The court incorporates by reference in this paragraph and adopts as the findings and orders of this court the document set forth below. This document has been entered electronically in the record of the United States Bankruptcy Court for the Northern District of Ohio.

Mary Ann Whipple
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

In Re:	)	Case No.: 01-44007
	)	
Phar-Mor, Inc.,	)	Chapter 11
	)	
Debtor.	)	Adv. Pro. No. 03-4069
	)	
Phar-Mor, Inc.,	)	Hon. Mary Ann Whipple
	)	
Plaintiff,	)	
v.	)	
	)	
McKesson Corporation,	)	
	)	
Defendant.	)	
	)	

MEMORANDUM OF DECISION AND ORDER REGARDING CROSS MOTIONS FOR SUMMARY JUDGMENT

This is an action for damages due to Defendant McKesson Corporation's ("McKesson") alleged breach of a written pharmaceutical supply agreement with Plaintiff Phar-Mor, Inc. ("Phar-Mor"), the debtor in the underlying Chapter 11 case. The issue is whether a material adverse change provision in the parties'

contract permitted McKesson to alter the agreed terms upon which it extended unsecured credit to Phar-Mor to pay for the goods it bought. The case is presently before the court on Phar-Mor's Motion for Partial Summary Judgment and brief in support of its motion [Doc. ## 171 & 172], McKesson's Motion for Summary Judgment and brief in support of its motion [Doc. ## 173 & 174], their respective oppositions [Doc. ## 186 & 187] and replies [Doc. ## 194 & 195], and Phar-Mor's Supplement [Doc. # 217]. Also before the court is McKesson's Evidentiary Objection to the Affidavit of Adam Waterfield. [Doc. # 190].

The court has jurisdiction over this adversary proceeding under 28 U.S.C. §1334(b) and the general order of reference entered in this district. This is a core proceeding involving a "counterclaim[] by the estate against a person filing claims against the estate" that the court may hear and decide. 28 U.S.C. § 157(b)(1) and (b)(2)(C); [*see* Doc. # 13, p. 11].

After reviewing the motions, the responses and briefs with respect thereto, and the voluminous exhibits to the foregoing, and after hearing the arguments of counsel, for the reasons that follow, McKesson's evidentiary objection will be denied as moot, its motion for summary judgment will be granted and Phar-Mor's motion for partial summary judgment will be denied.

FACTUAL BACKGROUND

The following facts are undisputed. Phar-Mor was a discount retail drugstore chain headquartered in Youngstown, Ohio. In 2001, it operated 139 retail stores concentrated in eastern Ohio and western Pennsylvania. McKesson is one of only three wholesalers that distributes prescription pharmaceuticals to national and regional retail drugstore chains.

In June 1997, Phar-Mor and McKesson entered into a Supply Agreement ("Supply Agreement" or "Agreement") wherein Phar-Mor agreed to purchase from McKesson substantially all of its prescription drugs and pharmaceutical supplies. [Doc. # 172, Phar-Mor Brief, Ex. 5, ¶ 11]. Under the Supply Agreement, Phar-Mor agreed to a "purchase commitment" of at least $200 million per year and McKesson agreed to supply pharmaceuticals to Phar-Mor at a negotiated price and to extend unsecured credit to Phar-Mor with an average of 22.5 days to pay McKesson's invoices. [*Id.*, ¶¶ 8-9; Doc. # 172, Phar-Mor Brief, Ex. 6, Pearce Depo. p. 47]. The basic term of the Agreement was 60 months. [Doc. # 172, Phar-Mor Brief, Ex. 5, ¶ 11]. The Supply Agreement was conditioned upon Phar-Mor maintaining a "sound financial condition throughout the term hereof." [*Id.*, ¶ 9]. It also reserved McKesson's right to change payment terms or limit total credit if certain events occurred. [*Id.*]. Specifically, paragraph nine of the Agreement, entitled "Payment Terms," provided in relevant part:

> This Agreement is conditioned upon Phar-Mor's maintaining a sound financial condition throughout the term hereof and to that end, Phar-Mor agrees to promptly substantiate in writing, at McKesson's request, the existence of such condition with publicly available financial and other publicly available supporting information reasonably requested by McKesson.
>
> McKesson reserves the right to change a payment term or limit total credit if there has been either a material adverse change in Phar-Mor's financial condition or a payment default based on the payment terms and conditions specified in this Agreement which remains uncured for more than ten (10) days following notice of such payment default to Phar-Mor by McKesson. Upon the occurrence of either such event, McKesson may require cash payment or appropriate security before shipment of any further Merchandise to Phar-Mor. In the event of such changes by McKesson, Phar-Mor may terminate this Agreement on ten (10) days written notice to McKesson. Any such termination will not be considered a default under this Agreement subject to the payment of damages. . . .

[*Id.*]. In negotiating the Agreement, language that would have permitted McKesson to decide in its *sole discretion* whether a material adverse change in financial condition had occurred was removed at Phar-Mor's insistence. [Doc. # 172, Phar-Mor Brief, Ex. 8; Ex. 9, Trugman Depo. p. 65-66; Ex. 10, Malkin Depo. p. 25].[1] In addition, Phar-Mor negotiated the ability to terminate the Agreement in the event McKesson changed the payment terms. It advised McKesson that a change in payment terms by its largest supplier would have a significant impact on its ability to do business and, in that event, it needed to be able to seek other sources of supply. [Doc. # 172, Phar-Mor Brief, Ex. 10, Malkin Depo. p. 29].

The Supply Agreement also provides that "[e]ither party may, on ten (10) days notice, terminate this Agreement, if . . . [t]he other party shall . . . become unable or admit in writing its inability to meet its obligations as they mature. . . ." [Doc. # 172, Phar-Mor Brief, Ex. 5, ¶ 23.C.]. The Agreement further contains an anti-waiver provision stating that the "failure of either party to enforce at any time or for any period of time any one or more of the provisions thereof shall not be construed to be a waiver of such provisions or of the right of such party thereafter to enforce each such provision." [*Id.*, ¶ 26.F.]. The Agreement is to be construed in accordance with the laws of the State of Ohio. [*Id.*, ¶ 26.C.].

In early November 1999, the parties entered into an Amendment to Supply Agreement ("Amended

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[1]Absent a finding of ambiguity, the court questions whether this is admissible evidence under Ohio law. *See Cincinnati Ins. Co. v. CPS Holdings, Inc.*, 115 Ohio St. 3d 306, 308 (2007)("When the language of a written contract is clear, a court may look no further than the writing itself to find the intent of the parties."). However, as each party refers to this evidence and neither party has objected to it, the court will consider it.

Agreement"). [Doc. # 172, Phar-Mor Brief, Ex. 11]. The parties extended the term of the Supply Agreement for an additional four years, through November 15, 2005. [*Id.*, ¶ 3]. Pursuant to the Amended Agreement, Phar-Mor's annual purchase commitment was increased to at least $300 million and McKesson agreed to increase the average number of days that Phar-Mor had to pay McKesson's invoices from 22.5 days to 26.5 days. [*Id.*; Doc. # 172, Phar-Mor Brief, Ex. 6, Pearce Depo. p. 72; Ex. 7, Schrank Depo. p. 34]. McKesson also agreed to make an annual compliance payment to Phar-Mor of $350,000 on November 15, 2000, and $300,000 on November 15 of each year thereafter provided "all of Phar-Mor's material contractual commitments required under this Supply Agreement [had] been met for the then concluding Contract Year." [Doc. # 172, Phar-Mor Brief, Ex. 11, ¶ 12].

Throughout the term of the Supply Agreement and the Amended Agreement, McKesson was Phar-Mor's largest single vendor, distributing to it over 30 percent of Phar-Mor's purchases in fiscal year 2001. [Doc. # 172, Phar-Mor Brief, Ex. 1, Seekely Aff. ¶4]. Following the Amended Agreement, Phar-Mor purchased from McKesson on average $1 million of merchandise per day. [Doc. # 172, Phar-Mor Brief, Ex. 6, Pearce Depo. p. 396]. As of March 2001, Phar-Mor had an overall excellent payment history with its approximately 2000 merchandise vendors, including McKesson, and had vendor support from over 99 percent of its vendors.[2] [Doc. # 172, Phar-Mor Brief, Ex. 1, Seekely Aff. ¶ 5-6]. With respect to McKesson, Phar-Mor paid its invoices in a timely fashion and was never in payment default. [*Id.;* Ex. 6, Pearce Depo. p. 396].

On March 19, 2001, McKesson sent a letter to Phar-Mor suspending McKesson's performance under the Amended Agreement unless Phar-Mor agreed to reduced payment terms. [Doc. # 172, Phar-Mor Brief, Ex. 15]. The letter stated that McKesson was concerned about the soundness of Phar-Mor's financial condition and its ability to make future payments to McKesson when they become due for the following reasons: "Recent Moody's downgrade; reduction in bank line availability and indications that availability will decrease significantly toward the end of the calendar year; and financial deterioration, including deteriorating margins, continuing net losses, and declining comp sales." [*Id.*]. The letter referenced McKesson's right to change Phar-Mor's payment terms under the material adverse change provision of the Supply Agreement and also requested that Phar-Mor provide "adequate assurances of due and timely

[2] By vendor support, Phar-Mor refers to the fact that its payment and/or credit terms had not been restricted in 2001 by over 99 percent of its vendors. [Doc. #172, Phar-Mor Brief, Ex. 1, Seekely Aff. ¶ 6].

performance" of its obligations under the Agreement, "as provided by Uniform Commercial Code Section 2-609. . . ." [*Id.*].

After some negotiation, the reduced payment terms agreed upon, albeit under protest by Phar-Mor, required purchases made Sunday through Saturday to be paid fifteen days from Saturday with a 29 basis point reduction in cost of goods sold and required Phar-Mor to provide a $1.4 million deposit. [Doc. # 175, Winick Decl., Ex. V, p. 2 and Ex. W, p. 2]. According to Martin Seekely, Chief Financial Officer at Phar-Mor, the reduction in cost of goods sold offset the increased borrowing costs resulting from the change in payment terms. [Doc. # 175, Winick Decl., Ex. X, p. 306]. However, the change in credit terms resulted in an $8.4 million reduction in Phar-Mor's borrowing availability, which occurred on April 9, 2001. [*Id.* at 304 and Ex. O, p. 119].

It is undisputed that the following events occurred during the months leading up to McKesson's March 19, 2001, letter:

1. On September 29, 2000, Phar-Mor filed its Form 10-K with the Securities and Exchange Commission ("SEC") for the fiscal year ending July 1, 2000, reporting $5.34 million in operating income and a net loss of $11.023 million after accounting for an extraordinary gain of $1.117 million from the repurchase of its senior debt. [Doc. # 175, Winick Decl., Ex. E, p. 13, 14]. In fiscal year 1999, Phar-Mor had reported $15.01 million in operating income and net income, with no extraordinary gains, of $596,000. [*Id.* at 12-13].

2. On October 12, 2000, Global Credit Services reported that Phar-Mor's erosion of working capital was "turning into an avalanche," declining annually from approximately $159 million in fiscal year 1997 to $47 million in fiscal year 2000. [Doc. # 175, Winick Decl., Ex. G, p. 13]. It also reported that Phar-Mor's borrowing availability under its $100 million credit facility had declined to only $10 million, a reduction of approximately $50 million from a year earlier, but that it had signed a letter of intent with a new bank to replace its credit facility with a $150 million line. [*Id.* at 1-2, 15]. Global Credit Services advised Phar-Mor vendors to "monitor their credit risk closely." [*Id.* at 1].

3. On November 9, 2000, Phar-Mor filed its Form 10-Q with the SEC for the first fiscal quarter of 2001, ending September 30, 2000, reporting a net loss of $8.502 million and a 2.9% decline in same store sales as compared to the first quarter of the prior fiscal year. [Doc. # 175, Winick Decl., Ex. J, p. 5, 8]. For the first quarter of fiscal year 2000, ending October 2, 1999, Phar-Mor reported operating income of $422,000 and a net loss of $4.191 million. [*Id.*, p. 5].

4. On November 15, 2000, McKesson paid Phar-Mor the first compliance payment under the Amended Agreement in the amount of $350,000. [Doc. # 172, Phar-Mor Brief, Ex. 6, Pearce Depo. p. 77]. McKesson's credit manager, Jennifer Jenkins, testified that she was not aware that the compliance payment was made and that she would have been consulted if a credit requirement was to be satisfied before making the payment. [Doc. # 188, Winick Suppl. Decl., Ex. GG, p. 152].

5. On November 16, 2000, McKesson's credit manager issued an internal credit report based on Phar-Mor's recently released first quarter financial information for fiscal year 2001, noting that the first quarter losses were more than twice that of the first quarter of the previous year, that gross margins decreased by 2%, that the company's debt was continuing to increase and that its net worth had declined by more than $8 million. [Doc. # 188, Winick Suppl. Decl., Ex. HH, Ex. GG p. 128]. The report recommended shortening payment terms based on the company's financial deterioration. [*Id.,* Ex. HH, p. 1].

6. Phar-Mor closed on its new $150 million secured revolving credit facility with Fleet Retail Finance Inc. ("Fleet Credit Facility"), effective November 16, 2000, which established a first priority security interest in all of Phar-Mor's assets excluding real property and equipment. [Doc. # 175, Winick Decl., Ex. Q, p. 13]. The loan agreement provides that if borrowing availability falls below $20 million, Phar-Mor's consolidated net worth must not be less than $45 million. [Doc. # 188, Winick Suppl. Decl, Ex. KK].

7. On November 22, 2000, F&D Reports reported that "Phar-Mor's long term outlook is cloudy at best" and that it has experienced a "continued operational free-fall." [Doc. # 175, Winick Decl., Ex. L]. It noted that cash flow failed to fully cover Phar-Mor's increasing interest expense for the third straight quarter and that "[a]nother factor working against the Company is its highly leveraged balance sheet." [*Id.*]. It noted Phar-Mor's new $150 million credit facility and observed that "[a]lthough additional borrowings may buy the Company some time, they will further debilitate the already weakened balance sheet." [*Id.*].

8. During December 2000 and January 2001, Phar-Mor repurchased over $40 million of its 11.72% senior debt at approximately 50 cents on the dollar, as compared to prices between 80 and 90 cents on the dollar a year earlier. [Doc. # 175, Winick Decl., Ex. O, p. 81-82 and Ex. M, p. 1].

9. On February 2, 2001, Moody's Investors Service downgraded all ratings of Phar-Mor, including its 11.72% senior unsecured notes (due September 2002) to Caa1 from B3, the senior implied rating to B3 from B2, and the senior unsecured issuer rating to Caa1 from B3. It stated that "[t]he rating

action was prompted by declining operational and debt protection measures over the past three years that have deteriorated at an increasing rate since the beginning of 2000." [Doc. #175, Winick Decl., Ex. P, p. 1].

10. On February 9, 2001, Phar-Mor filed its Form 10-Q with the SEC for the second quarter of fiscal year 2001, ending December 30, 2000. It reported $789,000 in operating income and a loss, before the extraordinary gain resulting from the repurchase of its senior debt, of $9.255 million for the quarter. However, the extraordinary gain of $17.097 million resulted in net quarterly income of $7.842 million. Phar-Mor reported same store sales decreased by 2.2% as compared to the second quarter of the previous fiscal year. [Doc. #175, Ex. Q, pp. 5-6, 10]. As of December 30, 2000, Phar-Mor's availability under the Fleet Credit Facility was $58.571 million. [*Id.* at 13]. For the second quarter of fiscal year 2000, ending January 1, 2000, Phar-Mor had reported operating income of $9.976 million and net income after a $206,000 extraordinary gain, of $8.188 million. [*Id.* at 5-6].

11. On February 13, 2001, referring to Phar-Mor's operational losses as "internal hemorrhaging," Global Credit Services downgraded Phar-Mor's credit rating to an "F" and advised clients to "monitor their exposures and reduce terms and credit lines." [Doc. # 175, Winick Decl., Ex. I, pp. 1-2]. It also reported that, by early February 2001, Phar-Mor's borrowing availability under the Fleet Credit Facility had decreased to approximately $44 million. [*Id.*].

12. On March 19, 2001, the day McKesson changed Phar-Mor's payment terms, Phar-Mor's stock price had dropped to $0.8125 per share, a decline of approximately 38% from its share price of $1.313 on November 15, 2000, the date of the $350,000 compliance payment, and a decline of approximately 79% from its share price of $3.875 on November 5, 1999, the date of the Amendment to the Supply Agreement.

13. On May 10, 2001, Phar-Mor filed its Form 10-Q with the SEC for the period ending March 31, 2001, [Doc. # 175, Winick Decl., Ex. S], before McKesson's change in credit terms had a financial impact on Phar-Mor, [*see* Doc. # 175, Winick Decl., Seekely Depo., Ex. X, p. 304-06 and Ex.O, p. 119]. Phar-Mor again reported a quarterly loss, before extraordinary gains, of $6.263 million. [Doc. # 175, Winick Decl., Ex. S, p. 5]. However, it reported an extraordinary gain, again resulting from the repurchase of its senior debt, in the amount of $2.634 million, resulting in a net loss of $3.629 million. [*Id.* at pp. 6, 11]. As of March 31, 2001, Phar-Mor's availability under the Fleet Credit Facility had decreased to $36.663 million. [*Id.* at p. 13].

At the time McKesson changed Phar-Mor's payment terms, McKesson had no concern that Phar-

Mor would not be able to pay its invoices in March 2001. [Doc. # 172, Phar-Mor Brief, Ex. 6, Pearce Depo, p. 399]. According to Alan Pearce, McKesson's Senior Vice President, Financial Services, as of March 19, 2001, McKesson had some concern, albeit a minor concern, regarding Phar-Mor's ability to make payments in April 2001 and increasing concern for each successive month thereafter. [*Id.* at 399-401, 404].

On April 18, 2001, in response to McKesson's request for adequate assurance, Phar-Mor sent written forecasts of Phar-Mor's balance sheets, income statements, cash flow and borrowing availability for the last nine months of 2001. [Doc. #172, Phar-Mor Brief, Ex. 16]. The forecasts state that "Phar-Mor gives no assurance that the Forecasts will be realized, and it is under no obligation to report changes in the Forecasts." [*Id.* at 3]. McKesson's credit manager testified that projections were not a sufficient response and that she did not determine whether Phar-Mor's forecasts were credible. [Doc. #172, Phar-Mor Brief, Ex. 3, Jenkins Depo. p. 352-53(under seal)].

McKesson did not reinstate the payment terms in the Supply Agreement or in the Amended Agreement. On September 24, 2001, Phar-Mor filed a petition for relief under Chapter 11 of the Bankruptcy Code.

LAW AND ANALYSIS

I. Summary Judgment Standard

Under Federal Rule of Civil Procedure 56, made applicable to this proceeding by Federal Rule of Bankruptcy Procedure 7056, a party will prevail on a motion for summary judgment when "[t]he pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986); Fed. R. Civ. P. 56(c). In order to prevail, the movant must prove all elements of the cause of action or defense. *Taft Broadcasting Co. v. United States*, 929 F.2d 240, 248 (6th Cir. 1991). Once that burden is met, however, the opposing party must set forth specific facts showing there is a genuine issue for trial. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249-51 (1986); *60 Ivy St. Corp. v. Alexander,* 822 F.2d 1432, 1435 (6th Cir. 1987). Inferences drawn from the underlying facts must be viewed in a light most favorable to the party opposing the motion. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586-88 (1986).

In cases such as this, where the parties have filed cross-motions for summary judgment, the court must consider each motion separately on its merits, since each party, as a movant for summary judgment, bears the burden to establish both the nonexistence of genuine issues of material fact and that party's

entitlement to judgment as a matter of law. *Lansing Dairy v. Espy*, 39 F.3d 1339, 1347 (6th Cir. 1994); *Markowitz v. Campbell* (*In re Markowitz*), 190 F.3d 455, 463 n.6 (6th Cir. 1999). The fact that both parties simultaneously argue that there are no genuine factual issues does not in itself establish that a trial is unnecessary, and the fact that one party has failed to sustain its burden under Rule 56 does not automatically entitle the opposing party to summary judgment. *See* 10A Charles Alan Wright, Arthur R. Miller, & Mary Kay Kane, *Federal Practice and Procedure: Civil 3d* § 2720 (1998).

II. Overview of Arguments

Phar-Mor moves for partial summary judgment only on the issue of whether a breach occurred when McKesson changed Phar-Mor's payment terms on March 19, 2001, not on the issue of damages. Phar-Mor argues that McKesson breached the terms of the Supply Agreement when it changed Phar-Mor's payment terms because no material adverse change in its financial condition had occurred. Phar-Mor first contends that McKesson's admissions and conduct conclusively demonstrate that there was no material adverse change in Phar-Mor's financial condition as contemplated in paragraph nine of the Supply Agreement. Also, relying on the report of its economic expert, Mark Gleason, Phar-Mor argues that a detailed analysis of key items on its balance sheet conclusively demonstrates that a material adverse change in financial condition did not occur. Finally, Phar-Mor argues that paragraph nine of the Supply Agreement provides a comprehensive mechanism by which any concerns of McKesson regarding Phar-Mor's financial condition could be addressed and, as such, McKesson had no separate or distinct rights or remedies under the Uniform Commercial Code ("UCC") § 2-609.

McKesson opposes Phar-Mor's summary judgment motion, arguing that it made no admissions regarding Phar-Mor's financial condition, that the Gleason report fails to consider all relevant facts relating to Phar-Mor's financial condition, and that it properly invoked its rights under the UCC. In addition, McKesson moves for summary judgment, arguing that there is no genuine issue regarding the fact that Phar-Mor experienced a material adverse change in its financial condition and that in any event it sustained no legally compensable damages as a result of the change in payment terms.

The court agrees that the undisputed facts demonstrate that a material adverse change in Phar-Mor's financial condition occurred and, thus, that McKesson is entitled to summary judgment since it had a contractual right to change Phar-Mor's payment terms. As such, the court need not address the parties' arguments regarding damages or rights under the UCC, and McKesson's evidentiary objection to the affidavit of Adam Waterfield presented by Phar-Mor in support of its UCC arguments will be denied as

moot.

In reaching its decision, the court will first address the general standards of contract interpretation under Ohio law as applicable to both summary judgment motions. Then it will separately address, in reverse order, each part of the contract standard in issue: material adverse change in financial condition. What does financial condition mean as used in the Supply Agreement? Was there an adverse change in Phar-Mor's financial condition? Finally, was the change material? The linchpins of the outcome of this case are the contractual meanings of financial condition and of materiality, and the application of those meanings to the undisputed facts presented to the court.

III. Contract Interpretation Standards

Material adverse change provisions, or MACS as they are called, are common clauses used in different ways in different types of commercial contracts, especially merger and acquisition agreements and loan agreements. They serve generally the same function as the MAC at issue in this case: to allow one or both parties to get out of a deal or, as McKesson's expert more euphemistically puts it, to manage the risk associated with a deal. [Doc. #189, Elson Declaration, ¶ 19, p. 7]. McKesson and Phar-Mor did not define in their Supply Agreement "material adverse change in financial condition" or adopt standards for what does or does not constitute a "material adverse change in financial condition" that would allow McKesson to change their agreed payment terms. The court must therefore apply basic principles of contract interpretation[3] under Ohio law. While not unique to Ohio law or unusual, these principles bear repeating here. The lack of a definition of or standards for "material adverse change in financial condition" in the Supply Agreement has driven both parties to expert witnesses to develop a definition for application by the court. Not surprisingly, Phar-Mor's expert Gleason and McKesson's expert Craig Elson come up with

[3]Some courts, and at least one commentator, distinguish between the concepts of contract interpretation and contract construction. 5 Margaret N. Kniffin *Corbin on Contracts,* § 24.3 (Joseph Perillo ed., rev. ed. 1998). Ohio courts use these terms more casually, referring to construction and interpretation seemingly interchangeably, and do not generally distinguish between them. *Compare State ex rel. Petro v. R.J. Reynolds Tobacco Co.*, 104 Ohio St. 3d 559, 564 (2004)("We thus employ our usual method of contract construction in defining disputed terms.") *with Nationwide Mutual Ins. Co. v. Guman Brothers Farm*, 73 Ohio St. 3d 107, 108 (1995)(Where term has plain and ordinary meaning, "[i]t is...unnecessary and impermissible for a court to resort to construction of that language...Thus, the interpretation of this insurance contract is a matter of law."). *But see Saunders v. Mortensen*, 101 Ohio St. 3d 86, 88 (2004)("If we are able to determine the intent of the parties from the plain language of the agreement, then there is no need to interpret the contract."). Nor do courts applying Ohio law generally distinguish between them. *E.g., Dualite Sales & Service, Inc. v. Moran Foods, Inc.*, 194 Fed. Appx. 284, *288 (6th Cir., Sept. 5, 2006)("[w]e are guided by the rules of contract interpretation as decided by the Supreme Court of Ohio. 'The purpose of contract construction is to effectuate the intent of the parties.'" (quoting *Kelly v. Med. Life Ins. Co.*, 31 Ohio St.3d 130, 132 (1987)). This court is likewise not using these terms with any special significance or distinction.

different definitions. In doing so, however, they largely overlook the basic function of the court in contract interpretation disputes like this, which is to ascertain what Phar-Mor and McKesson meant in 1997 by a "material adverse change in financial condition." Unless a textbook definition or a trade usage or an interpretation of a MAC in a different contract in another court case[4] or SEC Regulations or FASB Standards or basic economic principles can be connected to what the parties intended in this contract, then such sources are not determinative or even helpful. The standards advocated by the respective experts are thus relevant only to the extent that the court can determine an identified standard, whatever its source, as properly reflecting the intentions of the parties.

Under Ohio law, the primary purpose in construing any contract is to ascertain and give effect to the contracting parties' intent. *State ex rel. Petro v. R.J. Reynolds Tobacco Co*, 104 Ohio St.3d 559, 564 (2004). In so doing, the court examines the contract as a whole and presumes that the parties' intent resides in the language they chose to use in their agreement. *Cincinnati Ins. Co. v. CPS Holdings, Inc.,* 115 Ohio St.3d 306 307-08 (2007)(citing *Kelly v. Med. Life Ins. Co.*, 31 Ohio St.3d 130, 132 (1987)); *R. J. Reynolds Tobacco Co.,* 104 Ohio St. 3d at 564 (citing and quoting *Kelly*); *Graham v. Drydock Coal Co.*, 76 Ohio St.3d 311, 313 (1996). If the contract is clear and unambiguous, the court must give effect to the parties' expressed intentions; the court "cannot in effect create a new contract by finding an intent not expressed in the clear language employed by the parties." *Alexander v. Buckeye Pipe Line Co.*, 53 Ohio St. 2d 241, 244 (1978). In construing the provisions of a contract, "common words appearing in a written instrument are to be given their plain and ordinary meaning unless manifest absurdity results or unless some other meaning is clearly intended from the face or overall contents of the instrument." *Id.* at 245-46.

The question of whether the language of a contract is ambiguous is a question of law to be decided by the court. *Long Beach Assn., Inc. v. Jones*, 82 Ohio St. 3d 574, 576 (1998). Likewise, "[w]hen the facts

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[4]The court is well aware that on its face the MAC in the Supply Agreement is narrower than most in its specification of the subject matter of the field of change that justifies action, which is only Phar-Mor's financial condition. It contrasts with broader MAC provisions that typically read something like the following warranty in an asset purchase agreement for a Chapter 11 debtor's assets that there had been no "material adverse change in the business, financial condition, results of operations or assets or liabilities of the Business..." *Pine State Creamery v. Land-O-Sun Dairies, Inc.*, 1999 U.S. App. LEXIS 31529 *3 (4th Cir., December 2, 1999). That case is one cited by Phar- Mor in support of its reading of the MAC in the Supply Agreement as excluding operating results. The district court in *Pine State Creamery* held that operating profits and losses did not fall within the scope of that condition as affecting "the Business," a finding that the Fourth Circuit Court of Appeals reversed. Given that the issue here is what Phar-Mor and McKesson intended, this and other cases are of limited utility to the court except to the extent that they provide general guidance on principles of contract construction as they may be applicable to a MAC and consonant with Ohio law.

presented in a case are undisputed, whether they constitute a performance or a breach of the contract, is a question of law for the court." *Luntz v. Stern*, 135 Ohio St. 225, 247 (1939). "As a matter of law, a contract is unambiguous if it can be given a definite legal meaning." *CPS Holdings, Inc.,* 115 Ohio St.3d at 308. If an ambiguity exists, only "then it is proper for a court to consider 'extrinsic evidence,' i.e. evidence outside the four corners of the contract, in determining the parties' intent." *Covington v. Lucia*, 151 Ohio App. 3d 409, 414 (2003). "However, courts may not use extrinsic evidence to create an ambiguity; rather, the ambiguity must be patent, i.e., apparent on the face of the contract." *Id.* (citing *Schachner v. Blue Cross & Blue Shield of Ohio*, 77 F.3d 889, 893 (6th Cir. 1996)); *Aerel, S.R.L. v. PCC Airfoils, L.L.C.*, 448 F.3d 899, 904 (6th Cir. 2006). Just because a term in a contract is not defined does not make it ambiguous. *R.J. Reynolds Tobacco Co.,* 104 Ohio St. 3d at 564; *Chicago Title Inc. Co. v. Huntington Nat'l Bank*, 87 Ohio St. 3d 270, 273 (1999); *Nationwide Mutual Fire Ins. Co. v. Guman Bros. Farm*, 73 Ohio St. 3d 107, 108 (1995); *see Kena Properties, LLC v. Merchants Bank & Trust*, 218 Fed. Appx. 402, *405-06 (6th Cir., Feb. 20, 2007)("material adverse condition" clause in a commitment letter determined to be unambiguous under Ohio law even though it was not defined by the parties). Nor does a contract's susceptibility to more than one reading in litigation render it ambiguous. *PCC Airfoils, L.L.C.*, 448 F.3d at 904.

Finally, the court agrees with, as consonant with Ohio law of contract construction, a point made by McKesson's expert, and the general observation in the most significant case to date interpreting a MAC, albeit in the context of a merger agreement. Specifically, "contractual language must be read in the larger context in which the parties are transacting." *In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14, 67 (Del. Ch. 2001); *see Saunders v. Mortensen*, 101 Ohio St. 3d 86, 89 (2004)("We have long held that a contract is to be read as a whole and the intent of each part gathered from a consideration of the whole."). The term in issue in this case is part of a long term supply relationship for the sale of pharmaceutical goods on unsecured trade credit, with McKesson's exposure under the payment terms of the Amended Agreement ranging between $20 million and $30 million.

IV. The Meaning of Financial Condition in the Supply Agreement

The parties advocate different interpretations of the meaning of "financial condition" as used in the Supply Agreement.

Phar-Mor asserts that "financial condition" means static factors related only to Phar-Mor's balance sheet or liquidity as measuring a company's ability to pay its debts at a point in time. Under Phar-Mor's definition of financial condition, operating results as shown by a company's income statements are

irrelevant to a company's financial condition.

McKesson's expert agrees to some extent with Phar-Mor's expert, concluding that "financial condition" means the ability of a company to generate cash to repay its debts, or as they are described by McKesson, "the providers of funds used to facilitate ... operations." [Doc. #189, Elson Decl., ¶ 19, p. 7]. However, McKesson asserts that "there are many, more specific indicia of a firm's ability to generate cash to meet its financing requirements" than just balance sheet factors as advocated by Phar-Mor, specifically factors and information reflected on Phar-Mor's income statements.

Phar-Mor's Definition of Financial Condition

Phar-Mor relies on the report of its expert, Mark Gleason, in contending that "financial condition" has a narrow meaning and excludes operating results from consideration. According to Gleason, the following definition of "financial condition" is widely accepted and well established in the accounting and financial fields: "the state of and the relationships among the various financial data found on a firm's balance sheet." [Doc. # 172, Phar-Mor's Brief, Ex. 17 and unnumbered p. 9 of Ex. A attached thereto]. Relying on this definition, Gleason states that "financial condition" is demonstrated by a company's balance sheet and liquidity, and excludes information derived from a company's income statement, [*id.* at unnumbered p. 10], information relied upon, at least in part, by McKesson in concluding that Phar-Mor had experienced a material adverse change in its financial condition. Thus, Phar-Mor argues that for a contractual basis to exist for changing Phar-Mor's payment terms, there must have been a material adverse change in Phar-Mor's balance sheet and liquidity factors as shown on the balance sheet as of March 19, 2001.[5]

Initially, the court finds Phar-Mor's reliance on the standard advanced in the Gleason report misplaced. In *Alexander*, the Ohio Supreme Court recognized that "although extrinsic evidence of a general custom or trade usage cannot vary the terms of an express contact, such evidence is permissible to show that the parties to a written agreement employed terms having a special meaning within a certain geographic location or a particular trade or industry, not reflected on the face of the agreement." *Alexander*, 53 Ohio

[5]If this is the parties' intent as to what the contractual standard means, then there are genuine issues of material fact respecting Phar-Mor's motion for partial summary judgment as shown by the experts' reports. Gleason asserts that there are no material adverse changes shown in Phar-Mor's balance sheet and properly considered measures of liquidity. Elson asserts that there are. [*See* Doc. #189, Elson Decl., ¶¶ 11, 91-100]. These genuine issues of material fact would also be grounds for denial of Phar-Mor's motion. Because the court disagrees with Phar-mor's construction of the contract standard, the court does not find that there are genuine issues of material fact and denies Phar-Mor's motion on different grounds.

St. 2d at 248. However, the Supreme Court found that in order to raise a genuine issue of material fact regarding the meaning of a term, a party must present evidence that the custom or usage is so widespread in the industry as to support a valid presumption that the parties having knowledge of the special usage must have intended a limited meaning. *Id.*

Gleason's report concludes that "financial condition" has a meaning of widespread acceptance in the accounting and financial fields, with reference to a book, FASB Standards and SEC Regulation S-K. There is nothing in his report or opinion that connects this meaning and these sources to the intentions of the parties in 1997. For example, there is no evidence of a special meaning within the pharmaceutical industry, which is the industry in which both McKesson and Phar-Mor were operating, and no evidence that the Supply Agreement was negotiated by the parties' accountants or financial officers, individuals whom the court might assume would have knowledge of the special usage indicated in Gleason's report. Rather, the Agreement was signed by Phar-Mor's Vice President, Pharmacy Operations, and McKesson's President, Customer Operations.

Moreover, the language of the Supply Agreement itself does not support such a finding. The only other place in the Supply Agreement that the words "financial condition" are used is earlier in the part of paragraph nine that conditions the contract upon "Phar-Mor's maintaining a sound financial condition throughout the term hereof..." [Doc. #172, Phar-Mor Brief, Ex. 5, ¶ 9]. "Sound financial condition" is likewise not defined. At McKesson's request, Phar-Mor agreed to promptly substantiate in writing "the existence of such condition," which the court construes as "the existence of such sound financial condition." However, the language of the Agreement does not limit the information that Phar-Mor is required to provide to substantiate the fact that it is maintaining a sound financial condition to providing the most recent balance sheet, as it logically would if the parties intended that Phar-Mor's financial condition mean the state of and relationships among the various data on the company's balance sheet. Rather, it more broadly requires Phar-Mor to provide "publicly available financial *and other publicly available supporting information. . . .*" [*Id.* (emphasis added)].

The court finds no factual basis presented to presume that the parties intended the limited definition of "financial condition" that is set forth in Gleason's report.

<u>McKesson's Definition of Financial Condition</u>

McKesson's expert and its lawyers focus on what amounts to a material adverse change, with its reference to the subject matter of the change as being "financial condition" only secondary in its arguments.

Looking to a corporate finance textbook, Elson sets forth several similar statements as to what "financial condition" means; e.g., "the firm's ability to obtain, and, importantly, pay for the capital needed to conduct its business;" "the firm's ability to fund the production of goods or the provision of services." However, as with Phar-Mor's expert, there is nothing in his declaration and opinion from which the court can connect those statements to the intentions of the parties in 1997. The court notes as to both experts that the parties knew how to use similar language. One of the grounds for termination of the Supply Agreement by either party was that the "other party shall make a general assignment for the benefit of creditors or shall become unable or admit in writing its inability to meet its obligations as they mature." [Doc. # 172, Phar-Mor Brief, Ex. 5, ¶ 23.C.]. But they did not state in paragraph nine of the Supply Agreement that McKesson could change Phar-Mor's payment terms in the event of a material adverse change in its ability to meet its obligations as they mature.

The court likewise cannot adopt as reflective of the parties' intentions in 1997 the definition of financial condition advocated by McKesson.

Court's Interpretation of Financial Condition in the Contract

Instead of either expert's advocated standard, the court is guided by *Alexander,* which requires that the court give words in a contract their plain and ordinary meaning unless a manifest absurdity results. As the Ohio Supreme Court has repeatedly observed, that a term has not been defined by the parties does not alone make it ambiguous. *R.J. Reynolds Tobacco Co.,* 104 Ohio St. 3d at 564; *Chicago Title Inc. Co. v. Huntington Nat'l Bank*, 87 Ohio St. 3d 270, 273 (1999); *Nationwide Mutual Fire Ins. Co. v. Guman Bros. Farm*, 73 Ohio St. 3d 107, 108 (1995).

To ascertain the plain meaning of the words used in a contract, the Ohio Supreme Court routinely looks to legal and other dictionaries, without, however, specifying the reason for its selection of any particular dictionary as conveying plain meaning. Examples abound. In *Guman Brothers Farms*, 73 Ohio St. 3d at 109, the Ohio Supreme Court looked to *Black's Law Dictionary* (6th ed. 1990) to determine the plain meaning of the term "employee" as used in an insurance contract. In *R.J. Reynolds Tobacco Co.*, 104 Ohio St. 3d at 564-65, the Ohio Supreme Court noted that "the trial court had presided over a battle of dictionaries" and affirmed its definition of the word "merchandise" in a settlement agreement as being in general accord with the definition of "merchandise" in *Black's Law Dictionary* (8th ed.2004). In *Goodyear Tire & Rubber Co. v. Aetna Casualty & Surety Co.*, 95 Ohio St. 3d 512, 519 (2002), the Ohio Supreme Court looked to *Webster's Ninth New Collegiate Dictionary* (1984) for definitions of "escape" and

"disperse" as used in an insurance contract. And in *Huntington National Bank*, 87 Ohio St. 3d at 274, the Ohio Supreme Court relied upon *Webster's Third New International Dictionary* (1986) to ascertain the plain meaning of "actual" as used in a title insurance policy. Following the Ohio Supreme Court's lead, the court will look to dictionary definitions to determine if there is a plain meaning of "financial condition."

Various dictionary definitions all point to a plain meaning of financial condition as broader than just balance sheet factors. For example, *Webster's Third New International Dictionary* defines "condition" as "a state of being," and "financial" as "relating to finances," together with "finances" as "the pecuniary affairs or resources of a . . . company," and pecuniary "of or relating to money." *Webster's Third New Int'l Dictionary* 473, 851 (1986). According to these definition of the words used in the parties' Supply Agreement, "financial condition" means the state of a company's pecuniary affairs or resources.

The *American Heritage Dictionary* similarly defines "financial" as "of, relating to or involving finance," "finance" as "the supplying of funds or capital" and "finances" as "monetary resources; funds, especially those of a government or corporate body," while "condition" is "a mode or state of being." *American Heritage Dictionary* 660, 383 (4th ed. 2000). According to these definitions of the words used in the Supply Agreement, "financial condition" means the state of a company's supplying of funds or capital or its monetary resources.

The Sixth Edition of *Black's Law Dictionary* lacks a relevant definition of condition, but broadly defines "financial" as "[f]iscal," which in turn is defined as "in general, having to do with financial matters, e.g. money, taxes, public or private revenues," or as "[r]elating to finances," with "finances" also broadly defined as " being concerned with "the value of the assets of the business system and the acquisition and allocation of the financial resources of the system." *Black's Law Dictionary* 630, 636 (6th ed. 1990). Using *Black's Law Dictionary*, then, financial condition broadly means the state of the value of the assets and the acquisition and allocation of the financial resources of a business system or, more simply, the state of a business' money or revenues.

More directly yet, *Ballentine's Law Dictionary* presents a unified definition of "financial condition" as "the wealth of a person and his income, whether from property or his earnings." *Ballentine's Law Dictionary* (1969).

Canvassing these dictionary resources, which are all similar in substance if not identical, the court finds that defining the words "financial condition" as having the plain meaning derived from *Webster's Third International Dictionary* is appropriate under the Supply Agreement. *See R.J. Reynolds Tobacco Co.*,

104 Ohio St. 3d 564-65. This is a general reference resource that is shown by electronic search to be frequently and routinely cited by Ohio courts to ascertain the plain meaning of words. S*ee, e.g, State ex rel. Stoll v. Logan Cty. Bd. Elec.,* Case No. 2006-2187, 2008 Ohio 333, ¶ 43, 2008 Ohio LEXIS 237, **19, 2008 WL 345506, *7 (Ohio slip op., Feb. 5, 2008). In the absence of a contractual definition or standard, parties choosing Ohio law to govern their agreement as Phar-Mor and McKesson did should reasonably contemplate *Webster's Third International Dictionary* as a source for ascertaining the plain meaning of the words used by the parties.

Accordingly, "financial condition" is the state of a company's pecuniary affairs or resources. Reviewing the Agreement as a whole, the Supply Agreement sets forth the terms of a daily business relationship in which McKesson supplies goods on credit and Phar-Mor pays for those goods. The parties have an ongoing mutual relationship, in contrast to a one-off sale of assets or a merger, and in contradiction to Phar- Mor's focus on a static point in time. The "financial condition" provision is placed in paragraph nine, entitled "Payment Terms," wherein the parties set forth the credit terms extended to Phar-Mor by McKesson and the circumstances under which such credit terms can be changed, that is, when there has been a material adverse change in Phar-Mor's financial condition. Applying the ordinary meaning of "financial condition" to the Supply Agreement will advance the obvious purpose of that provision, i.e., to afford McKesson the ability to adjust its future credit terms according to the degree of increased risk associated with a material change in Phar-Mor's pecuniary affairs. The term "financial condition" can be given a definite legal meaning in the context of the whole Agreement and is thus not ambiguous. Nor does applying this definition to the Supply Agreement lead to a manifest absurdity.

The court acknowledges this meaning of "financial condition" is much broader than Phar-Mor's construction and close to McKesson's construction. Phar-mor's lawyer argued in oral argument that "financial condition" cannot mean everything. But the specific contractual limiting factor that the parties negotiated and agreed upon for permitting a change in payment terms resides not in the meaning of financial condition, as advocated by Phar-Mor, but in materiality derived from an objective point of view instead of from a subjective point of view. This definition of financial condition is also one that comports in the court's view with basic principles of contract interpretation under Ohio law.

V. Was There An Adverse Change in Phar- Mor's Financial Condition?

With this construction of the Supply Agreement in mind, the court first addresses Phar-Mor's argument that McKesson's admissions and conduct demonstrate that there was no material adverse change

in Phar-Mor's financial condition. Specifically, Phar-Mor relies on the testimony of McKesson's corporate designee Alan Pearce that, to his knowledge, there had not been a material adverse change in Phar-Mor's financial condition in calendar years 1997 through November 5, 1999, the date of the Amendment to Supply Agreement, and admitted that during calendar year 2000, Phar-Mor never concluded that Phar-Mor had experienced a material adverse change in its financial condition. [*See* Doc. #172, Phar-Mor Brief, Ex. 6, Pearce Depo., pp. 128, 173-74]. It also argues that by making the $350,000 compliance payment on November 15, 2000, McKesson affirmed that Phar-Mor was in compliance with all "material contractual commitments" for the then concluding contract year, including the contractual condition requiring Phar-Mor to maintain a sound financial condition. Finally, because McKesson had no concern on March 19, 2001, the date it changed Phar-Mor's payment terms, that Phar-Mor would be unable to pay McKesson's March 2001 invoices, a material adverse change in Phar-Mor's financial condition could not have occurred.

Phar-Mor's arguments are flawed in several respects.

First, the fact that McKesson had not concluded by December 31, 2000, that a material adverse change in Phar-Mor's financial condition had occurred is not an admission that no such change had in fact occurred.

Second, the issue in this adversary proceeding is not whether Phar-Mor's financial condition was sound, a point that Phar-Mor often seems to overlook. Phar-Mor could still maintain a sound financial condition such that McKesson lacked the right to terminate the Supply Agreement, while at the same time having experienced a material adverse change in financial condition that permitted McKesson to change payment terms. More to the point, there is no evidence that the November 15, 2000, compliance payment was made based upon a determination that Phar-Mor's financial condition was sound. Rather, the undisputed evidence indicates that if McKesson had considered Phar-Mor's financial condition before making the compliance payment, Jennifer Jenkins, its credit manager, would have been, but was not, consulted. This evidence is consistent with evidence that an internal report of the review of Phar-Mor's credit by McKesson's credit department was not completed until November 16, 2000, [Doc. #172, Phar-Mor Brief, Ex. 13, p. 4], and with the testimony of Phar-Mor's designated representative that he has no knowledge that McKesson's credit department was consulted regarding the compliance payment, [Doc. # 188, Winick Suppl. Decl., Ex. II, Seekely Depo., p. 217]. Moreover, as McKesson argues, the requirement that Phar-Mor maintain a sound financial condition was for the benefit of McKesson. Nothing in the Supply Agreement precluded McKesson from making the payment even if a material adverse change in Phar-Mor's

financial condition had occurred. And to the extent that McKesson had the right to withhold the compliance payment if it had considered Phar-Mor's financial condition, its decision to make the payment cannot be used against it. The Supply Agreement provides that McKesson's failure to enforce a contractual right shall not be construed to be a waiver of that right. [Doc. # 172, Phar-Mor Brief, Ex. 5, ¶ 26.F.]. The court finds no basis to conclude that the compliance payment constitutes an admission by McKesson that there had been no change, let alone a material adverse change, in Phar-Mor's financial condition.

Finally, the fact that McKesson admits that it had no concern that Phar-Mor was unable to pay McKesson's March 2001 invoices is not an admission that Phar-Mor had not experienced a material adverse change in its financial condition. Phar-Mor relies on language in the Supply Agreement that there "has been" a material adverse change and equates a material adverse change with a change that affects the company's present ability to pay its outstanding invoices in a timely manner. As will be explained below, while the court agrees that whether an adverse change in financial condition had occurred is necessarily backward looking, the significance or materiality of the change is necessarily forward looking. A material adverse change in financial condition as contemplated in the Supply Agreement is a change of such a nature that knowledge of the change would affect a reasonable McKesson-like vendor's decision-making process in determining the credit terms *to be* extended to Phar-Mor *if the parties continue their ongoing business relationship*.

Relying on the definition of "financial condition" set forth in the Gleason report, Phar-Mor also argues that the subject matter of the change set forth in the contract excludes operating results and is limited to a change in its balance sheet and liquidity factors as shown on the balance sheet. Phar-Mor argues that a detailed analysis of its financial condition "conclusively" demonstrates that no such change had occurred at the time McKesson changed the payment terms under the Supply Agreement. This argument fails, however, since it relies only upon "key" balance sheet information evaluated in Gleason's report in analyzing Phar-Mor's financial condition. For the reasons discussed above, the court rejects the narrow definition advanced by Phar-Mor as to the parameters of the contractual field of change. The language of the Supply Agreement does not support such a limited interpretation of "financial condition." Rather, any financial or other supporting information that sheds light on the state of Phar-Mor's finances or pecuniary affairs may be considered. McKesson offers evidence of increasing and ongoing operating losses, a continued decline in same store sales, increasing debt and decreasing net worth, availability under Phar-Mor's new Fleet Credit Facility declining more rapidly than anticipated, as well as the responses of the bond

and equity market reflected in a nearly fifty percent erosion in bond prices from one year earlier and a dramatic decline in the price of Phar-Mor's stock such that it was trading for under $1.00 per share. In light of such evidence, the court finds that Phar-Mor is not entitled to judgment as a matter of law and, therefore, its motion for summary judgment will be denied.

As to McKesson's motion for summary judgment, Phar-Mor correctly argues that a material adverse change, by definition, requires a "change" as compared to some previous time. It argues, as it did in support of its own summary judgment motion, that the court should compare Phar-Mor's financial condition at the time McKesson changed its payment terms to the following three dates, each of which Phar-Mor contends McKesson's conduct or admissions demonstrate Phar-Mor was in sound financial condition: November 5, 1999, the date of the Amendment increasing Phar-Mor's trade credit; November 15, 2000, the date of the compliance payment; and December 31, 2000, the date through which Phar-Mor contends McKesson's corporate designee admits Phar-Mor was in sound financial condition. For the reasons discussed above, the compliance payment being made by McKesson did not constitute an admission of Phar-Mor's sound financial condition nor did McKesson's corporate designee admit that Phar-Mor's financial condition was sound through December 31, 2000. However, the court finds it appropriate to consider, as suggested by Phar-Mor, its financial condition as of November 1999 when the parties amended the Supply Agreement and McKesson increased Phar-Mor's trade credit terms as compared to its financial condition at the time the payment terms were later reduced. McKesson's corporate designee did testify that there had been no material adverse change in Phar-Mor's financial condition as of November 5, 1999.

The adverse change principally relied upon by McKesson is Phar-Mor's declining operating results and inability to generate cash as demonstrated by its income statements. The fiscal year ending just prior to the parties' Amendment to the Supply Agreement was fiscal year 1999 (ended July 3, 1999). [Doc. # 175, Winick Decl, Ex. E, p. 12]. For that year, Phar-Mor reported $15.01 million in operating income and net income, with no extraordinary gains, of $596,000. [*Id.* at 12-13]. Phar-Mor's expert Gleason observed the following with respect to Phar-Mor's operating performance though fiscal year 1999, which is the climate in which the Amended Agreement and extended payment terms were reached:

> During the fiscal years 1997 through 1999, Phar-Mor pursued an everyday low price (EDLP"), deep discount marketing and merchandising strategy whereby Phar-Mor set its shelf prices below those charged by conventional drug stores and supermarkets, and offered a broader array of products in each of its product categories than offered by mass merchandisers. In each of those fiscal years, Phar-Mor achieved significant positive

> operating income that increased year to year. Because the EDLP strategy did not rely on promotions and seasonal events to drive sales, Phar-Mor's business was stable, and Phar-Mor was able to accurately budget sales and operating income.

[Doc. # 172, Phar-Mor Brief, Ex. 17,, Ex. A thereto, unnumbered p.2 (footnotes omitted)].

That changed, negatively so. For the first quarter of fiscal year 2000 ending October 2, 1999, one month before McKesson agreed to increase Phar-Mor's trade credit, Phar-Mor reported operating income of $422,000 and a net loss of $4.191 million. [Doc. # 175, Winick Decl., Ex. J, p. 5]. During the second quarter of fiscal year 2000 ending January 1, 2000, the quarter during which Phar-Mor typically experiences its highest volume of sales and net income, [Doc. #175, Winick Decl., Ex. E., p. 6], Phar-Mor reported operating income of $9.976 million and net income after a $206,000 extraordinary gain, of $8.188 million. [Doc. # 175, Winick Decl., Ex. Q, pp. 5-6]. Nevertheless, by the end of fiscal year 2000, ending July 1, 2000, Phar-Mor reported only $5.34 million in operating income for the year, a decrease of almost $10 million as compared to fiscal year 1999, and an $11.023 million net loss after accounting for an extraordinary gain of $1.117 million, a decrease in net income of over $11 million as compared to the previous year. [Doc. #175, Winnick Decl., Ex. E, pp. 12-13].

Phar-Mor's operating results continued to decline during fiscal year 2001. During the first quarter it reported operating losses of $2.887 million and a net loss of $8.502 million, more than twice the net loss reported for the first quarter of fiscal year 2000. [Doc. #175, Winnick Decl., Ex. J, p. 5]. During the second quarter ending December 30, 2000, Phar-Mor reported only $789,000 in operating income as compared to $9.976 million during the second quarter of fiscal year 2000. [Doc. #175, Winnick Decl., Ex. Q, pp. 5-6]. Also in that quarter, it reported a net loss, before extraordinary items, of $9.255 million as compared to $10.393 million in income reported in the same quarter the year before. [*Id.*]. Although Phar-Mor was able to report an extraordinary gain of $17.097 million from the repurchase of its senior debt during the second quarter of fiscal year 2001, resulting in net quarterly income of $7.842 million, in the same quarter the year before, it reported net income of $8.188 million, which included an extraordinary gain of only $206,000. [*Id.*].

The court finds that Phar-Mor's decline in operating results as shown by steadily declining operating income, reduced margins and declining same store sales since November 1999 was an adverse change in its financial condition, i.e. a change for the worse in the state of its pecuniary affairs and resources.

VI. Was the Adverse Change in Phar-Mor's Financial Condition Material?

Lacking a contractual definition of or standards for materiality, the court looks to the plain meaning of the words in the context in which the parties are transacting. Dictionary definitions of "material" include the following: "being of real importance or great consequence: substantial," *Webster's Third New International Dictionary* at 1392, and "of such a nature that knowledge of the item would affect a person's decision-making; significant; essential," *Black's Law Dictionary* (8th ed. 2004). In a similar vein, the court in *Northern Heel Corp. v. Compo Industries, Inc.*, 851 F.2d 456 (1988), a case cited by both Phar-Mor and McKesson's economic expert Craig Elson for the meaning of materiality, explains that materiality "is not what a disappointed party says it is; rather, it demands an objective cross-matching of the significance of a fact to the essence of the transaction in question, and requires a plausible showing of the potentially adverse effect of the former on the latter." *Id.* at 463. Given the parties' undisputed abandonment through negotiations of a subjective standard in favor of an objective standard, this meaning is expressive of the parties' intent.

In this case, the "material adverse change" provision appears in paragraph nine of the Supply Agreement wherein Phar-Mor's payment terms are set forth, and is specifically linked to and describes the circumstances under which McKesson has the right to change the credit terms it extends to Phar-Mor. Thus, the court finds that the relevant transaction in question is the extension of unsecured credit to Phar-Mor in the sale of pharmaceuticals by McKesson under a long term supply agreement, and facts bearing on the level of risk involved in the extension of unsecured credit in the range of $20 million to $30 million on any given day relate to the "essence of the transaction." *See id.* An adverse change in Phar-Mor's financial condition is material then, applying an objective standard as negotiated by the parties, if it is a change of such a nature that knowledge of the change would affect a reasonable McKesson-like vendor's decision-making process in determining the credit terms to be extended to Phar-Mor based upon the risk of repayment involved in the extension of such credit if the parties continue their business relationship. Unlike a one time merger agreement or a term loan, the parties' transaction was a long term supply and credit agreement that extended for four more years. This definition aligns with the clear intent in paragraph nine that McKesson have the ability to adjust its credit terms where an increased risk is associated with the unsecured lending relationship as reflected by an adverse change in Phar-Mor's financial condition.

As evidence of the materiality of the adverse change, McKesson offers the analysis of Global Credit Services and F&D Reports, two major credit reporting services monitoring Phar-Mor's financial condition,

responses of the bond and equity market, and ratings by Moody's Investors Services, Inc. ("Moody's"), as well as the analysis of its expert Elson.[6] That third parties deemed Phar-Mor's operational declines important in evaluating credit risk is critical to a finding that a reasonable person in McKesson's position, not just McKesson, would deem them material to an evaluation of the extent of unsecured credit risk it assumed. Phar-Mor's own expert Gleason acknowledges that "indirect information" about a company's creditworthiness is customarily obtained from, among other sources, "reports prepared by industry analysts working for such companies as F&D Reports (F&D) and Global Credit Services("Global")." [Doc. #175, Winick Decl. ¶ 27, Ex. EE, p.7].

As early as October 2000, Global Credit Services advised vendors to monitor their credit risk with Phar-Mor. It stated that the depth of Phar-Mor's balance sheet restrains it from assigning Phar-Mor an "F" credit rating, but that "its operations certainly merit it." [Doc. #175, Winnick Decl., Ex. G, p. 1]. On November 20, 2000, it continued to give Phar-Mor an "E" credit rating but stated that "unless a turn around occurs soon, we have little hope for [Phar-Mor's] long-term viability. . . ." [Doc. #175, Winnick Decl., Ex. H]. Similarly, on November 22, 2000, F&D Reports reported that Phar-Mor had experienced a "continued operational free-fall" and that its "long-term outlook is cloudy at best." [Doc. #175, Winnick Decl., Ex. L]. Noting Phar-Mor's new $150 million credit facility, it concluded that "[a]lthough additional borrowings may buy the Company some time, they will further debilitate the already weakened balance sheet" and that "the Company's operations must show a marked improvement if it is to avoid a future crisis." [*Id.*]. On February 16, 2001, F&D Reports concluded that Phar-Mor's operations had continued to deteriorate. Also in February 2001, Global Credit Services downgraded Phar-Mor to an "F" credit rating, noting its continued operational losses and advised vendors to "monitor their exposures and reduce terms and credit lines." [Doc. #175, Winnick Decl., Ex. I, p.1]. Also, referring to Phar-Mor's repurchase of its senior debt at a discount, it stated that "[b]uying debt below par is no substitute for staving off the Company's internal hemorrhaging." [*Id.* at 2]. These credit reporting agencies indisputably viewed Phar-Mor's operational losses as material to a decision to extend unsecured credit in that they warranted consideration by vendors in determining the credit terms offered to Phar-Mor.

McKesson also offers evidence that Moody's, as well as the bond and equity markets, had negatively

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[6]McKesson argues more broadly that these facts and analyses are themselves material adverse changes in or define Phar-Mor's financial condition. The court disagrees, as they are factors external to Phar-Mor. Rather, these external sources are properly considered as evidence of materiality.

assessed the risk involved in investing in Phar-Mor. The price of Phar-Mor's senior unsecured notes plummeted to approximately 50 cents on the dollar, as compared to between 80 and 90 cents one year earlier. Although Phar-Mor argues that there is no evidence that the price of the notes relates to Phar-Mor's financial condition and, in any event, that the repurchase strengthened the balance sheet, a bond's price/yield/risk relationship is explained in the declaration of McKesson's economic expert. [*See* Doc. # 189, Elson Decl., ¶¶ 66-72]. Elson opined that "[t]he precipitous decrease in price for Phar-Mor's 11.72% Notes reflects the market's perception that Phar-Mor's repayment risk, (i.e., its ability to generate cash in the future to meet its operational and debt repayment needs), has significantly degraded." [*Id.* at ¶ 71]. And regardless of the effect of the repurchase of notes on Phar-Mor's balance sheet, as already determined, "financial condition" under the Supply Agreement is not limited to an analysis of the balance sheet only.

Elson's opinion regarding the significance of the bond price decline is consistent with Moody's rating, which rests on the level of risk associated with a company's long-term ability to meet debt payments, [*see* Doc. # 175, Winick Decl., Ex. DD, pp. 1-2]. "Prompted by declining operational and debt protection measures . . . that [had] deteriorated at an increasing rate since the beginning of 2000," Moody's downgraded all ratings of Phar-Mor's senior unsecured notes. [Doc. # 175, Winick Decl., Ex. P, pp.1-2]. According to Moody's:

> The Caa1 rating on the senior unsecured notes considers that this debt is effectively subordinate to significant amounts of unrated debt including a $150.0 million revolving credit facility and about $12.3 million of other debt. The revolving credit facility is secured by all of the company's assets except for equipment and real estate, while the other debt is comprised of mortgages, equipment notes, and tax notes. These rated notes rank equally to other senior unsecured debt including trade accounts payable. In a default scenario, Moody's believes that these senior unsecured notes likely would suffer a material loss.

[*Id.* at 2]. While it may be true, as argued by Phar-Mor, that a downgrade within Moody's broad speculative grade category is not by itself particularly significant and does not itself demonstrate or constitute a material adverse change in financial condition, there is no dispute that Phar-Mor's operational decline was an important factor considered by Moody's in assessing the risk associated with its ability to pay its debt obligations.

The stock market also weighed in with its assessment of Phar-Mor's financial condition. The drop in Phar-Mor's stock price to $0.8125 per share constitutes a decline of approximately 79% from its price on November 5, 1999, the date McKesson agreed to increase Phar-Mor's trade credit terms. Phar-Mor

argues that its share price does not define its financial condition and investors buy and sell stock for various unknown reasons, points with which the court agrees. However, the undisputed evidence regarding the price at which stock is bought and sold indicates that "[a]s equity prices approach zero, the implied equity value is generally considered to reflect only the potential substantial returns to equity associated with the very unlikely outcome of a financial turnaround" and that when the asset value cushion typically associated with positive equity value is no longer available, unsecured creditors are at significant risk of non-payment. [Doc. # 189, Elson Decl., ¶¶ 74-75]. As with Moody's downgrade, the stock price decline does not constitute a material adverse change in financial condition. As Phar-Mor points out, the share price had also dropped below $1 in August 2000. Nevertheless, this decline in equity value, together with the bond price erosion, and the analyses and warnings provided by major credit reporting services, signal an adverse change in Phar-Mor's financial condition that was in fact material.

Phar-Mor counters McKesson's contention that its operational decline constitutes a material adverse change, by pointing out that it had obtained the new Fleet credit facility in November 2000 that resulted in a $50 million increase in borrowing availability and that its net losses were absorbed by the addition of such increased availability. However, as F&D Reports observed, the increased borrowing could only buy Phar-Mor time. An improvement in the company's operations, rather than continued borrowing, was necessary to avoid a future crisis. [Doc. # 175, Winick Decl., Ex. L]. This point thus does not create a genuine issue of material fact as to either whether an adverse change in financial condition occurred or whether it was material.

Phar-Mor also argues that a future financial and liquidity crisis cannot be anticipated by McKesson and that such anticipation as a basis for changing credit terms is contrary to the terms of the Supply Agreement, which requires in the past tense that a material adverse change in financial condition must have occurred. Similarly, it argues that Moody's rating and the analysis of the credit reporting services are irrelevant because they too are forward-looking. However, McKesson relied upon losses that Phar-Mor had already experienced during the last half of fiscal year 2000 and during fiscal year 2001 and, thus, upon changes that had already occurred. And as discussed above, the materiality of any such change is necessarily forward looking as it requires a determination of the risk involved in extending Phar-Mor credit if the parties continue their business relationship through its extended term into the future.

Also, the fact that the overwhelming majority of Phar-Mor's other vendors were not contractually restricted from changing Phar-Mor's payment terms and, in fact, did not do so before McKesson restricted

payment terms, does not create a factual dispute regarding the materiality of the changes upon which McKesson acted. There is no evidence of what credit terms, if any, these vendors even offered to Phar-Mor. And to the extent that their exposure was significantly less or their credit terms were less favorable to Phar-Mor and afforded them more protection, they may have considered the risk but have based their decision to continue doing business on the same terms for any number of other reasons. Moreover, when so warranted by the financial condition of a company, some vendor must necessarily be the first to change credit terms. That the first vendor is the company's largest vendor with the most at stake is not surprising and is not a basis for finding a genuine issue of material fact regarding the materiality of the adverse change in financial condition.

Finally, Phar-Mor argues that McKesson, as well as the credit reporting services, failed to consider the fact that the cause of its decline in operating results was the merchandising strategy it had employed during 2000 but that it had initiated efforts in January 2001 to turnaround. The court agrees that the cause of an operational decline can bear on materiality. On summary judgment, McKesson does not contest Phar-Mor's evidence regarding the cause of the company's steady operational decline. However, Phar-Mor's evidence on this point actually serves to admit and reinforce the fact of operational decline. [Doc. #172, Phar-Mor Brief, Ex. 17, Ex. A thereto, unnumbered p. 27("However, the "high/low" strategy gradually drove away customers during the fiscal year ended June 2000, the effects of which continued through December 2000.")]. As David Schwartz of Phar-Mor admitted, when McKesson changed payment terms "we were right in the middle of our recovery." [Doc. # 186, Phar Mor Opposition, Ex. 21, Schwartz Depo. p.74 (sealed exhibit)]. More critically, assuming as true that Phar-Mor's merchandising strategy was the cause of its declining financial condition, and that it had implemented a new merchandising strategy starting in January 2001, Phar-Mor itself predicted that the results of that new strategy would not be fully known until October or November 2001. [Doc. #172, Phar-Mor Brief, Ex. 17, Ex. A thereto, at unnumbered pp. 3, 34; *see id.*]. From the standpoint of materiality, this is the same time frame as to which McKesson expressed concern about the risk of nonpayment. In the context of the parties' business relationship in general and the material adverse change provision in particular, the question is which party should bear the risk of the long term future success of the new merchandising strategy in improving the ability of the company to generate cash from operations, Phar-Mor or McKesson? Where Phar-Mor itself acknowledges that a long term turnaround effort is required to correct an admitted decline in operating results, the materiality of the adverse change cannot reasonably be disputed. The court finds that this is the type of

circumstance contemplated under the material adverse change clause in the Supply Agreement pursuant to which McKesson was entitled to shift back to Phar-Mor some of the risk that its new merchandising strategy would not work over the next six months, and in turn lessen the risk of nonpayment of McKesson's future invoices, by restricting credit terms.

CONCLUSION

The court finds that the undisputed facts set forth in this opinion demonstrate that an adverse change in Phar-Mor's financial condition had occurred and that such change was material in that it would affect the determination of a reasonable vendor in McKesson's position regarding credit terms to be extended to Phar-Mor if the parties continue their business relationship. Because a material adverse change in Phar-Mor's financial condition had occurred, McKesson did not, as a matter of law, breach the Supply Agreement when it changed Phar-Mor's payment terms on March 19, 2001.

A separate judgment will be entered by the court.

THEREFORE, for the foregoing reasons, good cause appearing,

IT IS ORDERED that McKesson's motion for summary judgment [Doc. # 173] be, and hereby is, **GRANTED**; and

IT IS FURTHER ORDERED that Phar-Mor's motion for partial summary judgment [Doc. # 171] be, and hereby is, **DENIED**; and

IT IS FINALLY ORDERED that McKesson's Evidentiary Objection to the Affidavit of Adam Waterfield [Doc. # 190] be, and hereby is, **DENIED as moot.**