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Client Alert

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No "Dummy Directors": DE Court Refuses to Dismiss Loyalty Claims Against Outside Directors for Failure to Monitor

In a recent bench ruling, Chancellor Leo E. Strine, Jr., of the Delaware Court of Chancery, refused to dismiss claims alleging that the former outside directors of a Delaware corporation doing business in China had breached their fiduciary duty of loyalty. The plaintiffs claimed that the directors failed their oversight function by not detecting the theft of the corporation's primary assets by a company insider. Although the case involves highly unusual facts, the court's dicta serves as a strong warning to outside directors, particularly those serving at companies whose primary operations are in foreign, less-developed countries. In particular, Chancellor Strine cautioned that:

> if you're going to have a company domiciled for purposes of its relations with its investors in Delaware and the assets and operations of that company are situated in China that, in order for you to meet your obligation of good faith, **you better have your physical body in China an awful lot** (emphasis added).

He further warned that such directors "better have in place a system of controls to make sure that you know that you actually own the assets" and "have the language skills to navigate the environment in which the company is operating."

Background

The alleged facts in *In re Puda Coal, Inc. Stockholders Litigation*, C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013), appear extraordinary and are also the subject of a Securities and Exchange Commission ("SEC") enforcement action and a federal securities law class action. The company was a publicly-held Delaware corporation with its operations in China. In 2011, the company disclosed that its outside auditor had resigned and that the audit committee of its board of directors was conducting an internal investigation, which the company said was in response to an article published online by a short seller alleging various improprieties. The audit committee determined that the company's chairman had inappropriately transferred the company's primary operating subsidiary to himself. The SEC suspended trading in the company's stock, and the outside directors later resigned from the board of directors due to an alleged lack of cooperation from the company in trying to investigate and pursue the company's claims.

Bench Ruling

In the Delaware derivative litigation, the stockholder-plaintiffs alleged that the directors had acted in bad faith by failing to adequately monitor the corporation. Among other things, the plaintiffs claimed that 18 months had passed before the board of directors determined that most of the corporation's assets had been stolen by the chairman. As summarized by the court, the complaint alleged that "somebody took hold of an American vehicle, filled it with assets, sold a large amount of stock to the American investing public[, and] that independent directors were willing to go on and be a vehicle and get payments without understanding the duties they were taking on."

Ruling from the bench, the court denied the defendants' motion to dismiss for failure to state a claim. The court held that the complaint sufficiently alleged that the former outside directors breached their fiduciary duty of loyalty by failing to discharge their oversight function. "Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world," the court said, "**have a duty not to be dummy directors**" (emphasis added).

Comparing a director to a "mannequin," the court explained that directors cannot "allow[] themselves to be appointed to something without any serious effort to fulfill the[ir] duties." It continued that "[t]here's no such thing as being a dummy director in Delaware, a shill, someone who just puts themselves up and represents to the investing public that they're a monitor." The court reasoned that outside directors are selected, not "for their industry experience," but "because of their independence and their ability to monitor the people who are managing the company." Thus, in light of the severity of the alleged theft and the length of time for which it went undiscovered, the court concluded that "[i]t's perfectly conceivable on these pled facts that there wasn't a good faith effort to try to monitor."

The court also indicated that the outside directors may have breached their fiduciary duty by resigning from the board of directors. By leaving the board, the outside directors left the company in control of the insider who allegedly stole its assets. The court stated that "if these directors are going to eventually testify that at the time that they quit they believed that the chief executive officer of the company had stolen the assets out from under the company, and they did not cause the company to sue or do anything, but they simply quit, I'm not sure that that's a decision that itself is not a breach of fiduciary duty."

Implications

Puda Coal is a bench ruling that should be understood in context.[1] The case involves extraordinary allegations of fraud that apparently went undetected for 18 months and eventually led to the voluntary resignations of the outside directors. It also comes at a time when U.S. regulators are increasing their oversight of Chinese companies, particularly in the context of reverse mergers and other cases of financial fraud.[2] In addition, Delaware's jurisprudence on the board of directors' duty of oversight (often referred to as "*Caremark* claims"[3]) makes clear that plaintiffs are subject to a high standard in holding directors liable.[4] *Puda Coal* is one of only a handful of *Caremark* claims to survive a motion to dismiss.[5]

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[1] Bench rulings, by their nature, are usually time-sensitive and do not contain the analysis and details associated with formal memorandum opinions. Chancellor Strine has previously observed that "[p]eople now are putting too much stock in bench rulings." *Brinkerhoff v. El Paso Pipeline GP Company, L.L.C.*, C.A. No. 7141-CS, trans. ruling at 3 (Del. Ch. Oct. 26, 2012).

[2] In 2011, the SEC issued an investor bulletin warning of the risks associated with reverse mergers. *See* SEC, Office of Investor Education and Advocacy, *Investor Bulletin: Reverse Mergers* (June 2011). For a recent Delaware case involving allegations of fraud at a Delaware corporation doing business in China, see *Paul v. China MediaExpress Holdings, Inc.* , C.A. No. 6570-VCP, mem. op. (Del. Ch. Jan. 5, 2012) (granting a stockholder's request to inspect books and records to investigate potential fraud where, among other things, the company's independent auditor had resigned). In 2011, the SEC issued an investor bullet warning of the risks associated with reverse mergers. SEC, Office of Investor Education and Advocacy, *Investor Bulletin: Reverse Mergers* (June 2011).

[3] This name is in reference to the Court of Chancery's decision in *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[4] In *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court held that liability predicated on a *Caremark* claim requires that the directors must have acted in bad faith by (i) "utterly fail[ing] to implement any reporting or information system or controls" or (ii) "having implemented such a system or controls, consciously fail[ing] to monitor or oversee its operations."

[5] *See, e.g., Louisiana Mun. Police Employees' Retirement Sys. v. Pyott*, 46 A.3d 313 (Del. Ch. 2012) (allowing claims to proceed alleging that directors knew the company was engaged in illegal off-label uses of a

Still, *Puda Coal* is a warning for many directors. Breaches of the duty of loyalty are not subject to exculpation under Delaware law. Thus, while the plaintiffs must still prevail on the merits at trial, these outside directors are exposed to potential personal liability for monetary damages to the corporation and its stockholders.

The court's decision is particularly important for companies whose sole or primary operations are overseas. Many of those companies face heightened risks due to the business environments in which they operate, including potential violations of the Foreign Corrupt Practices Act. For such companies, the court emphasized the importance of having adequate lawyers and auditors "who are fit to the task of maintaining a system of controls over a public company."

The court went further in addressing the practical and cultural issues associated with serving on the boards of such companies. In the context of this case, the court cautioned that a director "better have your physical body in China an awful lot." It continued that "[directors] better have the language skills to navigate the environment in which the company is operating" and understand that "if the assets are in Russia, if they're in Nigeria, if they're in the Middle East, if they're in China, **that you're not going to be able to sit in your home in the U.S. and do a conference call four times a year and discharge your duty of loyalty. That won't cut it**" (emphasis added).

Chancellor Strine also mused about what a potential nominee might consider in determining whether to join a board of directors:

> If it's a situation where, frankly, all the flow of information is in the language that I don't understand, in a culture where there's, frankly, not legal strictures or structures or ethical mores yet that may be advanced to the level where I'm comfortable? It would be very difficult if I didn't know the language, the tools. You better be careful there. You have a duty to think. You can't just go on this [board] and act like this was an S&L regulated by the federal government in Iowa and you live in Iowa.

While the court recognized that what is required of directors will vary from company to company, it allowed these claims to proceed in light of the significant allegations in the complaint. The court did not address the extent to which the directors may be protected by relying in good faith on the company's outside auditor.

Directors should also take note of the court's ruling with respect to the outside directors' resignations. As a general matter, directors are free to resign "at any time." Most directors likely assume that, if they resign, they cannot be liable for future board decisions or corporate acts. While *Puda Coal* should cause directors to carefully consider their options before resigning, it does not draw any bright-line rules. Nor should it open any flood gates of litigation against directors who leave a board of directors due to a good faith disagreement over corporate policy, for personal reasons, or otherwise.

As noted above, *Puda Coal* appears to have involved extraordinary facts. It also involved the resignation of all of the outside directors and a majority of the total number of directors, a situation that the court seems to have concluded would reasonably be expected to harm the corporation even further. Still, at trial, the court may find that the directors' resignations were not a breach of fiduciary duty given, among other things, the investigation that they conducted and the subsequent difficulties they faced in trying to exercise control over the corporation and pursue any claims against the insider.

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regulated product); *Am. Int'l Group, Inc. Consol. Deriv. Litig.*, 965 A.2d 763 (Del. Ch. 2009) (finding that the plaintiffs adequately pled that insider directors "knowingly tolerat[ed] inadequate internal controls" and that the complaint "fairly support[ed]" the assertion that the company was a "criminal organization").

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