (Del. Super. Apr. 22, 1993) (duty of good faith not applicable to lender's action when the note's terms indicate that the lender has a right to demand payment without cause); *see also Chamison v. Healthtrust, Inc.*, 735 A.2d 912, 921 (Del. Ch.) ("The implied covenant cannot contravene the parties' express agreement and cannot be used to forge a new agreement beyond the scope of the written contract."), *aff'd*, 748 A.2d 407 (Del. 1999) (TABLE); *Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc.*, 622 A.2d 14, 23 (Del. Ch.) ("[W]here the subject at issue is expressly covered by the contract . . . the implied duty to perform in good faith does not come into play."), *aff'd*, 609 A.2d 668 (Del. 1992) (TABLE).

simply, Automodular wanted PNC to react to these extant defaults and to the default that was imminent. It just did not like the way that PNC did so.

In my view, the fact that PNC prematurely relied on the Debt Service Coverage Ratio in sending its March 20, 2000 notice of default does not render it liable for damages that Automodular incurred because Automodular paid on April 28, 2000 rather than April 30, 2000. Had Automodular indicated that it would be happy to pay on May 5, 2000 as a result of what it knew to be an unavoidable default that would occur April 30, 2000, there is no triable doubt that PNC — which offered to refrain from collection actions until May 6, 2000 — would have accepted that request. And had Automodular agreed not to sue PNC, it could have deferred full repayment until the end of July 2000.

But Automodular did not accept that offer because it made the erroneous assertion that there was no basis for PNC to claim that a default would occur in the time frame of the negotiations because any possible basis for a claim of default was related only to the parties' mistaken views about GAAP. That the assertion was erroneous should have been evident to Automodular at the time because its own key executive had already determined that a capitalization of the startup expenses alone would not suffice to make Automodular compliant with the Debt Service Coverage Ratio.

In sum, this is a case in which a lender and borrower had a good faith dispute about a subject on which reasonable minds could differ.[8] The borrower voluntarily acted to resolve that dispute while reserving its right to show that the lender had no legal right to claim that the loan was due and payable in the time frame in which it was voluntarily paid. After litigation, the borrower's claim of no default has turned out to be without merit as the lender indisputably had the right to demand full repayment within days of the time of the voluntary repayment. It is also clear that the lender gave the

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[8] If Automodular could have met the Debt Service Coverage Ratio with different accounting treatment of the startup expenses, its contention that PNC acted in bad faith during the negotiations would still have been, in my view, unwarranted. Although Automodular had a plausible mutual mistake claim, it does not come close to showing that a lender that relies on the plain language of a written contract when the parties are surprised by the effects of the proper application of GAAP on contractual convenants is taking bad faith action, especially because it might be thought that Automodular, as a manufacturer, would be in the best position to understand the proper way to account for its own particular costs of operation. When those factors combine with the undisputed fact that Automodular was going to find itself in unavoidable breach of the Debt Service Coverage Ratio on March 31, 2000 regardless of accounting treatment, no rational inference of bad faith can be drawn from the factual record. Automodular might not like how PNC dealt with it but it suffered no cognizable legal injury at PNC's hands.

borrower two options that would have allowed it to repay the loan funds after the date on which the lender was legally entitled to demand their full repayment. On these undisputed facts, there is simply no material breach of contract giving rise to cognizable damages.[9] The proximate cause of any harm to Automodular was not wrongful conduct but Automodular's own conduct — including its refusal to compromise with PNC and most important its undisputed inability to comply with the Debt Service Coverage Ratio on March 31, 2000.

For these reasons, PNC's motion for summary judgment is granted, and Automodular's claims are dismissed with prejudice. IT IS SO ORDERED.

/s/ Leo E. Strine, Jr.
Vice Chancellor

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[9] *See, e.g.*, *Kronenberg v. Katz*, 2004 WL 1152282, at *29 (Del. Ch. May 19, 2004) ("[A] breach of contract claim under Delaware law requires a showing of compensable injury." (citing *Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544, 549 (Del. Ch. 2001); *Winston v. Mandor,* 710 A.2d 835, 840 (Del. Ch. 1997)).