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APPROVAL OF THE APPELLATE DIVISION

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NO. A-0028-10T2

RICHARD L. CLARKSON, as Trustee of the Lucille S. Ball Revocable Trust and as Trustee of the Clarkson Trust, DUANE CLARKSON and JOSEPH NITTI,

Plaintiffs-Appellants,

v.

VIOQUEST PHARMACEUTICALS, INC.,

Defendant-Respondent.

Argued May 11, 2011 – Decided September 8, 2011

Before Judges Fisher, Sapp-Peterson and Fasciale.

On appeal from the Superior Court of New Jersey, Law Division, Middlesex County, Docket No. L-8232-08.

Kevin J. Kotch argued the cause for appellants (Obermayer, Rebmann, Maxwell & Hippel, L.L.P., attorneys; Mr. Kotch and Ralph P. Ferrara, on the brief).

Scott L. Puro argued the cause for respondent (Backes & Hill, L.L.P., attorneys; Mr. Puro and Michael J. Canavan, on the brief).

PER CURIAM

Plaintiffs, Richard L. Clarkson, Trustee of the Lucille S. Ball Revocable Trust and Trustee of the Clarkson Trust, Duane Clarkson and Joseph Nitti, (hereinafter collectively referred to as "plaintiffs"), are investors who appeal the judgment entered by the court, following a trial on stipulated facts, dismissing their amended complaint filed against defendant, VioQuest Pharmaceuticals, Inc. ("VioQuest"). We affirm.

The parties waived a jury trial and proceeded to a bench trial on the following stipulated facts. VioQuest is a publicly-held biotechnology company specializing in drug development in the areas of oncology and antiviral diseases and disorders. It was incorporated in Delaware, with its principal place of business in New Jersey. On June 20, 2007, it issued a Private Placement Memorandum (PPM), in which it offered to sell between $1 million and $3.5 million in Senior Covertible Promissory Notes ("Notes"). Key provisions of the PPM cautioned investors that "purchase of our Securities entails a high degree of risk. No investment in the Securities offered hereby should be made by any person who is not in a position to lose the entire amount[.]" The PPM further cautioned that "[i]nvestors should be aware that they will be required to bear the financial risks of this investment for an indefinite period of time."

The PPM also cautioned potential investors that VioQuest has "a history of losses" and intends "to sell our only revenue generating assets[.]" The PPM further disclosed that since inception, VioQuest has "incurred an accumulated deficit of $31,058,000 as of March 31, 2007, and for the three months end[ing] March 31, 2007[,] we had losses from continuing operations of $2,256,000." The PPM disclosed that VioQuest has "had negative cash flows from operations and may not be able to generate sufficient cash to service all of our indebtedness, including the Notes." The PPM further indicated that "we will need to secure additional funding . . . in order for us to be in a position to pay the principal and accrued interest when due under the Notes, if the Notes have not previously converted into our common stock or other securities in accordance with the terms thereof."

Thereafter, between June 29 and July 3, 2007, VioQuest issued $3.7 million in Notes to forty investors, including plaintiffs, who, collectively, held notes totaling $210,000 in principal and interest. Plaintiffs entered into four contracts, representing their respective Notes. Other than the amounts, the terms of the Notes were identical. The critical portions of the Notes relevant to the issues before the court were:

1. <u>Principal and Interest</u>.

VIOQUEST . . . for value received, hereby promises to pay to the order of [Noteholder] . . . in lawful money of the United States of America . . . the principal amount of . . . together with interest as set forth below.

The Company promises to pay interest, compounded semi-annually, on the unpaid principal amount from the date hereof until such principal amount is paid in full at the rate of eight percent (8%), or such lesser rate as shall be the maximum rate allowable under applicable law . . . . Unless converted or prepaid earlier as set forth below, all unpaid principal and unpaid accrued interest on this Note shall be due and payable on the first anniversary of the final closing of the Company's sale of Bridge Notes (as defined below) (the "Due Date"). . . .

. . . .

2. <u>Mandatory Conversion</u>.

2.1 All unpaid principal and accrued unpaid interest on this Note shall be automatically converted into units of the Company's equity securities . . . issued in the Company's next equity financing (or series of related equity financings) involving the sale of Securities in which the Company receives at least $7,000,000 in gross aggregate cash proceeds . . . (a "Qualified Financing") . . . .

2.2 Immediately prior to the occurrence of a Sale of the Company (as defined below), all unpaid principal and accrued unpaid interest on this Note shall be automatically converted into shares of the Company's Common Stock . . . .

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. . . .

2.3 Upon conversion of this Note in accordance with the terms of Sections 2.1 and 2.2, the applicable amount of outstanding principal and accrued unpaid interest of the Note shall be converted without any further action by the Holder and whether or not the Note is surrendered to the Company or its transfer agent. . . .

. . . .

10. No Dilution or Impairment. The Company will not, by amendment of its Certificate of Incorporation or Bylaws or through any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other voluntary action, avoid or seek to avoid the observance or performance of any of the terms of this Note, but will at all times in good faith assist in the carrying out of all such terms and in the taking of all such action as may be necessary or appropriate in order to protect the rights of the Holder of this Note against dilution or other impairment.

11. Waivers. . . . This Note is being delivered in and shall be construed in accordance with the laws of the State of New York, without regard to the conflicts of laws provisions thereof.

. . . .

13. Amendments. Except as otherwise provided herein, any term of this Note may be amended with the written consent of the Company and the holders of not less than a majority of the then outstanding principal amount of the Bridge Notes, even without the consent of the Holder hereof; provided, however, that any amendment, modification or waiver of the terms and conditions of this

> Note that would adversely affect the Holder's rights hereunder with respect to the date by which this Note must be repaid or the rate at which interest accrues hereunder . . . shall not be effective against any Holder who has not consented in writing to such amendment or modification or granted such waiver. Subject to the foregoing sentence, any amendment effected in accordance with this Section 13 shall be binding upon each holder of any Bridge Note . . . The Company shall promptly give notice to all holders of outstanding Bridge Notes of any amendment effected in accordance with this Section 13.

Exercising its right under Paragraph 13 to amend the Notes, VioQuest received approval from nine Noteholders, who represented 53.8 percent of the Noteholders or a majority, to amend the Mandatory Conversion provision of the Notes. As amended, the provision stated:

> 2. <u>Mandatory Conversion</u>.
>
> 2.1 Upon the closing of a New Securities Offering, (i) all principal and accrued but unpaid interest on this Note shall be automatically converted into shares of the Company's newly-designated Series B Convertible Preferred Stock, par value $0.001 per share (the "<u>Series B Preferred Stock</u>"), at a conversion ratio of one (1) share of Series B Preferred Stock for every $1,000 of unpaid principal and accrued interest due under this Note as of the closing of the New Securities Offering, and (ii), each holder of shares of Series B Preferred Stock (each, a "<u>Series B Holder</u>") shall be granted the right, exercisable at any time on and after the closing of the Offering but on or prior to April 1, 2008 (the "<u>Exercise Period</u>"), to convert shares

> of Series B Preferred Stock into New Securities pursuant to Section 2.2 hereof (the "Series B Participation Right").
>
> . . . .
>
> 2.3 Upon conversion of this Note in accordance with the terms of . . . Sections 2.1 and/or 2.2, the applicable amount of outstanding principal and accrued unpaid interest of the Note shall be converted without any further action by the Holder and whether or not the Note is surrendered to the Company or its transfer agent.

The amendment resulted in the mandatory conversion of the Notes into Series B Preferred Stock, and provided VioQuest with secured equity financing for at least $500,000. The effect of the amendment was to lower the amount of the Common Stock needed to be purchased in order to effectuate mandatory conversion of the Notes to equity. On March 14, 2008, VioQuest closed a $2.9 million New Securities Offering of Series A Preferred Stock, and plaintiffs' Notes converted into Series B Preferred Stock.

Plaintiffs filed their complaint in the Law Division on October 2, 2008, alleging "breach of a Senior Convertible Promissory Note" and seeking "acceleration of the amounts due thereunder pursuant to its terms." Plaintiffs subsequently filed an amended complaint asserting claims for breach of contract, breach of the implied covenant of good faith and fair dealing, unjust enrichment, conversion and breach of securities. In addition to seeking compensatory damages, consequential, and incidental damages, as well as attorneys' fees and costs, plaintiffs also sought imposition of a constructive trust. The parties agreed to a bench trial on stipulated facts.

In a written opinion, the trial judge initially found that the terms of the Notes were clear and unambiguous. The judge next concluded that in accordance with the agreement, VioQuest obtained the requisite consent from the majority of the Noteholders before amending the mandatory conversion provision. The judge determined that the only issue before the court was whether, contrary to the terms of the Notes, the "Amendment adversely affected the date of repayment or the rate at which interest accrues[,] thereby requiring VioQuest to have obtained the written consent of all Noteholders." Further, the judge found that the amendment

> lowered the amount of Common Stock needed to be purchased in order for the Notes to mandatorily convert to equity. The intent of the Amendment was not to alter the date of repayment of the Notes, though it may have been an unintended consequence. VioQuest's ability to continue its operations, and in return repay all debts incurred, required the Company to seek further investments and convert the Notes into equity. By amending the contract's provisions to allow for mandatory conversion to equity through securing a lower amount of equity financing, VioQuest was able to secure significant shareholder investments. The amendment was purely intended to continue the viability of VioQuest, not to alter the date of repayment of the Notes.

The judge noted that as a Delaware corporation, VioQuest was prohibited "from redeeming its own stock" if "'redemption would cause any impairment of the capital of the corporation[,]'" and was also prohibited from issuing dividends when its losses greatly exceed the value of its capital. See Del. Code Ann. tit. 8, §160(1) and §170(a) (2011). Finally, the judge observed that "[p]laintiffs are sophisticated investors. . . . [who] knew or should have known the nature of a biotech startup" and that

> [d]efendant did not breach its contract with [p]laintiffs when it amended the price at which the Notes mandatorily converted to equity. The original contract's own terms provided for such a type of amendment and both parties knew or should have known that it was likely the Notes would convert to equity. Defendant did not enact the amendment in bad faith and there is no evidence of fraud or malfeasance. Delaware law does not allow the [d]efendant to issue dividends at this time; however, [d]efendant is obligated to issue dividends to [p]laintiffs at such a time that Delaware law permits.

On appeal, plaintiffs raise the following points for our consideration:

> POINT I
>
> VIOQUEST BREACHED THE PROMISSORY NOTES BY AMENDING THE NOTES IN A WAY THAT ADVERSELY AFFECTED PLAINTIFFS' RIGHT TO GET TIMELY REPAID.

A. VIOQUEST BREACHED THE NOTES BY FAILING TO PAY THE PRINCIPAL AND INTEREST DUE UNDER THE NOTES.

B. VIOQUEST'S ATTEMPTED AMENDMENT OF THE NOTES IS NOT BINDING ON PLAINTIFFS AS, INTER ALIA, THE CHANGES ADVERSELY AFFECTED PLAINTIFFS' RIGHTS TO GET REPAID BY JULY 3, 2009.

1. THE AMENDMENT ADVERSELY AFFECTED PLAINTIFFS' RIGHT TO GET REPAID BY JULY 3, 2009.

2. INDIVIDUAL NOTEHOLDER CONSENT IS REQUIRED FOR ANY AMENDMENT THAT ADVERSELY AFFECTS THE NOTEHOLDERS' RIGHTS TO GET TIMELY REPAID, WHETHER THIS WAS AN INTENDED OR UNINTENDED CONSEQUENCE OF THE AMENDMENT.

C. VIOQUEST'S ATTEMPTED AMENDMENT IS A BREACH OF THE EXPLICIT CONTRACTUAL REQUIREMENT THAT VIOQUEST TAKE NO ACTION TO "AVOID THE OBSERVANCE OR PERFORMANCE . . . OF THE TERMS OF THIS NOTE."

<u>POINT II</u>

VIOQUEST HAS BREACHED ITS IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING.

I.

The crux of plaintiffs' argument in support of their claim that the judgment entered should be reversed is that the trial judge "erred in finding that VioQuest had not breached the Notes" because the "amendment of the Notes was never effective against [p]laintiffs as it adversely affected their right to be repaid by July 2009 and they did not consent to the amendment." They contend the "plain language of the Notes" provides that "any amendment that 'adversely affected' the Noteholder's right to be repaid by July 2009 must be consented to by the individual [N]oteholder." They assert that the effect of the amendment excused VioQuest from repaying their principal and interest by July 2009 and instead converted that obligation into "dividends and redemption of stock[,]" payable at a time uncertain. Plaintiffs argue "it is no defense that the 'adverse affect' was an unintended consequence of the amendment[.]" Because the Amendment converted the Notes to equity, they contend that VioQuest cannot "cure this defect by offering to pay dividends and redeem stock by July 2009[,]" as Delaware law precludes VioQuest from taking such action "given its precarious financial condition[.]" Moreover, plaintiffs argue VioQuest also breached the provision in the contract whereby it "promised that it would not do anything to avoid its performance of the original terms of the [N]ote."

VioQuest counters that plaintiffs' argument fails for the following reasons: (1) "the Bridge notes required VioQuest to take all necessary actions to avoid the impairment of the Noteholders['] rights under the Note[,]" and by amending the Notes to convert them into equity, "VioQuest protected its investors from the ultimate impairment of their investment, the dissolution of the company"; (2) "the Notes themselves provide that they are amendable by their terms" and VioQuest complied with those terms by receiving "the required approval of the Amendment from the holders of a majority of Notes"; and (3) the Notes "provided for a mandatory conversion . . . . when new financing was obtained by VioQuest." VioQuest further argues that Judge Ryan properly found that "'VioQuest did not need the written consent of all Noteholders for the Amendment to have taken effect.'"

We begin our review by first noting that although plaintiffs appeal the entire judgment, plaintiffs' brief addresses only their breach of contract and breach of the implied covenant of good faith and fair dealing claims. We therefore deem the appeal of the judgment entered with respect to the remaining claims, namely, unjust enrichment, conversion, breach of security, and imposition of a constructive trust, is waived. Sklodowsky v. Lushis, 417 N.J. Super. 648, 657 (App. Div. 2011) (citing Jefferson Loan Co. v. Session, 397 N.J. Super. 520, 525 n. 4 (App. Div. 2008) and Zavodnick v. Leven, 340 N.J. Super. 94, 103 (App. Div. 2001)).

Next, Paragraph 11 in each of the Notes at issue expressly provides that the Notes shall "be construed in accordance with the laws of the State of New York, without regard to the conflicts of laws provisions hereof." Both parties reference New Jersey law, with plaintiff noting that "there is not an appreciable difference in the law of the two jurisdictions[.]" Therefore, in our disposition we also refer to both New Jersey and New York jurisprudence.

The construction of the terms of a contract is a question of law for the court, and we therefore owe no special deference to a trial court's interpretation of the provisions of a contract. Kieffer v. Best Buy, 205 N.J. 213, 223 (2011) (citing Manalapan Realty, L.P. v. Twp. Comm. of Manalapan, 140 N.J. 366, 378 (1995) (holding that "[a] trial court's interpretation of the law and the legal consequences that flow from established facts are not entitled to any special deference.")). We therefore "look at the contract with fresh eyes." Ibid.; see also W.W.W. Assocs. v. Giancontieri, 566 N.E.2d 639, 642 (N.Y. 1990).

The construction of a contract under both New York and New Jersey law shares consistent tenets and poses no public policy conflict. New Jersey courts have reasoned that a court's goal, when interpreting a contract, "is to ascertain the 'intention of the parties to the contract as revealed by the language used, taken as an entirety; and, in the quest for intention, the situation of the parties, the attendant circumstances, and the objects they were thereby striving to attain[.]'" Driscoll Constr. Co. v. State of N.J., Dep't of Transp., 371 N.J. Super. 304, 313 (App. Div. 2004) (quoting Onderdonk v. Presbyterian Homes of N.J., 85 N.J. 171, 184 (1981)). "The judicial task is simply interpretative; it is not to rewrite a contract for the parties better than or different from the one they wrote for themselves. . . . Thus, we should give contractual terms their plain and ordinary meaning, . . . unless specialized language is used peculiar to a particular trade . . . or industry[.]" Kieffer, supra, 205 N.J. at 223 (internal quotations and citations omitted).

Similarly, New York courts have reasoned, "when parties set down their agreement in a clear, complete document, their writing should as a rule be enforced according to its terms. . . . Whether or not a writing is ambiguous is a question of law to be resolved by the courts." W.W.W. Assocs., supra, 566 N.E.2d at 642. Further, a contract should be read "as a whole to determine its purpose and intent[.]" Ibid. Moreover, a court "may not by construction add or excise terms, nor distort the meaning of those used and thereby make a new contract for the parties under the guise of interpreting the writing." Bailey v.

Fish & Neave, 868 N.E.2d 956, 959 (N.Y. 2007) (citation and internal quotation marks omitted).

Here, both parties contend the terms of the Notes are clear and unambiguous but attach different interpretations to the critical language governing the conditions for amending the Notes and the effects of any such amendment. We are satisfied that if we were to agree with the interpretation that plaintiffs seek to ascribe to the language, we would be engaged in creating a new contract for plaintiffs better than what they in fact bargained for. Ibid.

Nothing in the amendment changes the date of repayment of the Notes or alters the rate at which interest accrued under the Notes. The clear and unambiguous terms of Paragraph 13 do not require the consent of each Noteholder for all amendments but only as to amendments that "would adversely affect the Holder's rights hereunder with respect to the date by which this Note must be repaid or the rate at which interest accrues hereunder[.]" Had the amendment provision intended that consent from each Noteholder be required for any other impact upon the Noteholder as a result of an amendment, the language, "with respect to the date by which this Note must be repaid or the rate at which interest accrues hereunder," would not have been included. Instead, the language of the Notes would have required consent from all Noteholders for any amendment that "would adversely affect the Holder's rights hereunder[.]"

Thus, by its clear and unambiguous terms, the Notes expressly contemplated that the rights of Holders may be altered in other contexts without the necessity of consent from any of the Noteholders. For example, when the requisite equity financing is secured, "[a]ll unpaid principal and accrued unpaid interest on this Note shall be automatically converted into units of [VioQuest's] equity securities," which is in fact what occurred here. Additionally, because VioQuest is a Delaware corporation and the Notes are subject to interpretation under New York law, plaintiffs' right to dividends are affected by provisions under both Delaware and New York law that prohibit the declaration of dividends except out of profits. See Small v. Sullivan, 157 N.E. 261, 263 (N.Y. 1927) (holding that a "corporation has no right to declare dividends with a substantially impaired capital.)"; see also Wittenberg v. Fed. Mining & Smelting Co., 133 A. 48, 49 (Del. Ch. 1926) (holding that "corporations cannot declare dividends except out of profits.").

As the trial court observed, plaintiffs are sophisticated investors, who, through the PPM and SEC filings, knew or should have known the risks they were undertaking with this investment as well as the likelihood that the Notes would convert to equity. VioQuest adhered to the requirements of the amendment provision in Paragraph 13 of the Notes by securing the consent of the majority of Noteholders before amending its terms to lower the amount of Common Stock needed to be purchased for the Notes to be subject to mandatory conversion to equity units of the company. In doing so, VioQuest was able to secure significant shareholder investment. Such action was consistent with Paragraph 10 of the Notes, which directs VioQuest to undertake "all such action as may be necessary or appropriate in order to protect the rights of the Holder of this Note against dilution or other impairment." Plaintiffs are still entitled to redemption of their Series B Preferred Stock, in accordance with the provisions set forth in the Notes, but only when VioQuest is legally permitted to do so.

Plaintiffs' remaining claim that VioQuest's actions breached the covenant of good faith and fair dealing are without sufficient merit to warrant discussion in a written opinion. R. 2:11-3(e)(1)(E). We add the following brief comments.

The implied covenant of good faith and fair dealing "is breached when a party to a contract acts in a manner that, although not expressly forbidden by any contractual provision, would deprive the other party of the right to receive the benefits under the agreement." Jaffe v. Paramount Commc'ns, Inc., 644 N.Y.S.2d 43, 47 (App. Div. 1996). This covenant "embraces a pledge that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract[.]" Moran v. Erk, 901 N.E.2d 187, 190 (N.Y. 2008) (citation and internal quotation marks omitted).

However, "New York law . . . does not recognize a separate cause of action for breach of the implied covenant of good faith and fair dealing when a breach of contract claim, based upon the same facts, is also pled." Ari & Co. v. Regent Int'l Corp., 273 F. Supp.2d 518, 522 (S.D.N.Y. 2003) (citation and internal quotation marks omitted). Thus, under New York law, "where the relief sought by the plaintiff in claiming a breach of the implied covenant of good faith is intrinsically tied to the damages allegedly resulting from the breach of contract . . . there is no separate and distinct wrong that would give rise to an independent claim." Ibid. (citations and internal quotation marks omitted). See also Engelhard Corp. v. Research Corp., 702 N.Y.S.2d 255, 256 (App. Div. 2000) ("The cause of action for breach of the implied covenant of good faith and fair dealing was properly dismissed as duplicative of the breach of contract claim[.]").

Here, plaintiffs contend that the effect of the amendment to the Notes was to deprive plaintiffs of the right to receive the benefits of the Notes, namely, repayment of the principal with interest by July 3, 2009. This, however, is not a consequence that was unforeseeable or which plaintiffs may claim is contrary to the provisions of the agreement. Plaintiffs knew that the Notes were subject to mandatory conversion to equity units when the requisite financing was obtained. Plaintiffs' claim is "intrinsically tied" to mandatory conversion of the Notes to equity units, and, therefore, plaintiffs have not established a "separate and distinct wrong that would give rise to an independent claim" under New York law. Ari, supra, 273 F. Supp.2d at 522.

Nor do plaintiffs establish a viable claim under New Jersey law. Although New Jersey recognizes an independent cause of action for breach of the covenant of good faith and fair dealing, in order to maintain such a cause of action, a plaintiff "must provide evidence sufficient to support a conclusion that the party alleged to have acted in bad faith has engaged in some conduct that denied the benefit of the bargain originally intended by the parties." Brunswick Hills Racquet Club, Inc. v. Route 18 Shopping Ctr. Assocs., 182 N.J. 210, 225 (2005). "[D]iscretionary decisions that happen to result in economic disadvantage to the other party are of no legal significance" in an action alleging breach of the duty of good faith and fair dealing. Wilson v. Amerada Hess Corp., 168 N.J. 236, 251 (2001).

Here, plaintiffs bargained for a high rate of return on an investment, which they knew or should have known was fraught with risk at the outset. Plaintiffs entered into an agreement on notice that the Notes were subject to mandatory conversion upon the occurrence of the triggering event. While plaintiffs may have hoped for a more favorable return on their investment in the form of repayment of the principal and accrued interest by July 9, 2009, repayment would not occur if mandatory conversion of the Notes occurred. This result cannot be characterized as contrary to the reasonable expectations of plaintiffs, nor as arbitrary, capricious, or unreasonable conduct on the part of defendant.

Affirmed.