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Corporate Governance Group

Client Alert

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DELAWARE COURT ADOPTS NARROW DEFINITION OF “BENEFICIAL INTEREST” FOR PURPOSES OF VOTING TRUST AGREEMENT; REFUSES TO APPLY BROADER EXCHANGE ACT DEFINITION

Often, contracting parties include terms of art in their agreements without clearly defining them, exposing themselves to the possibility that a court will be unwilling to look outside the four corners of the contract for an interpretation should a dispute as to meaning arise. This can result in unintended consequences. A recent Delaware case, *Mangano v. PeriCor Therapeutics, Inc.*,¹ illustrates the perils of imprecise drafting, and testifies to the reluctance of the Court of Chancery to redraft or apply external facts when called on to interpret a provision of a contract that has a commonly understood meaning – although perhaps not the meaning intended by one or both of the parties.

Background

In 2004, Dennis Mangano co-founded PeriCor Therapeutics, a biopharmaceutical company that develops cardioprotective compounds known as adenosine regulating agents. In early 2005, Mangano granted PeriCor the exclusive right to several chemical compounds, together with the non-exclusive rights to the databases supporting these compounds. In return, Mangano received shares representing 85% of PeriCor’s outstanding stock. This transaction was memorialized in a Stock Purchase Agreement (“SPA”) under which PeriCor was granted a right of first refusal obligating Mangano, before selling any of his PeriCor shares to a third party, to offer them to PeriCor on the same terms. Transfers to other family members were exempted from the right of first refusal, “ostensibly as a convenience to [Mangano] for estate-planning purposes.”

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¹ C.A. No. 3777-VCN (Del. Ch. Dec. 1, 2009).

Shortly after this share issue, Mangano and PeriCor entered into a Voting Trust Agreement (“VTA”) aimed at “limiting Mangano’s control over the Company.” In accordance with the VTA, Mangano transferred nearly half of his shares to a voting trust, which obligated the voting trustee to vote those shares in conformity with the majority of PeriCor’s other outstanding shares on matters submitted to a shareholder vote. The VTA provided that the voting trust would terminate at such time as Mangano’s beneficial interest dropped below 45% of PeriCor’s outstanding shares. Importantly, the term “beneficial interest” was not defined in the VTA.

In April 2008, Mangano requested that PeriCor record the transfer of 200,500 of his shares to his sister, Roberta Magnotti. Under the exception for intra-family transfers contained in the SPA, PeriCor did not have a right of first refusal with respect to this transfer. PeriCor effectuated the transfer and subsequently recorded Magnotti’s name as the owner of the transferred shares in its stock ledger. In Mangano’s view, this transfer resulted in a reduction of his beneficial interest in PeriCor’s outstanding shares below 45% and, accordingly, the termination of the voting trust.

Soon thereafter, at PeriCor’s 2008 annual meeting, Mangano nominated an opposing slate of director candidates. Magnotti attended the meeting and voted her shares in favor of her brother’s candidates. Mangano sought to vote the shares still held of record by the voting trust, which if counted with other favorable votes, would have resulted in the election of his director candidates. PeriCor, however, refused to consider the voting trust terminated. As a result, Mangano was not permitted to vote these shares and his director candidates were defeated. Mangano, convinced that the voting trust had ended, sought relief from the Delaware Court of Chancery.

The Parties’ Arguments

Mangano moved for partial summary judgment, asserting that the transfer of shares to his sister reduced his beneficial ownership sufficiently to terminate the voting trust. In response, PeriCor argued that Mangano had in fact retained a beneficial interest in the shares transferred to his sister, and as such, his beneficial interest at all times exceeded the 45% termination threshold in the VTA. According to PeriCor, the term beneficial interest is “inherently ambiguous,” which required the Court to look outside the four corners of the VTA to the underlying purpose of the voting trust when interpreting the term. Because, in PeriCor’s view, the parties intended for the voting trust to prevent Mangano from using his voting power to take control of PeriCor, the term beneficial interest “must be interpreted in a way that would prohibit Mangano from effecting a termination of the VTA by transferring shares while maintaining effective voting control of at least 45% of PeriCor’s stock.”

In support of its contention that Mangano retained control of the shares transferred to his sister, PeriCor argued that (i) “Magnotti is unsophisticated in the medical and pharmaceutical matters that drive PeriCor’s business,” (ii) Magnotti is “confused as to what she is able to do with her PeriCor shares, . . . [and] unaware that there is no public market for her shares,” and (iii) given Mangano’s role as patriarch of his extended family and Magnotti’s “abject lack of sophistication regarding the Company’s affairs,” Mangano could expect that his sister would vote in accordance with his wishes. PeriCor also pointed out that Mangano himself testified at a deposition that he would have been surprised if his sister had not voted in favor of his slate.

Based on these arguments, PeriCor urged the Court to conclude that “although the transfer may have caused a change in the legal title to the shares, it left Mangano’s voting control, and therefore his beneficial interest, undiminished.”

The Court's Analysis

Ruling in Mangano's favor, the Court focused on the meaning of "beneficial interest" as used in the VTA. The Court acknowledged that Delaware case law "makes clear that beneficial ownership or interest has 'no universal meaning,' but is instead 'a phrase of art which implies certain relationships and attributes but which requires particularization before its meaning can be precisely determined.'" Based on a review of relevant Delaware case law, the Court concluded that even though "'beneficial interest' is a term laden with ambiguity, ... it at least implies the existence of some enforceable right or benefit."

Based on the facts before it, the Court could find "nothing ambiguous about whether Mangano maintains a beneficial ownership in the shares transferred to Magnotti." Although Mangano could have anticipated that Magnotti would "vote alongside him most of the time," she was under no obligation to do so, legally or contractually. Magnotti remained "free to vote her shares as she wishes," and both Mangano and Magnotti "denied that they had an agreement or understanding, formal or otherwise, that Magnotti would vote the shares in accord with her brother's wishes." The Court concluded, therefore, that "under no reasonable interpretation ... could it be said that Mangano retained a 'beneficial interest' in his sister's stock" under that term's "commonly understood meaning."

It might be surprising to practitioners that, in rejecting PeriCor's contention that the Court should look beyond the four corners of the VTA to interpret "beneficial interest," the Court specifically declined to apply the definition of "beneficial owner" used in Section 13(d) of the Securities Exchange Act of 1934.² The Court considered this analogy to be "problematic for two reasons: 1) the parties expressly agreed that the contract would be governed by Delaware law; and 2) the policies that support these laws are not applicable here." According to the Court, "Section 13's disclosure requirements were enacted to 'alert the marketplace about every large, rapid aggregation or accumulation of securities which might represent a potential shift in corporate control.'" These provisions, in the Court's words, "implement a 'policy of full disclosure' in an attempt to 'protect investors engaged in the purchase and sale of securities.'"

The Court found such a broad definition to be "inapposite" to the dispute before it, particularly in light of the fact that the VTA was governed by Delaware law. In the Court's view, "PeriCor does not need an expansive reading of beneficial ownership or interest for its protection." Rather, if PeriCor had wanted to prevent Mangano from terminating the voting trust by transferring shares to a family member, it could have done so either by not including the intra-family exception to the right of first refusal in the SPA, or by defining "beneficial interest" unambiguously in the VTA "to include shares held by family members instead of allowing the term to go undefined."

² Section 13(d) of the Securities Exchange Act of 1934, as amended, defines a "beneficial owner" as "any person who, directly or *indirectly*, through any contract, arrangement, understanding, *relationship*, or otherwise has or shares: (1) voting power which includes the power to vote, or to direct the voting of, such security....". 17 C.F.R. § 240.13d-3(a) (emphasis added).

Conclusion

Mangano is yet another in a recent series of Delaware cases which illustrate the principle that “[i]n general, when interpreting a contract between sophisticated, represented parties, the Court is reluctant to read contractual provisions into an agreement that could have been included by the parties themselves.”³ Further, *Mangano* demonstrates that unintended consequences can result when parties to a contract fail to clearly define terms which are susceptible of more than one meaning, particularly depending upon the context in which they are used. Finally, deal makers and their legal advisors must be mindful that when drafting multiple related agreements, more often than not, the agreements will overlap and should be carefully read together to ensure that there are no ambiguities or loopholes which could defeat the parties’ underlying intentions.

³ For discussions of other recent Delaware decisions illustrating this trend, please see our recent Client Alerts entitled “In Dismissing Claims Arising Under a Contractual ‘Earn-Out’ Provision, Delaware Court of Chancery Discusses Several Important Issues Relating to Contract Interpretation and Remedies,” dated December 18, 2009; “Delaware Court Dismisses Seller’s Attempt to Require Hedge Fund to Finance its Controlled LLC’s Obligations Under Asset Purchase Agreement,” dated June 30, 2009; and “Delaware Court Again Rules That Express Contract Terms Prevail in Claims Brought by Preferred Shareholder,” dated July 15, 2009.

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