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A Failure to Monitor: Delaware Court Refuses to Dismiss Loyalty Claims Against Outside Directors of Foreign Based Company

On February 6 in *In re Puda Coal, Inc. Stockholders Litig.*, Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery, in a bench ruling, declined to dismiss breach of loyalty claims brought by stockholders against the independent directors of a Delaware corporation whose only operations and assets were in China. Although the facts of the *Puda Coal* case (involving unauthorized transfers of corporate assets) reflect an extreme situation, the court's decision serves as a strong reminder to independent directors of Delaware publicly-held corporations regarding their obligation to monitor corporate activities. The decision also is notable for its suggestion that directors who resign after serious problems are uncovered may increase their potential liability by doing so.

Background

Puda Coal, Inc. ("**Puda**") was a publicly-held Delaware company with assets and operations solely in China. In 2011, an 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 of Puda then resigned from the board of directors claiming an alleged lack of cooperation in trying to investigate and pursue the company's claims against the chairman. In the subsequent Delaware derivative litigation, the stockholder-plaintiffs alleged that the directors had acted in bad faith by failing to adequately monitor the company.

The Decision of the Delaware Court of Chancery

The Court found that the plaintiffs' complaint sufficiently pled a claim of breach of the duty of loyalty under *Caremark*[1] at the motion to dismiss stage because, among other things, the independent directors failed to properly oversee the actions of the company by not detecting the unauthorized sale of assets located in China by the company's chairman for 18 months, even though the transfers were reported in Chinese government documents and discovered by bloggers.

Because the defendants were directors of a company whose assets were kept on the other side of the world, Chancellor Strine said they had a heightened duty to keep track of the day to day activity at Puda. Chancellor Strine warned that directors must, from time to time, be physically present in the country that houses the company, and "better have in place a system of controls to

[1] *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996) (plaintiffs must prove a "sustained and systemic failure" to exercise oversight in order to show a lack of good faith and hold directors liable for wrongdoing that occurs on their watch)

make sure that you know that you actually own the assets. [They] better have the language skills to navigate the environment in which the company is operating. [They] better have retained accountants and lawyers who are fit to the task of maintaining a system of controls over a public company." The defendants neither toured the facilities nor held quarterly board meetings in person. They rarely, if ever, went to China during their time as independent directors to inspect the facilities or otherwise. They did not send in auditors to produce reports, yet repeatedly signed off on filings stating that Puda owned assets that it no longer did. To Chancellor Strine, this level of inaction was adequate to sustain the pleading of a breach of fiduciary duty claim.

"There'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." Comparing an indifferent director to a "mannequin," Chancellor Shrine explained that under no circumstances can directors "allow[] themselves to be appointed to something without any serious effort to fulfill the[ir] duties."

Chancellor Strine also suggested that the directors' decision to quit rather than defend the interests of the company in court might in itself be a breach of fiduciary duties. Chancellor Strine stated that it was unacceptable that when the "theft" of the assets was confirmed, the independent directors declined to sue the chairman and instead resigned, leaving the company in the control of the man they had just investigated. The defendants constituted a majority of the board, and as such, their status provided the only mechanism by which a suit could be filed on behalf of the company and by which the stockholders could be granted any relief without filing a derivative lawsuit.

Key Takeaways

- Independent directors are required to exercise effective oversight over the operations of the corporations on whose boards they serve. What constitutes effective oversight will depend on the circumstances. If operations are difficult to monitor (including because they are geographically remote), special efforts may be required.
- Under some circumstances, a director's resignation may constitute a breach of the director's fiduciary duties. Although as a general matter directors are free to resign at any time, *Puda Coal* shows that the ability to resign may be limited if the resignation can be expected to harm the interests of the corporation or its stockholders in a major way.

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