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Re: Pharmalytica Services, LLC v. Agno Pharmaceuticals, LLC
C.A. No. 3343-VCN
Date Submitted: June 27, 2008

Dear Counsel:

Plaintiff Pharmalytica Services, LLC is a Delaware limited liability company with a governance problem. In October 2006, its governing board removed Defendant Jian-Ge ("James") Chen ("James Chen") from his position on Pharmalytica's "management team" and as its President and Chief Executive Officer. Although James Chen objected to that effort at the time, he made no formal challenge. In November 2007, Pharmalytica filed this action and asserted claims sounding in breach of fiduciary duty, equitable and legal fraud, and breach of

Pharmalytica's limited liability company agreement, against James Chen, his wife, Defendant Mu He, and their separate business venture, Defendant Agno Pharmaceuticals, LLC ("Agno Pharma"). On or about June 9, 2008, however, Pharmalytica learned that James Chen was in China asserting Pharmalytica's rights to appoint designees to the board of Jiangsu Agno Pharma Company, LLC, a joint venture established under the laws of the People's Republic of China between Pharmalytica and Jiangsu Zhangwei Investment, Ltd., a Chinese chemical manufacturer (the "Joint Venture"). That prompted the filing of Pharmalytica's pending motion for a preliminary injunction by which it seeks to prevent James Chen from taking any action on behalf of Pharmalytica with respect to the Joint Venture or otherwise and from representing himself, individually or with the other Defendants, as a representative of Pharmalytica.

I. BACKGROUND

Pharmalytica, formed in January 2000, provides bioanalytical testing services to pharmaceutical, biotechnology, and medical device clients. Its members are James Scull, David Chen, Richard Wedlich, James Chen, and Mu He.[1] The Joint

[1] James Chen and Mu He collectively own 35% of Pharmalytica. James Chen asserts that Scull is not a member of Pharmalytica. Although this action is brought in the name of Pharmalytica, it may more accurately be viewed as the product of a dispute among the members of Pharmalytica.

venture was established in August 2003 for purposes of providing pharmaceutical raw materials, intermediates, and finished dry products on a global basis.

For reasons that are not clear, the members of Pharmalytica did not adopt a limited liability company agreement until March 2004. There is significant dispute as to the proper text of the operating agreement. Shortly after noon on March 8, 2004, James Chen circulated a draft agreement that he had prepared. Later that day, the members executed an operating agreement. The members of Pharmalytica, other than the individual defendants, assert that the draft from earlier in the day had been modified without their knowledge. The changes increased James Chen's authority over the enterprise. Among the changes that Pharmalytica's other members claim James Chen surreptitiously accomplished is an insertion that provides: "Chairman of the Board appoints and approves personnel to serve in the Board of Directors or Management Team for other companies and on Pharmalytica Services' joint-ventures." James Chen relies upon this provision as his authority for appointing members of the Joint Venture's governing body.

The operating agreement, drafted without the guidance of a lawyer, appears to establish a two-tiered management structure. There is a management team led by a president and chief executive officer to carry out ongoing, day-to-day operations.

Above the management team is a board of directors which "is the highest authority of the Company." The CEO is responsible for carrying out the board's decisions. In order for the board to act on major issues, its decisions must be unanimous. Other decisions may be made by majority vote. The operating agreement also establishes that the "Chairman of the Board is the legal representative of the Company."[2] The board has the authority to remove any member of the management team with or without cause based on a majority vote. The agreement also indicates that senior officers and other managers may be "dismissed from work" for illicitly seeking personal gain or other delinquent behavior based on a decision of the board of directors. James Chen asserts that his removal as a member of the management team (and from any other role) with Pharmalytica required the unanimous vote of the board of directors; without his vote that could not be accomplished.

In January 2004, James Chen and Mu He formed Agno Pharma which Pharmalytica claims is competing with it and, perhaps, with the Joint Venture. Indeed, Pharmalytica claims that Agno Pharma has been used by James Chen and Mu He to facilitate the co-opting of business opportunities that would have been available to Pharmalytica, especially in China. Again, for reasons not entirely clear,

[2] James Chen and Mu He hold the power to appoint the Chairman of the Board.

it apparently took the other members of Pharmalytica the better part of two years to discover the existence of Agno Pharma and its competitive activities. They eventually scheduled a special meeting of members for October 24, 2006, with an announced purpose of disciplining James Chen for his actions that were adverse to Pharmalytica's interests. James Chen's counsel objected to the calling of that meeting and the proposed resolution that would have removed James Chen from Pharmalytica's management. Although James Chen did not attend the meeting on October 24, 2006, a quorum was present and there was a unanimous vote of the board members present in favor of a resolution that removed James Chen from any position in Pharmalytica's management and recited as follows:

> [T]he Board wishes James Chen to know that this action to remove him from the Pharmalytica Services management team and from the positions of President and CEO is the result of the Members['] determination that he (James Chen) has failed to meet his responsibility as outlined in the LLC Operating Agreement as President and CEO and specifically has failed to carry out the decisions of the board members and has failed to conduct the daily management of the Company.

James Chen was promptly notified of the outcome of this meeting, and the Joint Venture in China was informed that James Chen was no longer a member of

Pharmalytica's management team and that he did not have the authority to act unilaterally for Pharmalytica.[3]

It appears that, following the October 24, 2006, meeting James Chen did not directly engage in work on behalf of Pharmalytica. Pharmalytica alleges that he continued to compete surreptitiously with it and to use the Joint Venture's contacts to gain work for his business Agno Pharma. By June of this year, Pharmalytica's other members had learned that James Chen had been purporting to act on behalf of Pharmalytica in China. Specifically, he attempted to appoint his chosen representatives to the board of the Joint Venture. A document captioned "Certificate of Appointment," dated May 28, 2008, identifies James Chen as the legal representative and Chairman of the Board of Pharmalytica. It appears that James Chen was using this document to authorize his actions in China.

[3] Notably, the resolution removing James Chen from a member of the management team and as President and CEO does not address his status as Chairman of the Board. One of the other members of Pharmalytica, James Scull, avers that James Chen's term as Chairman expired at the end of 2006. James Chen, on the other hand, asserts that he continues as Chairman. Both versions of the operating agreement allow James Chen and Mu He to appoint the Chairman of the Board. It is something of an academic question as to who holds the official "title" of Chairman of the Board because, in any event, it would appear that Mu He and James Chen have the present ability to designate a new Chairman.

Pharmalytica has submitted a poor quality document suggesting that the certificate had been embossed with the seal of Pharmalytica.[4]

II. CONTENTIONS

Pharmalytica argues that James Chen's purported representation of the entity must be halted because he has no authority to represent the company and because his conduct is antithetical to the interests of the company. Indeed, it argues that James Chen is using his connections to Pharmalytica as a stalking horse to benefit his company Agno Pharma. Pharmalytica contends that James Chen was duly and properly removed from any office within Pharmalytica and that he should not be allowed to prosper because of the fraud he perpetrated by furtively substituting the operating agreement draft in 2004.

The Defendants point out that the evidence offered by Pharmalytica, even at an admittedly early stage in the proceedings, is incomplete and without the detail necessary to support the issuance of interim equitable relief. Specifically, they argue that many of Pharmalytica's allegations are speculative. More importantly, they posit that any efforts to remove James Chen from office failed for a variety of

[4] Pharmalytica asserts that Chinese business culture attaches great significance to the use of a corporate seal.

reasons, primarily because of the unanimity requirement for major decisions by the board of directors.

III. ANALYSIS

In order to obtain a preliminary injunction, the moving party must demonstrate a reasonable probability of success on the merits, that irreparable harm will result in the absence of interim relief, and that a balance of the harm that it will suffer in the absence of relief outweighs the harm that would be suffered by the non-moving party if relief is granted.[5]

Although Pharmalytica has brought an action seeking a preliminary injunction against James Chen and the other Defendants from taking action on behalf of Pharmalytica or holding themselves out as authorized representatives of Pharmalytica, the relief sought by Pharmalytica is in the nature of the relief that may be granted under 16 *Del. C.* § 18-110, the limited liability company companion to 8 *Del. C.* § 225 governing corporations. That section allows for continued operation of the venture, with a goal of minimal disruption, while the identity of those properly holding corporate power can be established.[6]

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[5] *Hayford v. Citicorp Trust Bank*, 2007 WL 2985049, at *2 (Del. Ch. Oct. 11, 2007).

[6] In actions brought under Section 225 of the Delaware General Corporation Law, this Court has entered orders preserving the status quo pending the ultimate resolution of a governance dispute,

In this instance, it is clear that James Chen did not act in a constructive and direct fashion for the benefit of Pharmalytica following the October 2006 meeting: he went for roughly eighteen months without apparently taking any steps on behalf of Pharmalytica. To appear in China last month and assert authority on behalf of Pharmalytica is conduct that is difficult to reconcile with his course of action in the interim since the October 2006 meeting and it is also inconsistent with the reasonable expectations of the majority members of Pharmalytica.[7]

In sum, the rational, ongoing governance of Pharmalytica requires certainty as to who is running the entity and preserving the status quo, as has traditionally been

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recognizing that a preliminary injunction would be an awkward form of relief in this setting. DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY, §8.08[f], at 8-177 (2008). *See, e.g.*, *Frankino v. Nat'l Auto Credit, Inc.*, 1999 WL 959188, at *1 (Del. Ch. Sept. 28, 1999); *Raptor Sys., Inc. v. Shepard*, 1994 WL 512526 (Del. Ch. Sept. 12, 1994). Similarly, status quo orders may be utilized in actions brought under Section 18-110 of the Limited Liability Company Act. *See CAPROC Manager, Inc. v. Policemen's & Firemen's Ret. Sys. of Pontiac*, 2005 WL 937613, at *1 (Del. Ch. Apr. 11, 2005). The appropriateness of entering a status quo order is based on considerations similar to those consulted in determining whether other forms of interlocutory injunctive relief are appropriate. *See Raptor Sys., Inc.*, 1994 WL 512526, at *2. As the label suggests, status quo orders, in the usual case, provide for incumbents to continue in office. *See* 1 EDWARD P. WELCH, ANDREW J. TUREZYN & ROBERT S. SAUNDERS, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 225.1 (5th ed. 2008 supp.). Here, however, the functional status quo recommends that James Chen not be returned to active management positions pending this matter's resolution; he has not contested that he has been inactive in Pharmalytica's affairs since 2006. Restoring him at this juncture would ignore the realities of Pharmalytica's operation in the interim.

[7] Coloring the concerns here is the apprehension of the other members of Pharmalytica that James Chen is using this "connection" to Pharmalytica to further his interests and the interests of Agno Pharma at the expense of Pharmalytica. It is not necessary, for present purposes, to pursue this aspect of Pharmalytica's claim.

done in actions under 8 *Del. C.* § 225, is the proper course. Accordingly, the management that has been in control of Pharmalytica since October 2006 shall in the interim remain in control and that requires precluding James Chen (and those acting in concert with him) from purporting to represent the interests of Pharmalytica in China, or elsewhere.

Thus, based on the record developed to this point, Pharmalytica has demonstrated a reasonable probability of success on the merits of its claim that James Chen should not be acting on Pharmalytica's behalf.[8]

In addition, the record amply demonstrates that James Chen's conduct in China without ongoing authority to act on behalf of Pharmalytica is likely to cause significant and irreparable harm to the company. Given the distance and the complications that may arise under the law of the People's Republic of China, with respect to the governance of the Joint Venture, it follows that in the absence of interim relief, irreparable harm is likely.

As for a balancing of the harms, the risks to Pharmalytica from James Chen's conduct are obvious and material; the potential harm to James Chen is minimal,

[8] The Court adheres to the preliminary injunction standards because that is the mechanism chosen by Pharmalytica to present its claim. The traditional analysis under 8 *Del. C.* § 225 and 6 *Del. C.* § 18-110 eschews formalistic application of the preliminary injunction framework.

especially in light of his absence from Pharmalytica for approximately eighteen months.[9]

IV. CONCLUSION

For the foregoing reasons, the Court finds, after balancing all the appropriate factors, that Pharmalytica is entitled to a status quo order that would prohibit, pending final resolution of the merits or further order of the Court, James Chen and the other Defendants from taking any action on behalf of Pharmalytica in relation to the Joint Venture or otherwise and from representing themselves, individually or collectively, as representatives of Pharmalytica with any power to act on its behalf.

An implementing order will be entered.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K

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[9] Even though James Chen may technically hold the position of Chairman of the Board of Pharmalytica or, together with his wife, have the present power to appoint himself to that position, his extended absence from the Company militates against allowing him simply to resurface and purport to represent the Company.