IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

CREATIVE RESEARCH MANUFACTURING, Plaintiff, v. ADVANCED BIO-DELIVERY LLC and PHLO SYSTEM, INC., Defendants.	)	Civil Action No. 1211-N

MEMORANDUM OPINION

Submitted: November 8, 2006
Decided: January 30, 2007

Philip A. Rovner, Esquire, Matthew E. Fischer, Esquire, POTTER ANDERSON & CORROON, Wilmington, Delaware; Roger Royse, Esquire, ROYSE LAW FIRM, PC, Palo Alto, California, *Attorneys for Plaintiff/Counterclaim Defendant Creative Research Manufacturing*

No attorney appeared for Defendants/Counterclaim Plaintiffs Advanced Bio-Delivery LLC and Phlo System, Inc.

PARSONS, Vice Chancellor.

Plaintiff, Creative Research Manufacturing ("CRM"), filed a complaint against Defendants, Advanced Bio-Delivery LLC ("ABD") and Phlo System, Inc. ("PSI") (collectively, "Defendants" or "ABD/PSI"), in this Court on March 25, 2005. The complaint alleges that Defendants breached their contract with CRM and misappropriated CRM's intellectual property, a major component of the parties' agreement. On July 28, 2006, based on ABD/PSI's failures to comply with a court order, meet its discovery obligations and obtain counsel, this Court entered a limited default judgment against Defendants directed to the merits of this action. The order provided, among other things, that the allegations of CRM's verified complaint be deemed true, established, and proven and that CRM was not in default of its obligations under the contract. Pursuant to Court of Chancery Rule 55(b), the Court also ordered that a further proceeding be held to consider the remaining aspects of CRM's proposed default judgment, including its entitlement to damages and any of the other relief it sought. The Rule 55(b) hearing took place on October 27, 2006, and Defendants failed to appear. For the reasons that follow, the Court grants subject to a few modifications CRM's proposed Final Judgment and Order.

I. FACTS AND PROCEDURAL HISTORY

A. The Dispute Between CRM and ABD/PSI

The following facts come from the verified complaint, the allegations of which are deemed true, pursuant to the July 28, 2006 Order, as well as CRM's reply to Defendants' counterclaims. Any facts alleged in CRM's reply are deemed true for the same reasons stated in the ruling supporting the Court's July 28, 2006 Order.

Plaintiff CRM is a California corporation with its principal place of business in California. Defendant ABD is a Delaware LLC formed in June 2000 with its principal place of business in New Jersey. Defendant PSI is a Delaware corporation formed in August 1999 with its principal place of business in New Jersey. PSI manages ABD and is wholly-owned by Phlo Corporation, a publicly-traded Delaware corporation.

CRM operates a contract research and development facility with some manufacturing capabilities. In or about 2001, CRM and ABD/PSI began discussions regarding the possibility of CRM licensing certain technology to ABD. The parties ultimately entered into an Alliance and Services Agreement (the "Alliance Agreement") in August 2002, but made it effective as of November 15, 2001, because CRM had been providing services to Defendants since that time. As part of the Alliance Agreement, CRM made available two of its products and related technology to ABD/PSI, giving it a "worldwide, exclusive, sublicensable, royalty-free, perpetual irrevocable license and right to the CRM Technology."

Under the Alliance Agreement, CRM undertook to provide research and development services to ABD/PSI by devoting ten days per month in its lab to work for ABD/PSI. In exchange, CRM was to receive a 15% interest in ABD and the greater of 3% of ABD's operating profit or "minimum distributions" of cash payments. For calendar year 2002, the "minimum distribution" amount to CRM was $200,000; thereafter, the minimum annual amounts were $300,000. The Alliance Agreement had an initial term of three years.

ABD/PSI launched several products based on CRM's technology and services. Meanwhile, CRM continued to develop new products and improve the technology. CRM also provided patent-related services to ABD/PSI. Between 2001 and 2005, CRM provided ABD/PSI with constant verbal and email updates and frequent written reports on the status of ongoing projects. Yet, during the same time period, ABD/PSI failed to pay the full minimum distributions to CRM. ABD/PSI also failed to provide CRM with an accounting, thereby preventing CRM from determining if it was entitled to more than the minimum amounts. For the first minimum distribution due on March 31, 2003, ABD/PSI paid CRM only $125,000 of the $200,000 owed, and it made this payment almost a year late, on February 20, 2004. Of the $300,000 ABD/PSI owed for calendar year 2003, it paid only $100,000. For calendar years 2004 and 2005, ABD/PSI paid nothing at all.

The parties signed a Memorandum of Understanding ("MOU"), dated as of September 9, 2003. Officers of ABD/PSI represented to CRM's president, Cheryl R. Mitchell, Ph.D. ("Dr. Mitchell") that the purpose of the MOU was to enable ABD/PSI to allocate, for accounting purposes, a portion of the minimum distributions to technology they received from CRM. In particular, the MOU allocated $532,784 of the minimum distributions to that technology. The MOU also provided that in the event of a termination of the Alliance Agreement, CRM would be entitled to a termination amount equal to no less than $532,784 less any minimum distributions previously made to CRM. Although the MOU may be unenforceable for lack of consideration, it confirms that CRM transferred technology to ABD and received a 15% membership interest in ABD.

On February 10, 2005, CRM provided ABD/PSI and its patent attorneys three full drafts of patent applications (without the claims) for technologies CRM had developed since the Alliance Agreement. On February 22, 2005, CRM's inventors participated in a teleconference with ABD/PSI's patent attorneys to discuss the patent applications. Three days later, on February 25, ABD/PSI delivered to CRM a purported notice of termination of the Alliance Agreement (the "Notice of Termination"), asserting that CRM had failed to deliver the intellectual property required under the Agreement. The Notice of Termination purported to terminate both the Alliance Agreement and CRM's 15% interest in ABD, and it demanded that CRM pay for the costs of completing the patent application.

After sending the Notice of Termination, ABD/PSI's vice president and general counsel, Anne Hovis, informed CRM that ABD/PSI intended to complete the filing of the patent application after a scientific study, without using any further research and development of CRM. CRM asserts that this filing would be premature and could diminish the value of the patents. Despite the Notice of Termination, ABD also continues to refer to CRM's employees on its website and has refused to remove these references.

By letter dated March 4, 2005, CRM denied that it was in default of its obligations under the Alliance Agreement. Having tried, and failed, to persuade ABD/PSI of the merits of its position, CRM commenced this action against them. Notwithstanding ABD/PSI's breach, CRM has continued working on the patents so as to complete the analysis required.

B. CRM's Litigation in this Court and Attempts at Discovery

CRM filed its complaint against ABD/PSI on March 25, 2005. ABD/PSI answered and asserted three counterclaims on May 10, 2005. CRM replied on May 30. On June 1, 2005, ABD/PSI's Delaware attorneys filed an unopposed motion to substitute counsel, which this Court granted the same day. On October 25, 2005, CRM filed its first motion to compel. The Court granted this motion and ordered ABD/PSI to pay CRM $250 in attorneys' fees. On December 12, CRM filed a renewed motion to compel and for attorneys' fees. The Court granted that motion as well and ordered ABD/PSI to pay CRM $1500 in attorneys' fees. On December 22, Defendants' second Delaware counsel moved to withdraw, which this Court allowed on the condition that ABD/PSI obtain substitute counsel.

On January 26, 2006, CRM again moved for default judgment. In that motion, CRM argued that ABD/PSI repeatedly had failed to engage in discovery or abide by the Court's various discovery orders.

On February 16, 2006, ABD/PSI obtained new counsel, who represented to the Court that they would immediately provide any outstanding discovery. On that basis, the Court denied CRM's motion for default judgment, subject to Defendants providing by March 10 "an affidavit confirming that no documents had been withheld from production on the basis of any objection other than attorney-client privilege and/or work product." On March 10, rather than produce such an affidavit, ABD/PSI's new counsel moved to withdraw. CRM again moved for default judgment.

On March 21, 2006, the Court denied the latest motion for default judgment and ordered Defendants to submit an affidavit by March 31, with the help of counsel, detailing their attempts to comply with the outstanding discovery. On March 31, ABD/PSI submitted an inadequate affidavit prepared without the assistance of counsel. Consequently, Defendants' counsel renewed their motion to withdraw, which the Court granted on April 20, based on ABD/PSI's reportedly having obtained new in-state and out-of-state counsel on April 17.

On April 18, 2006, the Court entered a scheduling order, providing for a trial on the merits of this action beginning on August 28, 2006. On May 11, CRM again moved to compel and for sanctions because Defendants still had provided neither the required affidavit nor the requested discovery. In a teleconference on May 16, the Court ordered ABD/PSI to complete their document production and supplement their discovery by June 6. On June 6, counsel for ABD/PSI represented to CRM's counsel that his client "has determined that the responses are sufficient and will not be supplemented."[1] He further stated that ABD/PSI "has not located any additional documents to produce."[2]

On June 15, 2006, CRM's counsel objected to the adequacy of the ABD/PSI's representations.[3] ABD/PSI's counsel did not respond to these objections; rather, they moved to withdraw on June 20. Both ABD/PSI's local and out-of-state counsel cited

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1 Ex. A to June 23, 2006 Letter from Philip Rovner to Court.

2 *Id.*

3 Ex. B to June 23, 2006 Letter from Philip Rovner to Court.

their client's insistence upon taking action or not taking action with which counsel has a fundamental disagreement as a reason for their motions. Additionally, they asserted that the client had created a situation where it would be unreasonably difficult to continue the relationship based on, among other things, Ms. Hovis's making ethical complaints to the State Bar Association against ABD/PSI's counsel.

On June 27, the Court held a teleconference on the motions to withdraw. Although ABD and PSI are artificial entities, I allowed them to appear without counsel solely for the purpose of disputing the motions of their counsel to withdraw. After listening to both sides, I concluded that it would be unreasonably difficult for the attorneys to go forward with the representation of Defendants. Thus, pursuant to Delaware Rules of Professional Conduct 1.16(b)(4), (b)(6) and (b)(7), I granted ABD/PSI's local counsel's motion to withdraw. Because of the likelihood of material prejudice to CRM if both firms were permitted to withdraw, I denied Defendants' out-of-state counsel's motion to withdraw without prejudice. To keep the litigation on track, I also ordered Defendants to obtain acceptable replacement Delaware counsel by July 10, and both sides to submit status reports by that date.

On July 7, ABD/PSI's remaining out-of-state counsel advised the Court that they had not been successful in finding replacement Delaware counsel and renewed their motion to withdraw. On July 10, CRM filed its status report and requested leave to renew its motion for default judgment. The Court granted this request on July 11 and scheduled a hearing for July 27. By that date, ABD/PSI still had not obtained local counsel.

At the July 27 hearing, Defendants' out-of-state counsel explained the basis for the conflicts that had arisen with their client and that they had been unable to locate Delaware counsel. Again, I permitted Ms. Hovis to respond for Defendants solely for purposes of disputing the out-of-state counsel's motion to withdraw. Because Defendants had not obtained local counsel and their out-of-state counsel credibly represented that they had irreconcilable differences that made continuing representation unreasonably difficult, I concluded that the withdrawal of counsel was appropriate under Delaware Rules of Professional Conduct 1.16(a)(1), (b)(6) and (b)(7).[4] Therefore, I granted Defendants' out-of-state counsel leave to withdraw.

C. Default Judgment Against ABD/PSI Granted

At the July 27 hearing, I also granted a limited default judgment against ABD/PSI.[5] ABD/PSI's failure to obtain Delaware counsel, their inability to retain out-of-state counsel and their general obstruction of this litigation had created a situation that seriously prejudiced CRM's ability to prosecute its claims. Defendants, as artificial entities, had delayed the proceeding to such an extent that they could not comply with the

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[4] Although ABD/PSI's out-of-state counsel also moved to withdraw under Rules 1.16(b)(4) and (b)(5), I denied that aspect of their motion without prejudice. Consideration of those arguments would have required more development of the factual record.

[5] Although the Court permitted Ms. Hovis to dispute the pending motion to withdraw, her submissions addressing the default judgment were rejected because Defendants, as artificial entities, cannot appear pro se. *See Parfi Holding AB v. Mirror Image Internet, Inc.*, 2006 WL 903578, at *2 n.4 (Del. Ch. Apr. 3, 2006); *Weber v. Kirchner*, 2003 WL 23190392, at *1 (Del. Ch. Dec. 31, 2003); *Transpolymer Indus., Inc. v. Chapel Main Corp.*, 582 A.2d 936, 1990 WL 168276, at *1 (Del. 1990) (Table).

existing scheduling orders even if the Court had granted them an extension to find their sixth or seventh counsel.

ABD/PSI's failure to meet the extended deadlines offered by the Court and their conscious disregard of various Court orders demonstrated an improper dilatory purpose. In pursuing these delay tactics, intentional or otherwise, Defendants prejudiced CRM's rights to pursue their claims in a timely fashion. Because CRM complied in good faith with the court's pretrial discovery procedures and repeatedly sought to expedite this litigation, they should not have been deprived of a prompt adjudication by litigants who disregarded the same rules.[6] Thus, on July 27, I granted a limited default judgment in CRM's favor, finding that the allegations of the verified complaint would be deemed true, established and proven, and that CRM was not and is not in default of its obligations under the Alliance Agreement.[7]

With respect to the damages and other relief sought by CRM, I decided to conduct a further proceeding pursuant to Rule 55(b). The July 28, 2006 order directed the parties to meet and confer regarding a proposed scheduling order for the damages hearing and to submit an agreed form of scheduling order by August 28. Absent agreement, each party was to submit their own proposed order and a letter stating their position. In CRM's August 28 letter, their counsel advised the Court that they had not been able to meet and

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6 *See Wahle v. Med. Ctr. of Del.*, 559 A.2d 1228, 1233 (Del. 1989).

7 I also awarded attorneys fees to CRM for its pursuit of their renewed motion for default judgment. At the October 27, 2006 hearing, I determined the amount of that award to be $5000.

confer with Defendants because they had not retained new counsel. Ms. Hovis, in response to CRM's letter, advised the Court that she had not received a copy of the July 28 order memorializing the July 27 oral ruling. On September 1, 2006, the Court notified both CRM and ABD/PSI, through Ms. Hovis, that it would extend the deadline for submitting a proposed scheduling order until September 15, 2006 (the "September 1 Letter"). The Court also reminded the parties that Defendants had to submit any proposed scheduling order through counsel, and that the hearing could take place in the October time slot previously reserved for the trial on the merits of this matter.

On September 15, 2006, the Court received another letter from CRM's counsel, largely restating the argument in their August 28 letter. Neither ABD/PSI nor Ms. Hovis filed anything suggesting that either or both Defendants had retained counsel. Thus, based on the communications from CRM's counsel, the Court scheduled the damages hearing for October 27, 2006.

D. October 27, 2006 Damages Hearing

1. Notice of the hearing

The Court held the damages hearing as scheduled on October 27, 2006. Only CRM appeared. Pursuant to the Court's request at the hearing, CRM filed and served on Ms. Hovis a further submission on November 8, 2006 with additional support for its claim for relief and a proposed form of Order. On November 15, 2006, Ms. Hovis telephoned my chambers and left a message that she had never received notice of the October 27 hearing (the "Hovis Voice Mail"). The following day, the Court sent a letter to all parties notifying them about the Hovis Voice Mail (the "November 16 Letter"). In

the November 16 Letter, I reiterated that ABD and PSI, as artificial entities, had to communicate with the Court through counsel and directed them to file any formal objection based on a lack of notice of the damages hearing in accordance with Court of Chancery Rule 79.1 on or before December 1, 2006. The Court also required CRM to provide evidence that ABD and PSI were sent notice of the October 27 hearing by November 22, 2006. Since the November 16 Letter, neither ABD nor PSI has filed any formal objection or otherwise communicated with the Court regarding this litigation.

CRM did submit a letter on November 22, stating that it did not know whether ABD and PSI had actual notice of the October 27 hearing. CRM argues, however, that the Court's September 1 Letter provided at least constructive notice to ABD and PSI that the hearing would occur in October. Further, CRM noted that Phlo Corporation's most recent quarterly SEC Form 10-QSB stated in relevant part:

> *As Advanced Bio-Delivery, the operating entity involved in this litigation, has been dissolved by operation of the provisions of its operating agreement and is no longer conducting business, [Phlo Corporation] did not continue to dedicate additional financial resources to the defense of the claims and the prosecution of its counterclaims.* Therefore, a decision was entered by a Delaware Court of Chancery in the fiscal quarter ended September 30, 2006, that the plaintiff's allegations are true. A decision has not yet been rendered with respect to the amount of damages, if any, suffered by the plaintiff or with respect to what relief, if any, may be awarded. Management believes that grounds for appeal currently exist which may be asserted once a final determination is made in the case.[8]

[8] Ex. E to Nov. 22, 2006 Letter from Philip Rovner to Court (emphasis supplied by CRM).

This filing demonstrates that ABD deliberately abandoned its defense of this litigation and had no intention of participating in the damages hearing.

2. Evidence presented at the October 27 damages hearing

At the damages hearing, CRM's President, Dr. Cheryl Mitchell, testified as to the Alliance Agreement, the technology at issue, the events leading up to ABD/PSI's Notice of Termination, and the damages CRM incurred as a result of ABD/PSI's breach, as well as the costs CRM incurred performing its end of the Agreement.

Dr. Mitchell, who holds a Ph.D. in Chemistry, explained how she had met Ms. Hovis in 2000 and why her company decided to work with ABD/PSI to capture a different segment of the oral rehydration market. Dr. Mitchell explained how the Alliance Agreement called for CRM to dedicate ten days of lab time per month to ABD/PSI and described the intellectual property CRM was to provide to ABD. Because ABD/PSI led CRM to believe that they had a venture capitalist supporting them, CRM continued to provide the lab time despite not having received the minimum distributions required under the Alliance Agreement. CRM also paid $62,685 in costs related to ingredients ABD/PSI ordered and had provided to CRM. In addition, CRM had begun to pay its manufacturers out of pocket in order to maintain those relationships and its reputation.

As to the ten days per month of lab time CRM contracted to provide to ABD/PSI, Dr. Mitchell explained that the lab operated roughly 21.5 days out of each month; thus, CRM alleged that it dedicated 46.5% of its lab's time to work for ABD/PSI under the Alliance Agreement. Based on CRM's 2002-2004 tax returns, later provided in redacted

form to the Court, the total operating costs of CRM during the period in question were $4,084,669, and 46.5% of that amount is $1,899,371. Adding in the $62,685 it paid out of pocket for manufactured ingredients, CRM claimed that the total cost it incurred in connection with the Alliance Agreement was $1,962,056. CRM also calculated the minimum distributions owed to it under the Alliance Agreement to be $771,027.40, of which ABD/PSI had paid only $225,000.[9]

3. Damages and relief requested

CRM seeks equitable rescission of the Alliance Agreement. Additionally, CRM seeks reimbursement for the product development and technological support services it provided to ABD/PSI under the terms of the Alliance Agreement. The amount CRM seeks is $1,737,056, representing the sum of the $1,899,371 in lab fees and the $62,685 in manufacturing expenses paid out of pocket, less the $225,000 already paid by ABD/PSI. CRM also requests post-judgment interest and its attorneys' fees.

In addition, CRM seeks a permanent injunction against ABD/PSI precluding them from filing any patent application related to technology developed by or received from CRM, utilizing or referring to any technology developed by CRM under the Alliance Agreement, utilizing or claiming any right or interest in any technology covered by any patent application or draft patent application provided by CRM to ABD/PSI and making

[9] *See* Verified Compl. ¶¶ 36-38. The odd amount represents the prorated portion of $300,000 attributable to work completed during the relevant part of the 2005 calendar year.

any reference to an ongoing business relationship with CRM, CRM's employees or Dr. Mitchell, including on any website controlled by ABD/PSI.

II. ANALYSIS

The Court conducted the hearing on October 27, 2006 pursuant to Court of Chancery Rule 55(b) to determine the appropriate relief for ABD/PSI's breach of contract.[10] CRM primarily seeks rescission of the Alliance Agreement. In addition, it seeks monetary relief consistent with an order rescinding the Agreement, injunctive relief, attorneys' fees and post-judgment interest. I will address each of those requested forms of relief in that order.

A. Equitable Rescission

This Court has jurisdiction over claims for equitable rescission.[11] Equitable rescission, or cancellation, is a form of remedy that provides equitable relief beyond a judicial declaration of contract invalidity or award of money or property and seeks to restore the plaintiff to his original condition.[12] Typically, it requires the court to "cause

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[10] Rule 55(b) states in relevant part: "If, in order to enable the Court to enter judgment or to carry it into effect, it is necessary to take an account or to determine the amount of damages or to establish the truth of any averment by evidence or to make an investigation of any other matter, the Court may conduct such hearings or order such references as it deems necessary and proper."

[11] *See Williams v. White Oak Builders, Inc.*, 2006 WL 1668348, at *4 n.72 (Del. Ch. June 6, 2006); DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY, § 12-4[a] at 12-52 (2005) ("[E]quitable relief may also be required, thus necessitating equitable rescission, where the unwinding of a transaction calls for the restoration of unique, specific property from one party to another.")

[12] *E.I. du Pont de Nemours & Co. v. HEM Research, Inc.*, 1989 WL 122053, at *3 (Del. Ch. Oct. 13, 1989).

an instrument, document, obligation or other matter affecting plaintiff's rights and/or liabilities to be set aside and annulled, thus restoring plaintiff to his original position and reestablishing title or recovering possession of property."[13] "An outright refusal of one party to a contract to perform the contract or its essentials constitutes such a repudiation as to entitle the other contracting party to treat the contract as rescinded, . . . and, as is generally held, an unjustified failure to perform basic terms of a contract warrants rescission rather than mere damages."[14] The party seeking rescission bears the burden of establishing that the court can restore the status quo between the parties.[15]

The Alliance Agreement contemplated payments to CRM from ABD/PSI for services rendered. The verified complaint demonstrates that the Alliance Agreement called for, among other things, minimum annual distributions to CRM. While CRM did receive partial payment toward these minimum distributions, the payments were delinquent and a substantial balance remains outstanding.[16] Further, Defendants' failure to provide the required accounting of their net profits during the years of the Alliance Agreement has prevented CRM from discovering whether they are entitled to more than

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13 *Id.*

14 *Sheehan v. Hepburn*, 138 A.2d 810, 812 (Del. Ch. 1958).

15 *Obara v. Moseley*, 692 A.2d 414, 1997 WL 70652 (Del. 1997) (Table) ("The court must substantially restore the prior position of all parties in its grant of rescissionary relief.").

16 Verified Compl. ¶¶ 35-38.

the minimum distribution.[17] ABD/PSI offered no excuse for their delay or failure to pay the full minimum distributions to CRM. ABD/PSI's refusal to perform an essential obligation under the Alliance Agreement (minimum payment) constitutes the requisite repudiation required for CRM to treat the contract as rescinded. Their failure to pay the minimum distributions is also a material breach of the Alliance Agreement.

Equitable rescission is justified here, particularly since the services and other obligations owed by each party under the Alliance Agreement are not so complex that it would be "impossible to 'unscramble the eggs.'"[18] Unlike a complex transaction with numerous parties involved, the only parties to the Alliance Agreement are CRM and ABD/PSI. Rescission would result in the Alliance Agreement being annulled and regarded as void *ab initio*. Restoring the parties to the positions they had before the Alliance Agreement would require, among other things, that the technology CRM provided to ABD/PSI be returned to it and that CRM return to ABD/PSI the 15% interest in ABD that it received as consideration under the Alliance Agreement.

The evidence that ABD/PSI planned to move forward with patent applications that could cause additional damage to CRM's own intellectual property provides further

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[17] For example, the Alliance Agreement made CRM a signatory to ABD's LLC Agreement. Pl.'s Ex. 3 (Verified Compl. Ex. A, Alliance Agreement, § 7.1(b), p. 7). Under Article IV of the ABD LLC Agreement, all members of ABD were entitled to access to the company's books and records. Pl.'s Ex. 3 (Verified Compl. Ex. B, ABD LLC Agreement, Art. IV). Because the Alliance Agreement entitled CRM to the greater of 3% of ABD's operating profit or the minimum distributions, CRM's request for books and records clearly was reasonable.

[18] *Gimbel v. Signal Cos.*, 316 A.2d 599, 603 (Del. Ch. 1974).

grounds for equitable rescission of the contract. CRM provided to ABD/PSI's patent attorneys three full drafts of patent applications related to technology developed by CRM for the Alliance Agreement.[19] CRM's February 22, 2005 teleconference with ABD/PSI's patent attorneys demonstrates that ABD/PSI was familiar with the technology CRM had provided. ABD/PSI's February 25, 2005 Notice of Termination shows a desire on their part to convert CRM's property for their own use. Through this litigation, CRM has proven that the Notice of Termination was wrongful. Therefore, the Court will order that the technology CRM owned and provided or assigned to Defendants under the Alliance Agreement be returned to CRM's title and possession as if it never left.

Equitable rescission also requires putting each party in as close to the position they would have been in but for the creation of the contract.[20] On these facts, this would require reimbursement of the expenses CRM incurred during the Alliance Agreement. CRM has provided evidence of its lab expenses and its out-of-pocket manufacturing expenses. Because the contract calls for CRM to devote ten days of each working month to projects related to the Alliance Agreement, CRM argues that 46.5% of its lab resources

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19 Verified Compl. ¶ 28.

20 *See Dick v. Reves*, 206 A.2d 671, 676 (Del. 1965) (allowing reimbursement of incidental expenses in a rescission for a real property contract that otherwise would not have been expended because the court will do "whatever is necessary to restore the parties to their original situation as nearly as possible"). *See also Obara*, 1997 WL 70652, at *1 ("The court must substantially restore the prior position of all parties in its grant of rescissionary relief.").

were devoted to ABD/PSI and should be reimbursed.[21] Using the 46.5% figure, CRM argues that it is entitled to $1,962,056 less the $225,000 paid by ABD/PSI for a total amount of $1,737,056.

Having reviewed the evidence and argument submitted by CRM in support of its claim for more than $1.7 million in expenses, I find the evidence insufficient to support that amount. In particular, I am not persuaded that it is reasonable to assume that 46.5% of all CRM's expense during the relevant period can be attributed to the Alliance Agreement. Instead, I find the summaries of the time recorded on CRM's official timesheets for "Phlo" related projects and attested to by Terra Briel[22] to be more reliable. Thus, to put CRM back in approximately the position it would have been in had the Alliance Agreement never been formed requires closer examination of those time sheets in relation to the expenses CRM incurred during the relevant period, as evidenced by its income tax returns.[23]

CRM admits that the time sheets summaries it introduced as Exhibit 7 at the damages hearing were prepared after this litigation began. While the summaries reflect "the time recorded on CRM official timesheets for 'Phlo' related projects," the entries for Dr. Mitchell's time from June 2004 through February 2005 are admittedly only estimates

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21 Dr. Mitchell testified that she arrived at the 46.5% number by estimating the number of working days available in a given month (21.5) and dividing it into the 10 days devoted to ABD/PSI projects.

22 Pl.'s Ex. 7.

23 See Ex. A to CRM's Post-Default J. Submission.

because corporate changes no longer required Dr. Mitchell to keep track of her time for individual projects during that period. Dr. Mitchell's estimated time in February 2005 is higher than in the other recorded months, but as she explained at the hearing, this resulted from her involvement in preparing the patent applications at that time. Otherwise, her estimate of time from July 2004 until December 2004 is below her average hours devoted to ABD/PSI before the estimated period. Accordingly, I find that the estimates of Dr. Mitchell's time are reasonable and that the time sheet summaries accurately reflect the time CRM's employees devoted to ABD/PSI projects.[24]

Determining the resources expended on ABD/PSI-related work also requires examination of the CRM Income Tax Return Summary of Operating Costs ("Summary of Operating Costs").[25] The first time period shown in the Summary of Operating Costs runs from July 1, 2002 until June 30, 2003. According to the summary of time sheets from August 2002 through December 2002, approximately eight CRM employees[26] devoted a total of 1828.75 hours to ABD/PSI projects, or an average of 365.75 hours per month for that period. The equivalent of one month of work by a full time CRM

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[24] In this regard, I do not find that Ms. Briel's comment that she understood "from direct conversations with employees of Creative Research Management that additional time was spent on "Phlo" projects but not specifically recorded on the official company time sheets," justifies any increase of the number of hours expended.

[25] CRM's Post-Default J. Submission, Ex. A.

[26] Because it appears that a ninth CRM employee only worked on ABD/PSI projects in August 2002, I find it more reasonable to calculate the average time spent by CRM from August through December 2002 using eight employees.

employee would be 8 hours/day times 21.5 working days/month or 172 hours. Using this measure, the 1828.75 hours spent by the CRM employees from August through December 2002 would equate to 26.6% of the time spent by those lab employees being devoted to ABD/PSI.[27] According to the summary of time sheets from January 2003 through June 2003, eight CRM employees devoted a total of 1248.75 hours to ABD/PSI, or 208.13 hours per each of the first six months of 2003. I infer from this that 15.13% of CRM's lab time from January through June 2003 was devoted to ABD/PSI. Over the eleven month period, then, 3,077.50 hours of CRM lab time involved work related to the Alliance Agreement, or 279.77 hours per month. Thus, assuming the full amount of time worked by CRM would be represented by eight employees working 172 hours/month, 20.33% of CRM's lab time was devoted to ABD/PSI in its 2003 fiscal year from July 1, 2002 to June 30, 2003. In this same period, CRM's operating expenses totaled $813,331. Therefore, I find that the ABD/PSI portion of the operating expenses from July 1, 2002 until June 30, 2003 is 20.33% of this total, or $165,369.06.

The second time period in question runs from July 1, 2003 until December 31, 2003. The time sheets indicate that the eight CRM employees devoted a total of 959.25 hours to ABD/PSI in this period, or 159.88 hours per month. If CRM had only eight employees during this period and they worked an average of 172 hours/month, then CRM devoted 11.62% of its lab time from July 2003 until December 2003 to ABD/PSI.

[27] This number was calculated by dividing the hours/month (365.75) by 1376 (the hours available per month (172) multiplied by the number of employees working (8)).

According to the Summary of Operating Costs for this same period, CRM's operating expenses totaled $493,393. Thus, I find the ABD/PSI portion of the operating expenses from July 1 until December 31, 2003 to be 11.62% of this total, or $57,326.46.

The final time period runs from January 9, 2004 until December 31, 2004. The time sheet summaries indicate that eight CRM employees worked 1120 hours on ABD/PSI projects during this period, or 93.33 hours per month. Using the same assumptions as before, I find that 6.78% of CRM's lab time in 2004 was devoted to ABD/PSI. CRM's Summary of Operating Costs for this same period indicates that its operating expenses totaled $2,777,945. Therefore, I find the ABD/PSI portion of the operating expenses for 2004 to be 6.78% of this total, or $188,426.50.

Adding these adjusted numbers for the three years in question, the total amount of CRM operating expenses attributable to ABD/PSI is $411,122.02. In addition, CRM also is entitled to recover $62,685.62 for out-of-pocket expenses it incurred on ABD/PSI's behalf. Those expenses include the amount of money CRM spent, with the understanding that it would be fully reimbursed, for manufactured ingredients and freight for ingredients supplied to Defendants in response to a purchase order that they provided to CRM, as well as the costs of providing marketing samples to Defendants and warehousing costs incurred by CRM on Defendants' behalf.[28] Thus, the total amount CRM spent, according to these calculations, was at least $473,807.02.

[28] *See* Pl.'s Ex. 3, ¶ 39; Ex. 4, p. 58; Ex. 6.

At the damages hearing, CRM sought either reimbursement for the costs it incurred for laboratory services to ABD and out-of-pocket ingredient manufacturing and freight expense less the $225,000 ABD/PSI paid to CRM toward the required minimum distribution payments or, alternatively, the minimum distribution amount still outstanding, which it claimed to be $546,027. The former figure is more in the nature of rescissionary damages, while the latter seems to reflect a possible measure of damages for breach of contract. Because CRM seeks several forms of relief based on a rescission theory, I conclude that a rescissionary damages approach is more appropriate in the circumstances of this case.

The Court of Chancery has broad discretion to fashion rescissory relief consistent with the equities of the situation and the conduct of the parties.[29] The objective is to substantially restore the parties to the position they would have occupied before the Alliance Agreement and to reestablish title and possession of property in the appropriate party.[30] In the circumstances of this case, the extensive nonmonetary relief being granted to CRM leads the Court to conclude that it would not be appropriate to use a breach of contract measure of damages, such as ordering payment to CRM of the unpaid balance of the minimum distribution payments. Instead, the Court will award rescissory damages in

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[29] *See Liberis v. Europe Cruises Corp.*, 702 A.2d 926, 1997 WL 725634 (Del. 1997) (Table) (affirming award of rescissory damages and partial restoration of status quo ante).

[30] *See E.I. du Pont de Nemours & Co. v. HEM Research, Inc.*, 1989 WL 122053, at *3 (Del. Ch. Oct. 13, 1989); *Obara v. Mosely*, 692 A.2d 414, 1997 WL 70652, at *1 (Del. 1997) (Table).

the amount of the operating costs and out-of-pocket expenses CRM incurred, $473,807.02, minus the $225,000 paid to CRM by ABD/PSI under the Alliance Agreement, which equals $248,807.02.

In summary, with regard to the equitable rescission CRM requests, the Court will rescind the Alliance Agreement, order all technology and intellectual property CRM provided to ABD/PSI returned to CRM's title and possession and award monetary relief in the amount of $248,807.02.

B. Injunctive Relief

CRM seeks a permanent injunction against ABD/PSI prohibiting them from (a) filing any patent application relating to any technology developed by or received from CRM; (b) utilizing or referring to any technology developed by CRM under the Alliance Agreement; (c) utilizing or claiming any right or interest in any technology covered by any patent application or draft patent application provided by CRM to Defendants; and (d) making any reference regarding an ongoing business relationship with CRM, CRM's employees, or Dr. Mitchell, including on any website controlled by Defendants.[31]

"To obtain a permanent injunction the moving party must demonstrate that: (1) it has proven actual success on the merits of its claims; (2) irreparable harm will be suffered if injunctive relief is not granted; and (3) the harm that will result if an injunction is not entered outweighs the harm that will befall the defendant if an injunction is granted."[32]

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[31] CRM's Post-Default J. Submission ¶ 9.

[32] *W.L. Gore & Assocs., Inc. v. Wu*, 2006 WL 2692584, at *10 (Del. Ch. Sept. 15, 2006), *aff'd*, 2007 WL 148690 (Del. Jan. 22, 2007).

By virtue of the default judgment, CRM has succeeded on the merits of its claims. Further, Dr. Mitchell's trial testimony showed that CRM's patents and its relationship with other clients have been adversely affected by ABD/PSI's actions with regard to the Alliance Agreement. The record also demonstrates that ABD/PSI's continued use of the technology and the draft patent applications provided to them by CRM would result in irreparable harm to CRM. This harm outweighs any harm that will befall ABD/PSI if the Court grants the requested injunction, particularly since Phlo Corporation's recently filed SEC Form 10-QSB indicates that its operating affiliate ABD has been dissolved. Thus, the Court will grant CRM's request for a permanent injunction subject to one modification. Paragraph 5(b) of CRM's proposed Final Judgment and Order would permanently enjoin Defendants from "utilizing or referring to any technology developed by CRM under the Alliance Agreement." The phrase "or referring to" in that clause is vague and ambiguous, and the prohibition of such conduct has not been justified in this proceeding. Accordingly, the Court will strike that phrase from the Final Judgment and Order, as entered.

C. Attorneys' Fees

CRM seeks attorneys' fees and expenses related to this matter exclusive of those amounts CRM previously requested in connection with this Court's previous awards of limited fees on three prior occasions.[33] It is a well-recognized exception to the American Rule that a prevailing party may obtain an award of attorneys' fees if it demonstrates that

[33] CRM's Post-Default J. Submission ¶ 10 n.3 and Ex. B (Rovner Aff.) ¶¶ 1-2.

the losing party engaged in bad faith conduct that increased the costs of the litigation or egregious pre-litigation conduct.[34] As previously described, ABD/PSI's conduct before and during this litigation has been egregious and meets the level of bad faith that justifies an award of attorneys' fees. In addition to Defendants prejudicing CRM's rights to pursue their claims in a timely fashion, they have openly defied orders of this Court designed to keep this litigation moving forward. ABD/PSI's behavior also has forced several of their different attorneys to withdraw. As to the amount of fees, the Court credits the Rovner Affidavit and grants, as reasonable, CRM's request for $121,632.00 in attorneys' fees and $13,129.85 in costs in connection with the prosecution of this action through July 28, 2006.[35]

D. Post-Judgment Interest

CRM is entitled to post-judgment interest from the date judgment is entered to the date of payment pursuant to 6 *Del. C.* § 2301(a). The applicable post-judgment interest rate is 11.25% (the Federal Reserve discount rate of 6.25% plus 5%).

III. CONCLUSION

For the reasons stated herein and in support of the Court's July 28, 2006 Default Judgment and Order, the Court will grant and enter CRM's proposed Final Judgment and

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[34] *Arbitrium (Cayman Is.) Handels AG v. Johnston*, 705 A.2d 225, 231 (Del. Ch. 1997), *aff'd*, 720 A.2d 562 (Del. 1998).

[35] Rovner Aff. ¶¶ 1-2, attached as Ex. B to CRM's Post-Default J. Submission. CRM does not seek reimbursement of the fees and expenses it incurred in connection with its request for equitable and injunctive relief and an award of monetary damages. *Id.*

Order subject to the amendment of paragraph 5(b) described above and the substitution of a new paragraph 7 on rescissory damages consistent with this memorandum opinion.