IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE CHINA AGRITECH, INC. SHAREHOLDER DERIVATIVE LITIGATION	))	C.A. No. 7163-VCL

MEMORANDUM OPINION

Date Submitted: February 21, 2013
Date Decided: May 21, 2013

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LASTER, Vice Chancellor.

China Agritech, Inc. ("China Agritech" or the "Company") purportedly operates a fertilizer manufacturing business in China. According to lead plaintiff Albert Rish, China Agritech is a fraud that serves only to enrich its co-founders, defendants Yu Chang and Xiao Rong Teng. Rish has sued derivatively to recover damages resulting from (i) the Company's purchase of stock from a corporation owned by Chang and Teng, (ii) the suspected misuse of $23 million raised by the Company in a secondary offering, (iii) the mismanagement that occurred during a remarkable twenty-four month period that witnessed the terminations of two outside auditing firms and the resignations of six outside directors and two senior officers, and (iv) the Company's failure to make any federal securities filings since November 2010 and concomitant delisting by NASDAQ. Before filing suit, Rish used Section 220 of the General Corporation Law, 8 *Del. C.* § 220, to obtain books and records, and his complaint relies both on materials that the Company produced and on the glaring absence from the production of books and records that the Company should have readily possessed and provided.

The defendants have moved to dismiss pursuant to Rule 23.1, contending that the complaint fails to plead that demand was made on the board or would have been futile. The defendants also have moved to dismiss pursuant to Rule 12(b)(6), contending that the complaint fails to state a claim on which relief can be granted. Alternatively, the defendants argue that the litigation should be stayed. The motions are denied.

I. FACTUAL BACKGROUND

The facts are drawn from the plaintiffs' verified amended stockholder derivative complaint (the "Complaint") and the documents it incorporates by reference. The

incorporated documents include publicly available information, such as the Company's press releases and filings with the Securities and Exchange Commission (the "SEC"), and non-public books and records obtained through the Section 220 demand. At this stage of the case, plaintiffs receive the benefit of all reasonable inferences, including inferences reasonably drawn from the absence of records produced in response to the Section 220 demand.

A. China Agritech

According to its public filings, China Agritech is a Delaware corporation that develops, manufactures, and markets environmentally friendly fertilizer products in the People's Republic of China. The Company accessed the domestic securities markets in February 2005 through a reverse merger with an inactive corporation that had retained its NASDAQ listing. "[U]sing a defunct Delaware corporation that happens to retain a public listing to evade the regulatory regime established by the federal securities laws is contrary to Delaware public policy." *Williams v. Calypso Wireless, Inc.*, 2012 WL 424880, at *1 n.1 (Del. Ch. Feb. 8, 2012). "Delaware has no interest in facilitating reverse mergers with defunct but still publicly registered shell corporations as a means to circumvent the regulatory protections provided by the federal securities laws." *In re Native Am. Energy Gp., Inc.*, 2011 WL 1900142, at *7 (Del. Ch. May 19, 2011). *See also Klamka v. OneSource Techs., Inc.*, 2008 WL 5330541, at *2 (Del. Ch. Dec. 15, 2008) (declining to appoint custodian that would allow Delaware corporation to be used for reverse merger to bypass traditional public registration process); *Clabault v. Caribbean Select, Inc.*, 805 A.2d 913, 918 (Del. Ch. 2002) (declining to order annual

meeting pursuant to 8 *Del. C.* § 211(c) where order would allow Delaware corporation to be used to bypass traditional public registration process), *aff'd*, 846 A.2d 237 (Del. 2003).

Defendant Chang founded China Agritech. Chang has served as the Company's President, Chief Executive Officer, Secretary, and Chairman of the board since February 2005. He owns approximately 55% of China Agritech's outstanding common stock, holding 34.1% directly and another 20.8% beneficially through China Tailong Group Limited. By virtue of his stock ownership and positions with the Company, Chang controls China Agritech.

Defendant Teng co-founded China Agritech. Teng has served as a director of the Company since June 2005. From February 3, 2005 until March 13, 2009, she served as the Company's Chief Operating Officer. She owns 1.68% of the Company's common stock directly.

In addition to the China Agritech stock that they hold individually, Chang and Teng own 85% and 15%, respectively, of Sammi Holdings Limited. This entity owns another 8.4% of the Company's outstanding common stock.

B. Problems With Internal Controls

In its Form 10-K for the year ending December 31, 2007, filed with the SEC on March 28, 2008, the Company disclosed that it "did not have in place the financial controls and procedures required to comply with U.S. financial reporting standards." Compl. ¶ 48 (internal quotation marks omitted). The Company reiterated this disclosure in three Form 10-Qs filed in 2008. *Id.*

In an effort to correct its control problems, the Company hired new executives and expanded its board. On October 22, 2008, defendant Yau-Sing Tang ("Y. Tang") joined China Agritech as its CFO and controller. On that same date, defendants Gene Michael Bennett, Lun Zhang Dai, and Hai Ling Zhang ("H. Zhang") became directors. The board then established an Audit Committee, a Compensation Committee, and a Nominating and Governance Committee (the "Governance Committee"), each populated with the new outside directors. Beginning with its Form 10-K for the year ending December 31, 2008, filed with the SEC on March 28, 2009, China Agritech disclosed that its internal controls and procedures were effective as of December 31, 2008.

C. The Yinlong Transaction

On February 12, 2009, Yinlong Industrial Co., Ltd. ("Yinlong") sold China Agritech the remaining 10% equity interest in China Agritech's otherwise 90% owned subsidiary, Pacific Dragon Fertilizers Co. Ltd. ("Pacific Dragon"). Chang and Teng owned 85% and 15%, respectively, of Yinlong's shares, making the deal an interested transaction. I refer to it as the "Yinlong Transaction."

China Agritech acquired the Pacific Dragon shares through a wholly owned subsidiary, China Tailong Holdings Company Ltd. ("Tailong"). China Agritech agreed to pay Yinlong $7,980,000 for the shares, with all but $1 million coming in the form of an interest-free promissory note from Tailong to Yinlong. The transaction closed on May 15, 2009. On the day of the closing, the parties entered into a supplemental purchase agreement. The supplemental purchase agreement amended the "settlement of the

purchase consideration" to a cash payment of $1 million and the issuance of 1,745,000 restricted shares of China Agritech common stock. Compl. ¶ 72.

The preceding description of the Yinlong Transaction tracks the allegations of the Complaint and parallels the description found in a proxy statement China Agritech filed on July 22, 2010. Compl. ¶ 72. A different account of the transaction appears in the Company's Form 10-K for the year ending December 31, 2009 (the "2009 10K"), filed with the SEC on April 1, 2010. Indeed, the 2009 10K offers not one, but two different versions of the Yinlong Transaction's price and structure. The first generally comports with the Complaint, describes the transaction as closing on May 15, 2009, but adds that Yinlong subsequently sold the 1,745,000 shares to Sammi Holdings. The second version asserts that the Yinlong Transaction was signed on February 12, 2009 and closed that same day. It ascribes to Pacific Dragon's equity a "carrying amount" of $5,410,321 and omits any mention of the promissory note, stating only that Tailong paid $1,000,000 in cash plus 1,745,000 shares of China Agritech common stock. *Compare* 2009 10-K at 47-48 *with id.* at F-24.

Chang, Teng, Dai, Bennett, and H. Zhang comprised the board at the time of the Yinlong Transaction. Dai, Bennett, and H. Zhang comprised both the Audit Committee and the Governance Committee.

In March 2009, defendant Ming Gang Zhu became China Agritech's Chief Operating Officer, taking over from Teng. In December 2009, defendant Zheng Wang joined the board as a designee of a fund that invested in the Company. Because of her affiliation, the board did not consider her to be an independent director. *See* China

Agritech, Inc., Current Report (Form 8-K) (Dec. 23, 2009). It is not apparent which, if any, committees she joined.

In early January 2010, Charles Law became an outside director. He joined the Governance Committee and the Compensation Committee.

D. The $23 Million Offering

In April 2010, China Agritech announced a public offering of 1,243,000 shares of common stock, plus an underwriter's option on an additional 186,450 shares, which the underwriter exercised (the "Offering"). The stated purpose of the Offering was to finance the construction of distribution centers for China Agritech's fertilizer products. The Offering raised total gross proceeds of $23 million. According to the Complaint, the funds have not been used to construct distribution centers or for any other discernible business purpose, suggesting either that the funds have been misused or that the stated purpose was false. At the time of the Offering, Chang, Teng, Dai, Bennett, H. Zhang, Law, and Wang comprised the board.

E. The Material Weaknesses Return

In its Form 10-Q dated August 16, 2010, China Agritech disclosed that material weaknesses had again undermined its disclosure controls and procedures. Compl. ¶ 92.

> Management has identified this material weakness to be inadequate supervision and review of the financial reporting process relating to the preparation of US GAAP based financial statements. As a result, management has determined it is necessary to make changes in its internal controls over financial reporting, which would specifically entail providing further training to the Company's finance team to improve their reporting skill levels with respect to US GAAP technical issues.

Id. The material weaknesses necessitated making adjustments to the Company's reported results for first quarter 2010. *Id.*

In its Form 10-Q dated November 10, 2010, the Company claimed to have fixed its internal controls problem: "[M]anagement enhanced the supervision and review of the financial reporting process" and deemed that the "remediation steps correct[ed] the material weaknesses" previously identified. Compl. ¶ 93. The November 2010 Form 10-Q was the last time that China Agritech made a federally mandated securities filing. Since then, China Agritech has posted occasional press releases on its website, but has not otherwise complied with its reporting obligations.

On November 13, 2010, three days after claiming that the material weaknesses were solved, the Company fired its outside auditor, Crowe Horwath LLP. The Audit Committee approved the termination. Dai, Bennett, and H. Zhang comprised the Audit Committee.

F. The Company Hires Ernst & Young.

Effective as of November 13, 2010, the Company hired Ernst & Young Hua Ming ("Ernst & Young") as its new outside auditor. On November 19, Dai's daughter, Lingziao Dai, was named head of China Agritech's internal audit department. She had served previously as China Agritech's Vice President of Finance since May 1, 2009.

Before approving the hiring of Ernst & Young, the Audit Committee considered that Ernst & Young had provided consulting services to the Company for its Sarbanes-Oxley Section 404 compliance effort from 2008 to 2010 and assisted the Company in

testing its internal controls. *See* Compl. ¶ 97. The Audit Committee determined that the services did not impair Ernst & Young's ability to serve as the Company's independent auditor. The Chairman of the Audit Committee, Bennett, confirmed to Ernst & Young that the Audit Committee had made this determination. *Id.*

On December 15, 2010, Ernst & Young provided a letter to the Audit Committee describing matters which, if not appropriately addressed, could result in audit adjustments, significant deficiencies or material weaknesses, and delays in the filing of the Company's Form 10-K for 2010. Company management claimed to have addressed the issues, but Ernst & Young did not agree.

G. The McGee Report

While Ernst & Young was raising issues with Company management, Lucas McGee was investigating China Agritech. McGee is a self-described "consultant and private investor with more than ten years of business and finance experience throughout Asia, including China, Hong Kong and Vietnam." Compl. ¶ 112. On February 3, 2011, McGee posted a report titled "China Agritech: A Scam" (the "McGee Report") on the investor website www.seekingalpha.com. McGee disclosed that he held a short position in the Company's stock and stood to profit from a decline in the Company's common stock price.

The McGee Report identified a series of alleged problems with the Company's business, including:

> • ***Factories are idle***: After visiting [China Agritech's] reported manufacturing facilities . . . we found virtually no manufacturing underway. The single exception was the

facility in Pinggu County on the outskirts of Beijing, where the plant was not in operation on the Friday when we visited but local people told us that it has sporadically produced some liquid fertilizer over the last year. Plants in Bengbu, Anhui (supposedly the largest), Harbin, and Xinjiang were completely shuttered.

- ***Harbin plant for sale:*** The Harbin facility – supposedly a major manufacturing facility for the $100 million revenue business – whose name has never been officially changed in government documentation from "Pacific Dragon," had a sign hanging on the gates last summer reading "this factory is for sale." Although the [C]ompany gives an adjacent address for the facility . . . the registration documents with the local Administration of Industry and Commerce (AIC) have not been updated (a serious regulatory violation in China).

- ***No contract with Sinochem***: A January [China Agritech] announcement states: "In May 2010, the Company signed a renewed contract supplying organic liquid compound fertilizers to Sinochem, China's largest fertilizer distributor." . . . But a manager with Sinochem told us that Sinochem has no contract with [China Agritech] and in fact has never bought or sold organic liquid fertilizers. . . .

- ***[China Agritech] not permitted to make granular fertilizer***: [China Agritech] claims that most of its sales volume now derives from granular compound fertilizers. But government officials familiar with the [China Agritech] operation say that [China Agritech] has not received a license to manufacture granular compound fertilizer and does not sell any.

- ***Unable to buy the product***: Although the [C]ompany has announced 21 regional distribution centers, we have not been able to locate any. We attempted . . . to purchase at least one bottle of the [China Agritech] product but were disappointed. . . .

- ***Fictional Revenue***: [W]e have received an analysis of audited [China Agritech] revenues reported to the Chinese government for the year 2009 . . . . In its [third quarter 2010

10-Q], [China Agritech] claims that it has 100,000 metric tons of production capacity in Anhui, 50,000 metric tons in Harbin, and 50,000 tons in Xinjiang. But a total value of . . . $3,000 in plant and equipment in Xinjiang would be insufficient to support 50,000 tons of production capacity. Indeed, when we visited the site of the Xinjiang plant, we found little more than a warehouse, shared with two other companies and demonstrating no activity.

Our early attempts to find the Xinjiang factory were unsuccessful . . . . [A]fter searching the area and asking county officials, we were able to discover a factory bearing [China Agritech's] name along with the names of two other companies [at a different location than the registered address] . . . . The facility, however, is idle and we were told by local people that there is no production activity there.

In Anhui, which [China Agritech] calls its principal production facility . . . [w]e visited and found a small plant on a rutted road outside Bengbu, completely deserted.

The Beijing plant is larger, but plant staff said in our presence that the facility was idle. The [C]ompany would not allow us in, but we drove around the plant and saw a few people on site washing clothes but no evidence of production. Local government officials said that [China Agritech] had not been able to obtain a production license for granular fertilizer and that it produced a very small volume of liquid fertilizer.

- ***No distribution centers***: In May 2010, [China Agritech] issued over 1.4 million new shares, raising just under $19 million for the construction of distribution centers. But we have not been able to find evidence that any distribution centers were actually built.

- ***Mysterious suppliers***: The companies that [China Agritech] lists in its corporate materials as suppliers of raw materials . . . cannot be found in any directory under possible Chinese names that would correspond to the transliterated names or under the alphabetic names. . . .

> - ***Financial Anomalies***: We have done some analysis of financial reports that [China Agritech] has provided to [the SAIC] . . .
>
> 1. The Harbin company, Pacific Dragon, has cumulative losses since 1994 of over 4 million RMB. . . . There were no sales expenses at all, only administrative expenses. In short, the 2009 audit report . . . shows a dead company.
>
> 2. The Anhui facility has generated losses every year since its establishment in 2006. By the end of 2009, it had lost 3.89 million RMB. The company had zero cash on its books.
>
> 3. The Xinjiang company reports zero fixed assets, meaning that it owns no equipment for production. . . .
>
> 4. The Beijing facility has licensed registered capital of $20 million, but by the end of 2009 had received 88 million RMB, so only more than half of the legally required amount. But despite the missing capital, half of the registered capital was still sitting in the account in cash in 2009, indicating that the company had not purchased much, if any, equipment.
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> - ***Money-losing compounds***: [Compound chemical fertilizers] earn slim or negative margins. In 2008, the compound fertilizer production volume showed negative growth, as raw materials prices soared and farmers limited consumption to manage their costs. . . .

Compl. ¶ 113 (internal quotation marks omitted). McGee concluded that China Agritech

> is not a currently functioning business that is manufacturing products. Instead it is, in our view, simply a vehicle for transferring shareholder wealth from outside investors into the pockets of the founders and inside management.

Id. ¶ 111 (internal quotation marks omitted). As will be seen, Rish did not simply regurgitate the assertions of the McGee Report in his Complaint, but rather used the McGee Report and the Company's responses to it when seeking books and records. Rish

then grounded his Complaint on the documents that the Company produced in response to his demand and on the inferences that can be drawn from those documents and the records that the Company failed to produce.

On February 4, 2011, the day after the McGee Report issued, the Company posted a press release on its website denying the allegations. On February 10, the Company issued a second press release in the form of an open letter from Chang to "Fellow Shareholders and Potential Investors" in which he contested key elements of the McGee Report. Compl. ¶ 114 (the "Rebuttal Letter"). In the Rebuttal Letter, Chang asserted that the Company (i) had used the proceeds of the Offering to develop twenty-one distribution centers, which were "in operation," (ii) had a business relationship with SinoChem "for three years," and (iii) had "the necessary license for the production of all of its fertilizer products." *Id.* ¶¶ 116-119.

On February 10, 2011, Law resigned from the board. The remaining directors appointed X. Zhang to fill his seat.

H. The Company Fires Ernst & Young.

On March 8, 2011, Ernst & Young met with the Audit Committee to discuss potential violations of law, including the United States securities laws. The issues identified by Ernst & Young included

> goods delivery notes that appeared to be modified after the fact; time sheets and related data for the Harbin facility that appeared to be destroyed; material purchases apparently made without supporting official tax invoice or with duplicative official tax invoice; a tax notice from the Harbin City tax bureau that appeared to be falsified; and what appeared to be material undisclosed related party transactions.

Compl. ¶ 97. Ernst & Young expressed concern about whether the firm could continue to rely on management's representations. Ernst & Young also noted that while Crowe Horwath had characterized a particular accounting issue as a significant control deficiency, Ernst & Young had determined that that the Company's treatment of the issue represented "a material accounting error that may require restatement of the Company's Forms 10-Q filed in 2010." *Id.* Ernst & Young asked the Audit Committee to take "timely and appropriate action." *Id.*

On March 10, 2011, the board formed a Special Investigation Committee (the "Special Committee") to investigate Ernst & Young's allegations. The original members of the Special Committee were Wang, Dai, Bennett, and H. Zhang. Because Dai, Bennett, and H. Zhang were members of the Audit Committee, they faced the awkward task of investigating, evaluating, and passing on the propriety of their own actions as members of the Audit Committee. Wang was the only member of the Special Committee who did not face the prospect of investigating her own actions, but she was also a director whom the board did not regard as independent.

On March 12, 2011, Company management drafted a press release stating that the Special Committee had been formed and explaining that the action was taken due to allegations "made by third parties" with respect to the Company and certain issues "identified in connection with the performance of the Company's year end audit." Compl. ¶ 97. When the actual press release was issued, it omitted the phrase "identified in connection with the performance of the Company's year end audit." *Id.* Ernst &

Young immediately advised Company counsel that the deletion of the reference to audit issues was a material omission. Ernst & Young stated that it would resign if a corrective press release was not issued. No correction was made.

On March 14, 2011, Chang informed Ernst & Young that the Audit Committee had terminated its engagement. Ernst & Young had no prior notice regarding its potential termination and had no reason to believe its termination was under consideration before the dispute over the press release. Later that day, the Company issued a press release that claimed the termination

> was the result of [Ernst & Young] entering into a SOX 404 service agreement including performing the test of the Company's internal controls from 2008 through 2010. Recently, the public and the management team have raised doubts about this service agreement's impact on [Ernst & Young's] independence to act as the Company's auditor. In order to give the public fair and truthful financial results, the Board of Directors came to the above decision.

Compl. ¶ 97 (internal quotation marks omitted). This claim was directly contrary to the determinations the Audit Committee made and Bennett conveyed to Ernst & Young in November 2010. Ernst & Young concluded that the press release "does not reflect the Company's actual reasons for terminating Ernst & Young . . . as the Company's auditors." *Id.*

On March 15, 2011, Ernst & Young sent the Company a letter detailing its concerns about its termination and the accuracy of the Company's purported reasons. The letter noted that it was being sent to fulfill Ernst & Young's obligations "under Section 10A(b)(2) of the Securities Exchange Act of 1934," which requires an

independent auditor to report directly to a company's board of directors if it believes an (i) "illegal act" has occurred that materially affects the issuer's financial statements and (ii) that management had not, either independently or as required by the board, yet taken "timely and appropriate remedial action." Compl. ¶ 96.

Wang, the chair of the Special Committee, resigned from the board on March 15, 2011. She "was a Special Committee member only for one day." Def. Op. Br. at 38 n.14. The other members of the Special Committee continued to serve. Bennett, the Chair of the Audit Committee, took over as Chair of the Special Committee.

On April 25, 2011, the remaining directors appointed defendant Kai Wai Sim to fill Wang's seat. On the same day, Bennett resigned from both the Audit Committee and Special Committee, although for the time being he remained a member of the board. Sim took over as Chair of the Special Committee. *See* Compl. ¶ 110 n.7. It is not clear whether Sim also took over as Chair of the Audit Committee. At that point, the members of the Audit Committee were Sim, Dai, and H. Zhang, and the members of the Special Committee were Sim, Dai, H. Zhang, and X. Zhang.

In April 2011, NASDAQ notified the Company that it would be delisted "based on public interest concerns and the Company's failure to file its 2010 form 10-K on time." China Agritech, Inc., Current Report (Form 8-K) (Apr. 18, 2011). The Company appealed the decision. In May 2011, NASDAQ denied the Company's appeal, and the Company's common stock was delisted on May 20.

On May 27, 2011, the Company announced that Zhu, the Company's COO, had resigned.

I. The Section 220 Investigation

The heady admixture of the allegations in the McGee Report, the discharge of two outside auditors, and the serial director and officer resignations might have prompted a rush to the courthouse. But heeding the Delaware Supreme Court's repeated admonitions to use Section 220 to conduct a pre-suit investigation,[1] Rish sought books and records relating to the Yinlong Transaction, the terminations of two outside auditors, the

[1] *See, e.g.*, *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1056 (Del. 2004) ("Both this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that the plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts."); *White v. Panic*, 783 A.2d 543, 556–57 (Del. 2001) ("[T]his case demonstrates the salutary effects of a rule encouraging plaintiffs to conduct a thorough investigation, using the 'tools at hand' including the use of actions under 8 *Del. C.* § 220 for books and records, before filing a complaint. . . . [F]urther pre-suit investigation in this case may have yielded the particularized facts required to show that demand is excused or it may have revealed that the board acted in the best interests of the corporation." (footnote omitted)); *Brehm v. Eisner*, 746 A.2d 244, 266–67 (Del. 2000) (disregarding plaintiffs' complaint "that the system of requiring a stockholder to plead particularized facts in a derivative suit is basically unfair because the Court will not permit discovery under Chancery Rules 26–37 to marshal the facts necessary to establish that pre-suit demand is excused" and reasoning that "[p]laintiffs may well have the 'tools at hand' to develop the necessary facts for pleading purposes . . . [by] seek[ing] relevant books and records of the corporation under Section 220"(footnote omitted)); *Scattered Corp. v. Chi. Stock Exch.*, 701 A.2d 70, 79 (Del. 1997) ("[P]laintiffs inexplicably did not bring [a Section 220 action before filing their derivative complaint]. Accordingly, plaintiffs cannot argue that they have used the available 'tools at hand to obtain the necessary information before filing a derivative action.'" (quoting *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996))); *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 567 n.3 (Del. 1997) ("This Court has encouraged the use of Section 220 as an information-gathering tool in the derivative context, provided a proper purpose is shown." (internal quotation marks omitted)); *Rales v. Blasband*, 634 A.2d 927, 934 n.10 (Del. 1993) (expressing surprise at the rarity with which Section 220 had been used to gather information to satisfy Court of Chancery Rule 23.1).

allegations in the McGee Report, the Company's response, and the nature and degree of oversight provided by the board and its committees.

On June 10, 2011, Rish sent the Company a demand for books and records (the "Section 220 Demand"). The Company initially refused to produce any documents in response.

On July 15, 2011, Rish filed a books and records action. Shortly after the litigation began, the Company began a rolling production of documents which was completed in October 2011. In total, the Company produced 227 pages of documents, approximately half of which were in Chinese. Compl. ¶ 14.

1. Books and Records About The Yinlong Transaction

In the Section 220 Demand, Rish asked for "all memoranda, presentations, reports, correspondence, email, minutes, recordings, consents, agendas, resolutions, summaries, analyses, transcripts, notes, and board or committee packages . . . concerning . . . the Yinlong Transaction." Compl. ¶ 73. It would be reasonable to think that a significant number of documents would be responsive to this request. Under its charter, the Audit Committee was responsible for reviewing "reports and written memoranda from the General Counsel relating to transactions . . . involving directors, director nominees, executive officers, significant shareholders or other 'related persons' in which the Company is or will be a participant." *Id.* ¶ 41. The Governance Committee was responsible for "[r]eview[ing] and determin[ing] whether to approve" related party transactions. *Id.* ¶ 43. The Yinlong Transaction qualified as a related party transaction. Section 6.10 of the Company's publicly filed bylaws provides that the Company's

Secretary "will attend all meetings of the stockholders and record all votes and the minutes of all proceedings . . . . The Secretary will perform like duties for the Board of Directors and committees thereof when required." China Agritech, Inc., Registration Statement (Form SB-2) (July 22, 2005) Ex. 3 at 12. At all relevant times, Chang was the Company's Secretary. Similarly, Section 8.4 of the Company's publicly filed bylaws provides that "[t]he Corporation will keep correct and complete books and records of account and minutes of the proceedings of its stockholders and Board of Directors . . . ." *Id.* at 15. One might reasonably expect that the Audit Committee and Governance Committee would have reviewed the Yinlong Transaction and have minutes and materials reflecting that process.

In response to the Section 220 Demand, China Agritech did not produce any Audit Committee meeting minutes or any other document reflecting any discussion or review of the Yinlong Transaction by the Audit Committee, the Governance Committee, or the full board. *Id.* ¶¶ 53, 60, 74. As evidence of board approval of the Yinlong Transaction, the Company produced signature pages for a written consent dated May 15, 2009, the day the Yinlong Transaction closed, but which bear a fax tag line of May 18, 2009. Compl. Ex. 3. The Company did not produce the pages of the resolution preceding the signature pages. The last substantive clause that appears on the signature page states:

> RESOLVED that all actions previously taken by persons known as officers of the Company in accordance with the resolutions contained in this Written Consent are hereby ratified, approved, and confirmed in all respects.

Compl. Ex. 3.

China Agritech also produced a copy of a share transfer agreement among Tailong, Pacific Dragon, and Yinlong in which Yinlong agreed to transfer its 10% stake in Pacific Dragon "at a price of United States $50,000 dollars." Compl. Ex. 4. Chang signed the share transfer agreement for both Yinlong and Tailong. A Pacific Dragon board resolution similarly noted that the transfer was for the equivalent of $50,000. Compl. Ex. 5. This amount falls orders of magnitude short of the seven-figure numbers that China Agritech disclosed in its public filings when describing the Yinlong Transaction.

2. Books and Records Relating To The Terminations Of Two Outside Auditors

In the Section 220 Demand, Rish asked for "any documentation regarding the termination of [Ernst & Young] as [the Company's] independent auditor." Compl. ¶ 107. It was reasonable to expect that the Company would have documents relating to the termination of Ernst & Young. The Audit Committee's Charter provides that its responsibilities include to "retain and terminate the independent auditor of the Company" and to "assist the Board's oversight of":

> i. the integrity of the Company's financial reporting process and system of internal controls;
>
> ii. the Company's compliance with legal and regulatory requirements;
>
> iii. the independent auditors' qualifications and independence; and
>
> iv. the performance of the Company's internal audit function and independent auditors.

Id. ¶ 40. To fulfill these obligations, the Audit Committee Charter identifies "duties and responsibilities" of the Audit Committee, including:

> - Be directly responsible for the appointment, compensation, retention, dismissal and oversight of the work of the Company's independent auditors (including resolution of disagreements between management and the auditors regarding financial reporting) . . . .
> - Review annually the overall plan of the audit as proposed by the independent auditors. . . .
> - Review with the independent auditors any audit problems or difficulties and management's response.
> - Report to the Board on the scope and results of the annual audit . . . .
> - Review annually the scope and results of the internal audit program. . . .
> - Meet at least quarterly with management, the internal audit manager, and the independent auditors in separate executive sessions. . . .
> - Report regularly to the Board on any issues that arise with respect to the quality or integrity of the Company's financial statements, the Company's compliance with legal or regulatory requirements, the performance and independence of the Company's independent auditors and the performance of the internal audit function.

Id. ¶ 41. The Company should have had minutes and other materials reflecting the Audit Committee's attention to these tasks and functions.

In response to the Section 220 Demand for records relating to the termination of Ernst & Young, the Company produced only three documents: (i) the March 14, 2011 resolution of the Audit Committee, (ii) the March 14, 2011 resolution of the Board, and

(iii) the letter Ernst & Young sent the Company on March 15, 2011, to fulfill its obligations "under Section 10A(b)(2) of the Securities Exchange Act of 1934." Compl. ¶¶ 96, 107. Not one document suggested any concern about Ernst & Young's independence before the March 14 decision to terminate Ernst & Young.

3. Books and Records Relating To The Issues In The McGee Report and the Company's Response

In the Section 220 Demand, Rish asked for books and records relating to the principal allegations made in the McGee Report and by the Company in its responsive press releases. The McGee Report starkly accused the Company of being a fraud. It would be reasonable to expect that a legitimate entity with *bona fide* operations would be able to provide ample documents demonstrating that fact. The problem for a legitimate entity would be the potential burden of having too many responsive documents, not the difficulty of digging up a few.

The Section 220 Demand sought "[a]ny contracts evidencing the construction and completion of . . . twenty-one (21) distribution centers." Compl. ¶ 116. China Agritech said it would use the Offering proceeds to construct distribution centers, and in his Rebuttal Letter, Chang stated that the Company had twenty-one distribution centers in operation. *Id.* In response to the Section 220 Demand, the Company produced only ten "franchise agreements" for retail stores at various locations in China. The ten agreements, all dated January 14-15, 2011, required the franchisee to provide a "design proposal" to the Company in advance of remodeling. *Id.* ¶ 117. No documents

suggested that remodeling had started, much less that the remodeling was complete and the stores were operating.

The Section 220 Demand sought "[a]ny contacts entered into between [China Agritech] and SinoChem." Compl. ¶ 58(a). The Company previously had identified SinoChem as one of its largest customers for organic granular compound fertilizer, responsible for $3,696,000, or 4.9%, of total sales. *Id.* ¶ 59. In the Rebuttal Letter, Chang stated that China Agritech had "partnered with SinoChem for three years." *Id.* ¶ 118. In response to the Section 220 Demand, the Company produced only the purported "English translations" of three alleged contracts with SinoChem that China Agritech previously had filed publicly. *Id.* Rish received no evidence of any original contracts. The Company's failure to produce copies of the original Chinese language contracts was conspicuous because the Company produced other original Chinese language documents.

The Section 220 Demand sought a "copy of the Formal Fertilizer Registration Certificate from the PRC Ministry of Agriculture." *Id.* ¶ 119. The McGee Report had alleged that the Company lacked the required licenses. In his Rebuttal Letter, Chang asserted that the Company had the necessary licenses. *Id.* In response to the Section 220 Demand, the Company produced a license certificate for *liquid* fertilizer, but not for *granular* fertilizer, one of the Company's major products.

4. Books and Records Relating To Board And Committee Oversight

Rish asked for books and records relating to the Audit Committee's oversight of the Company's financial statements, financial reporting process, and system of internal

controls. The Company's proxy statement filed by China Agritech on July 22, 2010 implied that the Audit Committee did not meet during 2009, although it did take action by written consent on three occasions. In response to the Section 220 Demand, China Agritech did not produce any Audit Committee meeting minutes for 2009 or 2010. *See* Compl. ¶ 53.

J. The Special Committee's "Findings"

On December 1, 2011, the Company issued a press release announcing that the Special Committee had completed its investigation. The Company noted that "[t]he investigation was subject to certain limitations," including that "[Ernst & Young] did not cooperate with the investigation . . . ." China Agritech, Inc., Current Report (Form 8-K) (Dec. 1, 2011); *see* Compl. ¶ 102. It is not clear what other limitations, if any, existed.

Without providing any details or explanation, the Company reported that according to the Special Committee, all was well:

> [T]he [Special] Committee concluded that the investigation appropriately addressed all material issues raised by [Ernst & Young], the circumstances of [Ernst & Young]'s termination, and the allegations in [the McGee Report]. With specific regard to [the McGee Report], the [Special] Committee concluded that the allegations were either factually incorrect or that there were reasonable explanations as to their non-materiality.
>
> Additionally, the [Special] Committee has determined that it is not unreasonable to conclude that [the Company's] termination of [Ernst & Young] was as a result of: (a) an independence issue that [Ernst & Young] itself first dismissed, then raised; (b) [Ernst & Young]'s demand for payment before it was contractually due; and (c) [Ernst & Young]'s refusal to communicate with [the Company] after receiving this payment, and before issuing an audit report.

> Further, the allegation that [the Company] dismissed [Ernst & Young] for its insistence on an independent investigation regarding the issues that [Ernst & Young] raised is contradicted by the fact that [the Company] formed a Special Committee to conduct just such an investigation *prior* to [Ernst & Young]'s termination.

China Agritech, Inc., Current Report (Form 8-K) (Dec. 1, 2011); *see also* Compl. ¶ 101.

K. The Parade Of Resignations

On January 6, 2012, Rish filed this lawsuit. At the time, defendants Chang, Teng, Dai, Sim, Bennett, H. Zhang, and X. Zhang comprised the board (the "Demand Board"). Sim, Dai, H. Zhang, and X. Zhang served on the Special Committee, and Sim, H. Zhang, and X. Zhang served on the Audit Committee.

On January 14, 2012, Sim resigned from the board. His resignation became effective on January 25.

On January 16, 2012, Y. Tang resigned as CFO.

On March 13, 2012, H. Zhang and X. Zhang resigned from the board. Their resignations became effective on March 15.

On June 7, 2012, Bennett resigned from the board.

The resignations left Chang, Teng, and Dai as the only members of the board. To recapitulate, Chang and Teng are the Company's co-founders. Chang controls a mathematical majority of China Agritech's outstanding voting power, and he is the Company's President, CEO, Secretary, and Chairman of the Board. Dai's daughter heads up the Company's internal audit department.

At the Company's annual meeting on June 25, 2012, Chang, Teng, and Dai were reelected. Chang dominated the vote: Of the 7,080,620 shares voted, Chang owned all but 6,982. Compl. ¶ 129.

II. LEGAL ANALYSIS

The defendants seek dismissal of the Complaint and the entry of judgment in their favor under Rule 23.1 and Rule 12(b)(6). Alternatively, they ask that the case be stayed. The motions are denied.

A. Rule 23.1

When a corporation suffers harm, the board of directors is the institutional actor legally empowered under Delaware law to determine what, if any, remedial action the corporation should take, including pursuing litigation against the individuals involved. *See* 8 *Del. C.* § 141(a). "A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984). "Directors of Delaware corporations derive their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation, from 8 *Del. C.* § 141(a)." *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981) (footnote omitted). Section 141(a) vests statutory authority in the board of directors to determine what action the corporation will take with its litigation assets, just as with other corporate assets. *See id.*

In a derivative suit, a stockholder seeks to displace the board's authority over a litigation asset and assert the corporation's claim. *Aronson*, 473 A.2d at 811; *see also*

Desimone v. Barrows, 924 A.2d 908, 914 (Del. Ch. 2007) (noting that the issue for a Rule 23.1 motion is "whether the . . . board should be divested of its authority to address [the underlying] misconduct."). A stockholder whose litigation efforts are opposed by the corporation can accomplish this feat only by obtaining a judicial ruling establishing demand excusal or wrongful refusal.

> Because directors are empowered to manage, or direct the management of, the business and affairs of the corporation, the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim *and* they have wrongfully refused to do so *or* where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.

Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993) (emphases added; citation omitted); *accord Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008) ("A stockholder may not pursue a derivative suit to assert a claim of the corporation unless the stockholder: (a) has first demanded that the directors pursue the corporate claim and the directors have wrongfully refused to do so; or (b) establishes that pre-suit demand is excused because the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation."); *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988) ("The right to bring a derivative action does not come into existence until the plaintiff shareholder has made a demand on the corporation to institute such an action or until the shareholder has demonstrated that demand would be futile."); *Maldonado v. Flynn*, 413 A.2d 1251, 1262 (Del. Ch. 1980) ("The stockholder's individual right to bring the action does not ripen, however, until he has made a demand on the corporation which has been

met with a refusal by the corporation to assert its cause of action or unless he can show a demand to be futile."), *rev'd on other grounds sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981) ("[W]here demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf."); *Ainscow v. Sanitary Co. of Am.*, 180 A. 614, 615 (Del. Ch. 1935) (Wolcott, Jos., C.) ("[A] stockholder has no right to file a bill in the corporation's behalf unless he has first made demand on the corporation that it bring the suit and the demand has been answered by a refusal, or unless the circumstances are such that because of the relation of the responsible officers of the corporation to the alleged wrongs, a demand would be obviously futile . . . .").

Rish concedes that he did not make a litigation demand on the Demand Board, and the Company opposes his efforts to pursue litigation. Consequently, for Rish to obtain authority to move forward on behalf of China Agritech, his Complaint must "allege with particularity . . . the reasons . . . for not making the effort [to make a litigation demand]," Ch. Ct. R. 23.1, and this Court must determine based on those allegations that "demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation." *Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006). The requirement of factual particularity does not entitle a court to discredit or weigh the persuasiveness of well-pled allegations. "The well-pleaded factual allegations of the derivative complaint are accepted as true on such a motion." *Rales*, 634 A.2d at 931. "Plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged . . . ." *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000). Put

differently, once a plaintiff pleads particularized allegations, then the plaintiff is entitled to all "reasonable inferences [that] logically flow from particularized facts alleged by the plaintiff." *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004). Rule 23.1 requires that a plaintiff allege specific facts, but "he need not plead evidence." *Aronson*, 473 A.2d at 816; *accord Brehm*, 746 A.2d at 254 ("[T]he pleader is not required to plead evidence . . . .").

The Delaware Supreme Court has established two tests for determining whether the allegations of a complaint sufficiently plead demand futility. *Wood*, 953 A.2d at 140 ("Two tests are available to determine whether demand is futile."). In *Aronson*, the seminal demand-futility decision, the Delaware Supreme Court crafted a specific two-part test that applies when a derivative plaintiff challenges an earlier board decision made by the same directors who remain in office at the time suit is filed. *See Aronson*, 473 A.2d at 814. The Court of Chancery "must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* The first of the two inquiries examines "the independence and disinterestedness of the directors" with respect to the decision that the derivative action would challenge. *Id.* "Certainly, if this is an 'interested' director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases." *Id.* at 815. If the underlying transaction was approved by a disinterested and independent board majority, then the court moves to the second inquiry: whether the plaintiff "has alleged facts with

particularity which, if taken as true, support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment." *Id.* at 815. A plaintiff might allege sufficiently, for example, that the directors were grossly negligent in approving the transaction. *Id.* at 812.

Under both parts of the *Aronson* test, the Court determines whether the particularized facts of the complaint are sufficient *to raise a reasonable doubt* about (i) the director's disinterestedness or independence or (ii) that the challenged transaction was a valid exercise of business judgment. *See id.* at 814. A plaintiff need not "plead particularized facts sufficient *to sustain a 'judicial finding'* either of director interest or lack of director independence" or other disabling factor. *Grobow v. Perot*, 539 A.2d 180, 183 (Del. 1988) (emphasis added). The Delaware Supreme Court in *Grobow* interpreted the Court of Chancery as having adopted a "judicial finding" standard and explicitly rejected it as "an excessive criterion" for pleading under the "reasonable doubt test." *Id.*

In *Rales*, the Delaware Supreme Court confronted a board whose members had not participated in the underlying decision that the derivative action would challenge, and therefore "the test enunciated in [*Aronson*] . . . [was] not implicated." 634 A.2d at 930. In response, the Delaware Supreme Court framed a second and more comprehensive demand futility standard that asks "whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* at 934. The Delaware Supreme Court envisioned that the *Rales* test would be used

> in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where . . . the decision being challenged was made by the board of a different corporation.

Id. (footnotes omitted).

A director cannot consider a litigation demand under *Rales* if the director is interested in the alleged wrongdoing, not independent, or would face a "substantial likelihood" of liability if suit were filed. *Rales*, 634 A.2d at 936 (internal quotation marks omitted). To show that a director faces a "substantial risk of liability," a plaintiff does not have to demonstrate a reasonable probability of success on the claim. In *Rales*, the Delaware Supreme Court rejected such a requirement as "unduly onerous." *Id.* at 935. The plaintiff need only "make a threshold showing, through the allegation of particularized facts, that their claims have some merit." *Id.* at 934. This standard recognizes that the purpose of the particularity requirement is not to prevent derivative actions from going forward, but rather "to ensure only derivative actions supported by a reasonable factual basis proceed." *In re Dow Chem. Co. Deriv. Litig.*, 2010 WL 66769, at *6 (Del. Ch. Jan. 11, 2010).

The *Aronson* and *Rales* have been described as complementary versions of the same inquiry.[2] This case illustrates that reality. The fundamental question presented by

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[2] *See David B. Shaev Profit Sharing Account v. Armstrong*, 2006 WL 391931, at *4 (Del. Ch. Feb. 13, 2006) ("the *Rales* test, in reality, folds the two-pronged *Aronson* test into one broader examination"); *Guttman v. Huang*, 823 A.2d 492, 501 (Del. Ch. 2003) ("At first blush, the *Rales* test looks somewhat different from *Aronson*, in that [it]

the defendant's Rule 23.1 motion is whether the Demand Board could have validly considered a litigation demand. *See* Ch. Ct. R. 23.1. The Complaint challenges at least three events that involved actual decisions: the Yinlong Transaction, the terminations of the outside auditors, and the Special Committee's determination to take no action. Five of the seven members of the Demand Board were directors at the time those decisions were made. Because less than "a majority of the directors making the decision have been replaced," *Rales*, 634 A.2d at 935, *Aronson* provides the demand futility standard for the five participating directors. *Rales* would provide the standard for the two remaining directors, but because the *Aronson* analysis establishes demand futility, I do not reach the *Rales* aspect. The outcome would be no different if *Rales* were used for all seven directors, because the *Rales* test asks whether a director would face a substantial risk of liability as a result of the litigation. To determine whether the participating directors would face a substantial risk of liability in litigation challenging their prior decisions, a reviewing court examines whether the directors had a personal interest in the decisions, were not independent with respect to the decisions, or otherwise would not enjoy the protections of the business judgment rule. Those are precisely the questions that *Aronson* asks.

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involves a singular inquiry . . . . Upon closer examination, however, that singular inquiry makes germane all of the concerns relevant to both the first and second prongs of *Aronson*."); Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 9.02[b][3][iii], at 9-97 (2011) ("[I]t is arguable that the current state of the law is conceptually inverted and that it would be both simpler and more direct to regard the original *Aronson* analysis as a subpart of the more generally applicable and flexible principle set forth in *Rales*.").

The litigation also alleges a systematic lack of oversight at China Agritech. That challenge does not involve an actual board decision, so *Rales* governs. The allegations of the Complaint, which rely on both books and records the Company produced in response to the Section 220 Demand and on the absence of books and records in critical areas, support a reasonable inference that the members of the Demand Board face a substantial risk of liability for oversight violations. Under *Rales*, it would have been futile for Rish to make a litigation demand with respect to the defendants' failures of oversight.

1. The Yinlong Transaction

To the extent the litigation challenges the Yinlong Transaction, it was futile under *Aronson* for Rish to make a litigation demand. The members of the Demand Board were Chang, Teng, Dai, Sim, Bennett, H. Zhang, and X. Zhang. Chang and Teng stood on both sides of the Yinlong Transaction, in which China Agritech purchased shares from an entity they owed. A director is deemed "interested" if he "has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders." *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). "In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision." *Rales*, 634 A.2d at 936. Directors who have received the benefits of a challenged transaction "have a strong financial incentive to maintain the status quo by not authorizing any corrective action that would devalue their current holdings or cause them to disgorge improperly obtained profits. This creates an unacceptable conflict that restricts them from evaluating the litigation independently." *Conrad v. Blank*, 940 A.2d

28, 38 (Del. Ch. 2007); *see also Ryan v. Gifford*, 918 A.2d 341, 355 (Del. Ch. 2007) (holding that a board member's acceptance of the backdated stock options raises a reason to doubt that director's disinterestedness); *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 591 n.72 (Del. Ch. 2007) (same).

Dai, Bennett, and H. Zhang were members of the Audit Committee when it approved the Yinlong Transaction. In a challenge to the Yinlong Transaction, Chang, Teng, and their fellow defendant directors would bear the burden of proving that the transaction was entirely fair. *See Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) ("Ordinarily, in a challenged transaction involving self-dealing by a controlling shareholder, the substantive legal standard is that of entire fairness, with the burden of persuasion resting upon the defendants."); *accord Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1116-17 (Del. 1994). The purchase price for the remaining 10% interest in Pacific Dragon that China Agritech acquired was set originally at $7.98 million. The day the transaction documents were signed, the Company issued an unsecured, interest-free promissory note for all but $1 million of the purchase price. At closing, the Company, through its subsidiary, "amended the settlement of the purchase consideration" to a $1 million cash payment plus 1,745,000 shares of the Company's common stock. Compl. ¶ 72. A document produced in response to the Section 220 Demand supports a reasonable inference that the actual value of the interest was approximately $50,000. *Id.* ¶ 75. The litigation risk that the Audit Committee members would face in an entire fairness challenge to the Yinlong Transaction raises a reasonable doubt about their ability to

disinterestedly consider a litigation demand. *See Conrad*, 940 A.2d at 38; *Ryan*, 918 A.2d at 355; *Tyson Foods*, 919 A.2d at 591 n.72.

Five of the seven members of the Demand Board therefore could not properly consider a litigation demand addressing the Yinlong Transaction. Demand is futile under *Aronson*, and I need not consider the remaining two directors under *Rales*.

2. Business Fraud

The Complaint more broadly contends that China Agritech is a fraud. Aspects of the fraud include failing to use the proceeds of the Offering for its stated purpose; not being able to produce basic documents essential to the Company's business, such as the original Chinese language contract with the Company's primary customer or a license to produce one of the Company's primary products; and repeated failures to maintain effective internal controls that prevented the Company from making public filings with the SEC since November 2010 and ultimately resulted in the delisting of the Company's common stock. *See* Compl. ¶¶ 85, 115-118, 121. Because this aspect of the Complaint challenges an ongoing failure of the board to provide oversight, *Rales* provides the test for evaluating demand futility.

The board of a Delaware corporation has a fiduciary obligation to adopt internal information and reporting systems that are "reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996). If a corporation

suffers losses proximately caused by fraud or illegal conduct, and if the directors failed "to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists," then there is a sufficient connection between the occurrence of the illegal conduct and board level action or conscious inaction to support liability. *Id.* "[I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." *Stone*, 911 A.2d at 370.

The burden on a plaintiff who seeks to establish liability under a failure-to-monitor theory "is quite high." *Caremark*, 698 A.2d at 971.

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* [*v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963)] or in [the *Caremark* case itself], . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.

Id. "Concretely, this latter allegation might take the form of facts that show the company entirely lacked an audit committee or other important supervisory structures, or that a formally constituted audit committee failed to meet." *Shaev*, 2006 WL 391931, at *5 (footnote omitted); *see Guttman*, 823 A.2d at 507 ("[T]he kind of fact pleading that is critical to a *Caremark* claim [is] . . . contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice

of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation.").

The allegations of the Complaint support a reasonable inference that China Agritech had a "formally constituted audit committee [that] failed to meet." *Shaev*, 2006 WL 391931, at *5. In response to the Section 220 Demand, China Agritech did not produce any Audit Committee meeting minutes for 2009 or 2010. The Company's proxy statement filed on July 22, 2010 similarly implies that the Audit Committee did not meet during 2009, although it did take action by written consent on three occasions.

During 2009 and 2010, the Company engaged in the Yinlong Transaction, conducted the Offering, disclosed a material weakness in its disclosure controls and procedures, claimed to have fixed the problem, terminated Crowe Horwath as its outside auditor, hired Ernst & Young as its new outside auditor, and named Dai's daughter as head of China Agritech's internal audit department. Yet there is no documentary evidence that the Audit Committee ever held a single meeting during this two year period. Then in 2011, Ernst & Young resigned and sent the Company a letter to fulfill Ernst & Young's obligations "under Section 10A(b)(2) of the Securities Exchange Act of 1934," which requires an independent auditor to report directly to a company's board of directors if it believes an (i) "illegal act" has occurred that materially affects the issuer's financial statements and (ii) that management had not, either independently or as required by the board, yet taken "timely and appropriate remedial action." Compl. ¶ 96.

Discrepancies in the Company's public filings with governmental agencies reinforce the inference of an Audit Committee that existed in name only. During its time

as a publicly listed entity in the United States, the federal securities laws mandated that the Company make periodic filings with the SEC. Regulatory requirements in China mandated that the Company make periodic filings with the State Administration for Industry and Commerce ("SAIC"). The Complaint alleges that in four of five years that the Company reported large profits in its filings with the SEC, the Company reported net losses to the SAIC. In the fifth year, the Company reported a large profit in its filings with the SEC, and one-fifth of that profit to the SAIC.

- In 2005, the Company reported revenue of $56,000 and a net loss of $28,000 to the SAIC. That same year, the Company reported revenue of over $25 million and net income of $3.68 million to the SEC. Compl. ¶ 67.
- In 2006, the Company reported revenue of $67,000 and a net loss of $1.03 million to the SAIC. That same year, the Company reported revenue of over $29.5 million and net income of $5.35 million to the SEC. *Id.* ¶ 66.
- In 2007, the Company reported revenue of $1.20 million and a net loss of $1.18 million to the SAIC. That same year, the Company reported revenue of $39.27 million and net income of $8.53 million to the SEC. *Id.* ¶ 65.
- In 2008, the Company reported revenue of $2.95 million and a net loss of $1.89 million to the SAIC. That same year, the Company reported revenue of $45.24 million and net income of $9.83 million to the SEC. *Id.* ¶ 64.
- In 2009, the Company reported revenue of $6.99 million and net income of $966,000 to the SAIC. That same year, the Company reported revenue of $76.13 million and net income of $6.17 million to the SEC. *Id.* ¶ 63.

Although the Delaware state courts have not yet confronted the implications of dramatic divergences between U.S. and Chinese regulatory filings, the federal district courts have considered whether alleged divergences can support a claim of securities fraud under the Private Securities Litigation Reform Act and Federal Rule of Civil Procedure 9(b). *See* 15 U.S.C. § 78u-4(b)(1) (requiring allegations be stated with

particularity; requiring plaintiff to specify fraudulent statements, their speaker, where and when the statements were made, and why they were fraudulent); Fed. R. Civ. P. 9(b) (same). When the financial statements differ significantly, courts have generally credited an inference of fraud.[3] When the differences have been less marked, courts have granted motions to dismiss complaints that did not adequately explain why the discrepancy was material and would support an inference of fraud.[4] A federal court previously found that the "drastically different" figures China Agritech filed with the SEC and SAIC supported an inference of *scienter*. *See Dean v. China Agritech*, 2011

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[3] *See, e.g.*, *McIntire v. China MediaExpress Hldgs., Inc.*, 2013 WL 752954, at *13-14 (S.D.N.Y. Feb. 28, 2013) (finding that "drastically different financial statements" filed with the SEC and SAIC "provide[d] an adequate basis" for claim); *Ho v. Duoyuan Global Water*, 887 F.Supp.2d 547, 567-69 (S.D.N.Y. 2012) (denying motion to dismiss complaint that cited large discrepancies in reported revenue for years 2006-2008, with revenue of $0, $3.2, and $1.9 million RMB was reported to the SAIC while $206.2, $272.9, and $424.4 million RMB was reported to the SEC, and other years in which negative revenue was reported to the SAIC while positive revenue was reported to the SEC); *Scott v. ZST Digital Networks, Inc.*, 2012 WL 538279, *8-10 (C.D. Cal. Feb. 14, 2012) (denying motion to dismiss where reported revenue differed "by a factor of over two thousand"; $6 million profit reported to SEC while a loss was reported to SAIC defeated motion to dismiss); *Miller Investment Trust v. Morgan Stanley & Co. Inc.*, 879 F.Supp.2d 158, 164-66 (D. Mass. 2012) (denying motion to dismiss where SEC filings "reflected substantially higher revenue" than SAIC filings, plaintiff alleged similarities in accounting standards and therefore met a notice pleading standard); *In re China Educ. Alliance, Inc. Sec. Litig.*, 2011 WL 4978483, at *2, *5 (Oct. 11, 2011) (denying motion to dismiss where SEC filings reported $16.7 and $22.2 million revenue for 2008-2009 and SAIC filings reported $616,643 and $700,000 for the same years).

[4] *See, e.g.*, *Brown v. China Integrated Energy*, 875 F.Supp.2d 1096, 1115 (C.D. Cal. 2012) (granting motion to dismiss where it was plausible that both reports presented the "same underlying financial data"); *In re China Valves Tech. Sec. Litig.*, 2012 WL 4039852, at *6 (S.D.N.Y. Sept. 12, 2012) (granting motion to dismiss where discrepancies were "not nearly as large as those in some cases where factually similar claims survived").

WL 5148598, at *4 (C.D. Cal. Oct. 27, 2011). The SEC has pursued an enforcement action against an entity that filed financial statements claiming sales figures fifteen times higher than similar figures in financial statements filed with Chinese authorities. *See S.E.C. v. Rino Int'l Corp.*, 1:13-cv-00711 (D.D.C. May 15, 2013); *see also* Securities and Exchange Commission Litigation Release No. 22699, May 15, 2013 (announcing settlement).

Taken together, the factual allegations of the Complaint support a reasonable inference that the members of the Audit Committee acted in bad faith in the sense that they consciously disregarded their duties. Unlike the parade of hastily filed *Caremark* complaints that Delaware courts have dismissed, and like those rare *Caremark* complaints that prior decisions have found adequate, the Complaint supports these allegations with references to books and records obtained using Section 220, and with inferences that this Court can reasonably draw from the *absence* of books and records that the Company could be expected to produce. *See Tyson Foods*, 919 A.2d at 578 ("it is more reasonable to infer that exculpatory documents would be provided [in response to a Section 220 demand] than to believe the opposite: that such documents existed and yet were inexplicably withheld.").

Because of their service on the Audit Committee, Dai, Bennett, and H. Zhang face a substantial risk of liability for knowingly disregarding their duty of oversight. These directors could not validly consider a litigation demand concerning the problems that occurred on their watch. Dai also could not validly consider a litigation demand for the additional reason that his daughter, Lingxiao Dai, served as Vice President of Finance

from May 1, 2009 until November 19, 2010, and as head of the internal audit department thereafter. A director lacks independence when "the director is unable to base his or her decisions on the corporate merits of the issue before the board." *Litt v. Wycoff*, 2003 WL 1794724, at *3 (Del. Ch. Mar. 28, 2003). A meaningful investigation into or litigation regarding China Agritech's lack of internal controls, financial reporting deficiencies, and potential violations of law would necessitate an investigation into Dai's daughter and could lead to a finding of wrongdoing against her. Close family relationships, like the parent-child relationship, create a reasonable doubt as to the independence of a director. *See Mizel v. Connelly*, 1999 WL 550369, at *4 (Del. Ch. July 22, 1999); *see also Grace Bros. Ltd. v. UniHolding Corp.*, 2000 WL 982401, at *10 (Del. Ch. July 12, 2000). Dai also cannot consider a demand that would place Chang or Teng at risk because his daughter's primary employment depends on the good wishes of the Company's controlling stockholders. *See Cal. Pub. Emps. Ret. Sys. v. Coulter*, 2002 WL 31888343, at *9 (Del. Ch. Dec. 18, 2002); *Mizel*, 1999 WL 550369, at *4.

Bennett and H. Zhang's resignations further call into question their ability to consider a demand. *Cf. Rich v. Chong*, 2013 WL 1914520, at *6, *9-10 (Del. Ch. Apr. 25, 2013) (considering director resignations in the context of demand refusal analysis). Bennett was the Chair of the Audit Committee and Special Committee. As such, he was optimally positioned to represent the interests of the Company and its minority stockholders. Yet for reasons that are unclear at this point, Bennett resigned from both committees on April 25, 2011, shortly after the firing of the two outside auditors and Wang's resignation. On June 7, 2012, Bennett resigned from the board. At the pleading

stage, when viewed in the context of the allegations of the Complaint as a whole, Bennett's resignation supports a reasonable inference that he could not meaningfully supervise Chang, which in turn contributes to an inference that he could not properly consider a litigation demand.

H. Zhang also was a member of the Audit Committee and Special Committee. Unlike Bennett, he continued to serve on both committees during the time when the Special Committee was conducting its investigation of the events surrounding the firing of the outside auditors. The Special Committee took no action as a result of its investigation, and the Company's description of the Committee's findings is hardly confidence inspiring. With respect to the McGee Report, the Company announced that "the Committee concluded that the allegations were either factually incorrect or that there were reasonable explanations as to their non-materiality." Compl. ¶ 103 (internal quotation marks omitted). This cryptic statement leaves open the possibility that (i) some of the troubling allegations the McGee Report were correct, and (ii) the information could be deemed material. As to Ernst & Young's resignation, the Committee

> determined that it is not unreasonable to conclude that [the Company's] termination of [Ernst & Young] was as a result of: (a) an independence issue that [Ernst & Young] itself first dismissed, then raised; (b) [Ernst & Young]'s demand for payment before it was contractually due; and (c) [Ernst & Young]'s refusal to communicate with [the Company] after receiving this payment, and before issuing an audit report.

Id. ¶ 105 (internal quotation marks omitted). This even more obtuse statement leaves open the possibility that "it is not unreasonable to conclude" that Ernst & Young resigned for precisely the reasons it cited in its letter. On March 13, 2012, shortly after the special

committee completed its work, H. Zhang submitted his resignation. At the pleading stage, when viewed in the context of the allegations of the Complaint as a whole, H. Zhang's resignation supports a reasonable inference that he had washed his hands of the Company and its problems, which in turn contributes to the inference that he could not properly consider a litigation demand.

The inferences drawn from Bennett and H. Zhang's resignations are necessarily fact-dependent. Their resignations were part of a parade of departures from the Company under highly suspicious circumstances. The Court's ability to draw such an inference on the facts alleged here does not suggest that an independent director's resignation typically would support either an inference of culpability or the inability to consider a demand.

Lastly, Chang could not validly consider a demand because he would face a substantial risk of liability in connection with the events of the 2009 through 2010 period. Chang was the Company's Chairman, CEO, and controlling stockholder. The disputes between the Company and Crowe Horwath and Ernst & Young pitted Chang and his management team against the outside auditors. Ernst & Young pointed the finger directly at Chang and his management team by advising the Audit Committee that it did not believe it could rely on management's statements. Ernst & Young also contended that it was senior management that made a materially misleading disclosure regarding Ernst & Young's termination. Chang's "potential culpability and the potential [adverse] consequences [to the Company] combine to raise reasonable doubt" as to whether he can disinterestedly consider a demand. *See, e.g.*, *e4e, Inc. v. Sircar*, 2003 WL 22455847, at *3 (Del. Ch. Oct. 9, 2003).

Chang, Dai, Bennett, and H. Zhang comprise a majority of the Demand Board. Demand is therefore futile under *Rales* for purposes of the *Caremark* claim, rendering it unnecessary to consider the other three directors.

3. The Termination of the Outside Auditors

To the extent the litigation challenges the termination of the outside auditors, demand is futile under *Aronson*. The particularized allegations of the Complaint, supported by the results of the Section 220 Demand, support a reasonable inference that both outside auditing firms raised serious issues about the Company's compliance with accounting requirements, and Ernst & Young took the additional step of questioning whether it could rely on management's representations and the Company's compliance with the law. The Audit Committee responded by terminating the firms and, in the case of Ernst & Young, permitting management to issue press releases that (i) failed to identify the outside auditors as the source of concern about the Company's financial statements and (ii) provided what can be regarded at the pleadings stage as pretextual grounds for Ernst & Young's termination. The books and records produced in response to the Section 220 Demand do not suggest any concern about or consideration of Ernst & Young's independence before the firm's sudden termination after the dispute over the Company's press release. *See Tyson Foods*, 919 A.2d at 578 (noting that exculpatory documents logically would be produced in response to a Section 220 demand).

Chang could not properly consider a litigation demand regarding the termination of the Company's outside auditors because his role in management as the Company's CEO gives rise to a reasonable inference that he would face personal and professional

risk in any litigation over the dispute, making him interested in the outcome. *See, e.g.*, *e4e*, 2003 WL 22455847, at *1-3.

The members of the Audit Committee could not properly consider a litigation demand regarding the termination of the Company's outside auditors because the allegations of the Complaint support a reasonable inference that they failed to act in good faith. The Complaint presents a pastiche of ongoing disputes between successive accountants and management, the doctoring of the initial press release about the delay of the 2010 10K to avoid mentioning audit issues, Chang's telephone call terminating Ernst & Young after the firm objected, the issuance of a second press release that can be viewed at the pleadings stage as containing pretextual excuses for the termination, Ernst & Young's formal objection "under Section 10A(b)(2) of the Securities Exchange Act of 1934," and Wang's immediate resignation after the Company received the letter. Taken together, the allegations support a reasonable inference that Chang wanted to get rid of Ernst & Young and that the Audit Committee rubberstamped his decision. At this stage of the litigation, Wang's hasty departure supports a reasonable inference that she questioned the propriety of the actions that the Audit Committee and management were contemplating and resigned in response. Compl. ¶ 96. Dai, Bennett and H. Zhang could not properly consider a demand to institute litigation involving these matters. Dai could not properly consider a litigation demand regarding the termination of the Company's outside auditors for the additional reason that his daughter is the head of the Company's internal audit department, which gives rise to a reasonable inference that he is incapable of acting in a disinterested fashion with respect to an audit dispute.

Chang, Dai, Bennett, and H. Zhang comprise a majority of the Demand Board. They could not properly consider a litigation demand addressing the outside auditor terminations, rendering demand futile under *Aronson*. I need not consider the remaining directors.

4. The "Sham" Special Committee Investigation

To the extent the Complaint challenges what it describes as "a sham 'investigation' the sole purpose of which was to cover up defendants' breaches of fiduciary duties," demand is futile under *Aronson*. Compl. ¶ 139; *see also id.* ¶¶ 106, 110. The Special Committee decided not to take any action with respect to the Audit Committee's termination of two successive outside auditors and the allegations made by Ernst & Young. The conscious decision not to take action was itself a decision. *See Aronson*, 473 A.2d at 813 ("a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule"); *Krieger v. Wesco Fin. Corp.*, 30 A.3d 54, 58 (Del. Ch. 2011) ("Wesco stockholders had a choice: they could make an election and select a form of consideration, or they could choose not to make an election and accept the default cash consideration."); *Hubbard v. Hollywood Park Realty Enters., Inc.*, 1991 WL 3151, at *10 (Del. Ch. Jan. 14, 1991) ("From a semantic and even legal viewpoint, 'inaction' and 'action' may be substantive equivalents, different only in form.").

The actions of four of the seven members of the Demand Board were at issue in the Special Committee investigation: Chang, as a member of management, and Dai, Bennett, and H. Zhang, as members of the Audit Committee. For the reasons discussed

in the preceding sections, these directors could not properly consider a demand under *Aronson* that asked them to assert litigation relating to the Audit Committee's termination of the outside auditors or management's related activities. A demand to assert litigation relating to the Special Committee's investigation implicates the same issues and creates the same problems for these individuals. Because these directors comprise a majority of the Demand Board, demand is futile under *Aronson*.

B. Rule 12(b)(6)

The defendants separately contend that the Complaint fails to state a claim on which relief can be granted. *See* Ch. Ct. R. 12(b)(6). In a Delaware state court, the pleading standards for purposes of a Rule 12(b)(6) motion "are minimal." *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 27 A.3d 531, 536 (Del. 2011).

> When considering a defendant's motion to dismiss, a trial court should accept all well-pleaded factual allegations in the Complaint as true, accept even vague allegations in the Complaint as "well-pleaded" if they provide the defendant notice of the claim, draw all reasonable inferences in favor of the plaintiff, and deny the motion unless the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof.

Id. at 536 (footnote omitted). The operative test in a Delaware state court thus is one of "reasonable conceivability." *Id.* at 537 (footnote and internal quotation marks omitted). This standard asks whether there is a "possibility" of recovery. *Id.* at 537 n.13. The test is more lenient than the federal "plausibility" pleading standard, which invites judges to "determin[e] whether a complaint states a plausible claim for relief" and "draw on . . . judicial experience and common sense." *Id.* Under the Delaware test, a trial court

commits reversible error by assessing plausibility. *See Cambium Ltd. v. Trilantic Capital P'rs III L.P.*, 36 A.3d 348, 2012 WL 172844, at *2 (Del. Jan. 20, 2012) (ORDER) ("The Court of Chancery erred by applying the federal 'plausibility' standard in dismissing the amended complaint.").

"The standard for pleading demand futility under Rule 23.1 is more stringent than the standard under Rule 12(b)(6) . . . ." *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 139 (Del. Ch. 2009). A complaint that pleads a substantial threat of liability for purposes of Rule 23.1 "will also survive a 12(b)(6) motion to dismiss." *McPadden v. Sidhu*, 964 A.2d 1262, 1270 (Del. Ch. 2008). Because Chang, Teng, Dai, Bennett, and H. Zhang face a substantial threat of liability on the plaintiffs' claims for purposes of Rule 23.1, it follows that the Complaint states a claim against these directors for purposes of Rule 12(b)(6).

When a complaint alleges specific acts of fraud at a corporation, particularly acts suggesting widespread fraud, the complaint need not tie the fraud to each particular defendant to survive a Rule 12(b)(6) motion. *Rich*, 2013 WL 1914520, at *13; *In re Am. Int'l Group, Inc.* (*AIG*), 965 A.2d 763, 782 (Del. Ch. 2009). The Court can draw a reasonable inference for purposes of Rule 12(b)(6) that "even when [the defendants] were not directly complicitous in the wrongful schemes, they were aware of the schemes and knowingly failed to stop them." *AIG*, 965 A.2d at 799.

Defendant Teng co-founded the Company and has served as a director throughout its existence. From February 3, 2005 until March 13, 2009, she served as the Company's COO. Defendant Y. Tang served as the Company's CFO and Controller from October

22, 2008 until January 16, 2012. Defendant Zhu served as the Company's COO from March 13, 2009 until May 27, 2011. Defendant Wang served as a director from December 2009 until March 14, 2011. Defendant Law served as a director of the Company from January 8, 2010 until February 10, 2011. During their tenures, the Company engaged in the Offering, suffered the problems that led to the terminations of Crowe Horwath and Ernst & Young, failed to file any periodic filings required by the federal securities laws, and was delisted by NASDAQ. For purposes of Rule 12(b)(6), it is reasonable to infer that Teng, Y. Tang, Zhu, Wang, and Law knew about the oversight problems and failed to stop them. At a later stage of the case, I will take into account Wang and Law's resignations, which could well serve to limit their potential liability for events described in the Complaint that post-date their board service. *See In re Puda Coal, Inc. S'holders Litig.*, C.A. No. 6476–CS, at 15–17 (Del. Ch. Feb. 6, 2013) (TRANSCRIPT). But because Wang and Law will remain in the case regardless as to certain claims, I will not attempt to parse the implications of their resignations at the pleadings stage.

Defendant X. Zhang served as a director from February 10, 2011, until his resignation on March, 15, 2012, and defendant Sim served as a director from April 25, 2011 until his resignation effective January 25, 2012. During this period, the Company failed to file any periodic filings required by the federal securities laws, and was delisted by NASDAQ. The Complaint supports a reasonable inference that oversight problems at the Company continued during this period and that X. Zhang and Sim knew about the problems and failed to stop them. The Complaint does not state a claim against X. Zhang

or Sim for matters pre-dating their service on the board. As with Wang and Law, I will take into account their resignations at a later stage of the case.

C. Section 102(b)(7)

The defendants argue that the Complaint should be dismissed because it does not assert a claim for which the defendants could be held liable in light of the exculpatory provision in China Agritech's certificate of incorporation. Because the Complaint pleads claims that implicate the duty of loyalty, including its embedded requirement of good faith, the defendants cannot invoke the exculpatory provision as a defense at this stage.

The Complaint challenges the Yinlong Transaction, an interested transaction with a controlling stockholder where entire fairness provides the presumptive standard of review. When the entire fairness standard of review applies, "the inherently interested nature of those transactions" renders the claims "inextricably intertwined with issues of loyalty." *Emerald P'rs v. Berlin*, 787 A.2d 85, 93 (Del. 2001). Chang and Teng benefitted directly from the Yinlong Transaction, and Dai, Bennett, and H. Zhang approved it. Given the standard of review, I cannot dismiss these defendants. *See In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169, 178-79 (Del. Ch. 2005); *Sanders v. Wang*, 1999 WL 1044880, at *11 (Del. Ch. Nov. 8, 1999).

The balance of the Complaint states claims that raise questions about whether the directors acted in good faith. A Section 102(b)(7) provision "can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty." *Stone*, 911 A.2d at 367. The standard for *Caremark* liability parallels the standard for imposing liability when directors failed to

act in good faith. *See Desimone*, 924 A.2d at 935; Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559 (2008) (discussing the re-interpretation of *Caremark* as a good faith case and the potential liability risks to directors that result).

> A failure to act in good faith may be shown, for instance, [1] where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, [2] where the fiduciary acts with the intent to violate applicable positive law, or [3] where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006) (quoting *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 755-56 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). "The third of [the *Disney*] examples describes, and is fully consistent with, the lack of good faith conduct that the *Caremark* court held was a 'necessary condition' for director oversight liability . . . ." *Stone*, 911 A.2d at 369 (quoting *Caremark*, 698 A.2d at 971). The ruling that the Complaint states an oversight claim against the defendants prevents them from invoking the Company's exculpatory provision at the pleading stage.

D. The Motion To Stay

The defendants alternatively seek to stay this action until three other actions have been adjudicated on the merits: *Gearing v. China Agritech, Inc.*, 11-cv-4417 (RGK) (C.D. Cal.) ("*Gearing I*"); *Gearing v. China Agritech, Inc.*, No. SC117290 (Cal. Super. Ct., Los Angeles Cnty.) ("*Gearing II*"); and *Smyth v. Chang*, No. 1:12-cv-01262 (D. Del.) ("*Smyth*").

Gearing I is a direct action filed on May 23, 2011, alleging violations of the federal securities laws and seeking damages from the Company, Chang, Y. Tang and Bennett. In an amended pleading, the plaintiffs added Teng, Zhu, Wang, Law, Dai and H. Zhang as defendants. On June 1, 2012, the plaintiffs voluntarily dismissed the action as against the individual defendants. On July 2, 2012, the district court entered an order dismissing the action in its entirety for failure to prosecute. The plaintiffs' appeal of that dismissal is currently pending. At present, *Gearing I* is not an active case to which this Court would defer.

On June 5, 2012, the *Gearing I* plaintiffs filed a separate direct action in state court in California ("*Gearing II*") that asserted claims against the Company, certain of the individual defendants, Crowe Horwath and another accounting firm, Kabani & Co. The action was removed to federal court and subsequently remanded. *Gearing II* does not challenge the Yinlong Transaction or the termination of Ernst & Young.

Smyth is a putative class action that was filed on October 4, 2012, alleging violations of the federal securities laws. The *Smyth* action does not challenge the Yinlong Transaction or the termination of Ernst & Young.

The granting of a motion to stay is not "a matter of right," but rather rests within "the sound discretion of the Court." *Citigroup*, 964 A.2d at 117. Delaware courts have a "significant and substantial interest in overseeing the conduct of those owing fiduciary duties to shareholders of Delaware corporations." *Ryan*, 918 A.2d at 349. This Court often will stay an indemnification-oriented derivative action that seeks to recover losses suffered by the Company from other litigation in deference to the primary litigation. *See*,

e.g., *South v. Baker*, 2012 WL 4372538, at *17–18 (Del. Ch. Sept. 25, 2012) ("This Court routinely stays *Caremark* claims that seek to shift losses from the corporation to the defendant fiduciaries. . . . [P]ursuing a *Caremark* claim during the pendency of the underlying litigation or governmental investigation may well compromise the corporation's position on the merits, thereby causing or exacerbating precisely the harm that the *Caremark* plaintiff ostensibly seeks to remedy.")

The current action is not primarily an indemnification-oriented action. It challenges the Yinlong Transaction, the use of the Offering proceeds, the termination of the Company's outside auditors, and other significant decisions. As to these matters, the current action is the dog, not the tail. It would be inefficient and prejudicial to Rish to stay this litigation pending the outcome of the securities actions, particularly when the securities actions do not appear to be moving forward actively. In lieu of a stay, the better course is to require coordinated discovery on overlapping issues.

III. CONCLUSION

The Complaint has survived a motion to dismiss, and this action will not be stayed. The parties shall confer regarding a schedule for conducting discovery and bringing the matter to trial.