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Delaware Chancery Court Clarifies Delaware Boards' Fiduciary Oversight Duties as to Corporate Operations Abroad

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In 2013, the Delaware Court of Chancery issued three decisions in which it denied motions to dismiss claims for breach of the duty of oversight (*i.e.*, *Caremark* claims) asserted against directors of Delaware corporations having significant operations in China. In each case, the court found that sufficient facts were pled against the defendant directors to support a finding that they acted in bad faith by consciously disregarding their oversight duties.

The decisions serve as cautionary tales to boards of directors that they may face personal liability for the damages suffered by the corporation if they do not actively monitor its foreign assets and operations. These decisions also provide directors with helpful insight into how they can satisfy their fiduciary oversight duties in such situations.

Puda Coal

In the *In re Puda Coal, Inc. Stockholders Litigation* case,[1] then-Chancellor and current Chief Justice Leo E. Strine, Jr. refused to dismiss a breach of fiduciary duty claim against the independent directors of Puda Coal, Inc., a Delaware corporation with all of its operations in China.

The plaintiffs alleged that the directors had failed to discover (for more than two years) the unauthorized transfer of Puda Coal's operating subsidiary by Puda Coal's chairman to himself,[2] and that the Puda Coal board caused the company to issue false and misleading statements representing, among other things, that the company still owned that asset.[3] The court ruled that such allegations supported a *Caremark* claim[4] for a breach of the fiduciary duty of oversight.[5]

In discussing what directors of Delaware corporations with significant assets and operations in foreign countries must do to fulfill their fiduciary duty of oversight, the court stated, in pertinent part:

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[1] *In re* Puda Coal, Inc. S'holders Litig., C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013).

[2] *Puda Coal*, Tr. at 19.

[3] *Id.*

[4] See *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (''Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . in my opinion 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.'').

[5] *Puda Coal*, Tr. at 19.

> [I]f 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. You better have in place a system of controls to make sure that you know that you actually own the assets. You better have the language skills to navigate the environment in which the company is operating. You better have retained accountants and lawyers who are fit to the task of maintaining a system of controls over a public company.
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> Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors. . . . I'm talking about the loyalty issue of understanding 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. That there will be special challenges that deal with linguistic, cultural and others in terms of the effort that you have to put in to discharge your duty of loyalty.
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> . . .
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> 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 and act like this was an S&L regulated by the federal government in Iowa and you live in Iowa.[6]

This bench ruling is noteworthy for a number of reasons. First, although failure to exercise proper oversight under *Caremark* has been described as ''possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,''[7] the *Puda* court held that the plaintiffs' allegations easily cleared this hurdle at the pleading stage, finding it to be ''perfectly conceivable on these pled facts that there wasn't a good faith effort to try to monitor.''[8]

Second, even if the defendant directors derived no personal benefit from the challenged conduct, a claim for breach of the duty of oversight under *Caremark* implicates the fiduciary duty of loyalty, potentially subjecting the defendants to personal liability that cannot be exculpated by a corporate charter provision adopted pursuant to Section 102(b)(7) of the Delaware General Corporation Law (''DGCL'').[9] Third, the court indicated that for directors of a Delaware corporation with significant assets and operations in a foreign country to fulfill their duty of oversight, personal visits to the foreign locations, language skills, and familiarity with the relevant cultural norms may be required.[10]

'Rich v. Chong (Fuqi International)'

In *Rich v. Chong*,[11] Vice Chancellor Sam Glasscock, III, refused to dismiss a *Caremark* claim pursuant to Court of Chancery Rules 12(b)(6) and 23.1, finding that the plaintiff adequately pled facts that ''lead me to reasonably infer that the [defendant] directors knew that [the company's] internal controls were deficient, yet failed to act.''[12]

Fuqi International, Inc., a Delaware corporation that resulted from a reverse-merger transaction in 2006, completed an initial public offering in 2009, raising approximately $120 million.[13] Fuqi's sole asset was its wholly owned subsidiary, a Chinese jewelry company.[14]

[T]he ['Puda Coal'] court indicated that for directors of a Delaware corporation with significant assets and operations in a foreign country to fulfill their duty of oversight, personal visits to the foreign locations, language skills, and familiarity with the relevant cultural norms may be required.

Less than one year after its IPO, Fuqi began issuing troubling public disclosures concerning deficiencies in its financial reporting, including that: (1) it had discovered ''material weaknesses'' in its accounting practices and ''certain errors'' related to the accounting for its inventory and cost of sales; (2) it would need to restate its 2009 financial results; (3) it was no longer in compliance with NASDAQ rules requiring the timely filing of Securities and Exchange Commission reports; and (4) the SEC had initiated a formal investigation into the company.[15]

As the court described, ''Fuqi's financial statements were replete with basic accounting errors,'' and there were ''material weaknesses in [Fuqi's] disclosure controls, procedures, and internal control over financial reporting.''[16] Notably, Fuqi's independent auditor discovered in March 2011 that the company's chairman had caused it to make cash transfers of more than $130 million to various Chinese entities whose business addresses and operations, if any, could not be verified.[17]

The court held that these allegations adequately pled a *Caremark* claim, finding that Fuqi had no meaningful controls. Although it had ''some sort of compliance system in place''—for example, Fuqi had an au-

[6] *Id.* at 17–22.
[7] *Caremark*, 698 A.2d at 967.
[8] *Puda Coal*, Tr. at 19, 22.
[9] *In re* Goldman Sachs Grp., Inc. S'holder Litig., 2011 BL 262738, at *18 (Del. Ch. Oct. 12, 2011).
[10] *Puda Coal*, Tr. at 17-22. Such requirements potentially could limit the available pool of qualified candidates to serve on the board of a Delaware corporation with significant overseas assets and operations.
[11] Rich v. Chong, 66 A.3d 963 (Del. Ch. 2013).
[12] *Id.* at 966.
[13] *Id.* at 968.
[14] *Id.* at 967–68.
[15] *Id.* at 967–69.
[16] *Id.* at 970.
[17] *Id.* at 971.

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dit committee and submitted financial statements to the SEC in 2009—these mechanisms were ''woefully inadequate.''[18] In particular, the court was troubled by problems with Fuqi's inventory recordkeeping, noting that ''Fuqi is a jewelry company, specializing in precious metals and gemstones which are valuable and easily stolen,'' yet ''Fuqi directors allowed the corporation to operate [with] few to no controls over these vulnerable assets.''[19]

Vice Chancellor Glasscock also echoed the sentiment of then-Chancellor Strine in *Puda Coal*, stating that ''U.S.-based directors of companies with substantial operations outside the U.S. . . . must actively monitor the extraterritorial operations of the Delaware entity.''[20] Thus, although the Fuqi board may have had regular meetings and an audit committee, the company lacked meaningful controls because, in the court's view, ''there does not seem to have been any regulation of the company's operations *in China*.''[21]

Based on the allegations in the complaint, the court further determined that the Fuqi board ignored red flags, finding that ''the Fuqi board had several 'warnings' that all was not well with the internal controls.''[22] Initially, the court observed that, because Fuqi was a preexisting Chinese company that gained access to the U.S. capital markets through a reverse merger, ''Fuqi's directors were aware that there may be challenges in bringing Fuqi's internal controls into harmony with the U.S. securities reporting systems.''[23]

Despite its knowledge of the preexisting weaknesses of Fuqi's internal controls, however, the Fuqi board allowed $130 million in cash to be transferred out of the company, some of which was transferred more than six months *after* the company publicly disclosed that it would need to restate its 2009 financial results due to accounting improprieties.[24] The court continued:

> That these cash transfers were not discovered until March of 2011, when Fuqi's auditor discovered them, reinforces the inference that the internal controls were (and possibly still are) grossly inadequate. That [the chairman] was able to transfer $130 million out of the company's coffers, without the directors knowing about it for over a year, strains credulity. Either the directors knew about the cash transfers and were complicit, or they had zero controls in place and did not know about them. If the directors had even the barest framework of appropriate controls in place, they would have prevented the cash transfers.[25]

The court's decision is significant because, among other things, it recognizes the potential problems associated with foreign companies accessing the domestic securities markets through a reverse merger with an inactive Delaware corporation still listed on a national securities exchange.[26]

The court suggested that such companies' internal controls generally are weaker than those of U.S.-based companies, and cautioned directors of such companies that they face added challenges in ensuring that their internal controls comply with Delaware and federal law. The court specifically rejected the defense's argument that Fuqi should be entitled to ''extra latitude because it is a Chinese company attempting to comply with American securities regulations,'' responding that ''Fuqi is a *Delaware* company that must accept both the benefits and the responsibilities associated with being organized under the laws of this State.''[27]

'China Agritech'

In the *In re China Agritech, Inc. Shareholder Derivative Litigation* case,[28] plaintiff stockholders alleged that China Agritech, Inc., purportedly a fertilizer manufacturing business in China, was a fraud that served only to enrich its co-founders.[29]

Aspects of the alleged fraud included: (1) a conflicted transaction whereby China Agritech purchased shares of another corporation owned by China Agritech's co-founders (who also served on its board); (2) China Agritech's failure to use the proceeds from a secondary offering for its stated purpose; (3) China Agritech's inability to produce basic documents, such as minutes of board and committee meetings, the contract with its primary customer, and the license to produce one of its main products; (4) ''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 (5) repeated failures to maintain effective internal controls that prevented China Agritech from making public filings with the SEC for two years, which resulted in its stock being delisted from NASDAQ.[30]

The ['Fuqi International'] court specifically rejected the defense's argument that Fuqi should be entitled to ''extra latitude because it is a Chinese company attempting to comply with American securities regulations,'' responding that ''Fuqi is a *Delaware* company that must accept both the benefits and the responsibilities associated with being organized under the laws of this State.''

On a defense motion to dismiss pursuant to Rules 12(b)(6) and 23.1, Vice Chancellor J. Travis Laster held that the plaintiffs, whose allegations relied on the books and records the company produced pursuant to an earlier DGCL § 220 action (as well as the absence of books and records in basic areas), had adequately pled a *Caremark* claim and that pre-suit demand would have been futile.[31]

At the outset of his opinion, Vice Chancellor Laster expressed his dis-

[18] *Id.* at 982.
[19] *Id.* at 983.
[20] *Id.* at 983 n.166.
[21] *Id.* at 983.
[22] *Id.*
[23] *Id.* at 983–84.
[24] *Id.* at 984.

[25] *Id.* The court also criticized the company for failing to pay the fees of the audit committee's advisors, characterizing it as a deliberate failure to utilize the audit committee and, as a result, inferring that the board disabled itself from being informed. *Id.* at 985.
[26] In November 2011, the SEC approved new rules to toughen listing standards for reverse merger companies. *See* SEC Release No. 2011-235 (Nov. 9, 2011), *available at* http://www.sec.gov/news/press/2011/2011-235.htm.
[27] *Chong*, 66 A.3d at 984 n.169.
[28] *In re* China Agritech, Inc. S'holder Deriv. Litig., 2013 BL 133748 (Del. Ch. May 21, 2013).
[29] *Id.* at *1.

[30] *Id.* at *1, 9.
[31] *Id.* at *1, 17.

approval of, and Delaware's public policy against, China Agritech (or any foreign company) accessing the U.S. securities markets through a reverse merger with an inactive corporation that had retained its NASDAQ listing.[32] The court next criticized the China Agritech board and audit committee for approving the conflicted transaction with the company's cofounders, a transaction by which China Agritech paid almost $8 million in exchange for the stock of another company valued at only $50,000.[33]

Among other facts the Court found troubling was that China Agritech reported drastically different financial results in its filings with the SEC as compared with its filings with the Chinese government, suggesting to the court that the company may have committed fraud.[34] The court also found problematic the fact that the audit committee failed to meet for more than two years and fired the company's two outside auditors after each raised serious issues about its compliance with accounting requirements, and that one of those outside auditors sent the company a letter demanding that it fulfill its obligations "under Section 10A(b)(2) of the Securities Exchange Act of 1934."[35]

In sum, the court concluded that the audit committee "existed in name only,"[36] and that the committee members "acted in bad faith in the sense that they consciously disregarded their duties."[37]

The court also determined that the entire China Agritech board "knew about the oversight problems and failed to stop them."[38] Accordingly, the court held that the plaintiff stockholders had adequately pled a *Caremark* claim against the defendant directors,[39] and that the China Agritech board could not validly consider a pre-suit litigation demand.[40] Moreover, "[b]ecause the [c]omplaint plead[ed] claims that implicate the duty of loyalty, including its embedded requirement of good faith," the court ruled that "the defendants cannot invoke the exculpatory provision [adopted pursuant to DGCL § 102(b)(7)] as a defense[.]"[41]

Conclusion

The Delaware Court of Chancery's rulings in *Puda Coal*, *Chong* and *China Agritech* serve as cautionary tales to a board of directors (or audit committee thereof) whose company's assets and operations (or a significant segment thereof) are located in a foreign country: Delaware corporate law requires directors to "actively monitor" the company's foreign assets and operations to fulfill their fiduciary duties of oversight.[42] As then-Chancellor Strine emphasized, "[t]here's no such thing as being a dummy director in Delaware."[43]

In its three recent rulings, the Delaware Court of Chancery indicated that personal visits to the company's operations in foreign locations and foreign language skills may be required for directors to fulfill their fiduciary duties of oversight. Further, the court made clear that there is not a more-lenient standard for a Delaware corporation's internal controls because the company operates in a foreign country that has a less-rigorous regulatory regime; rather, the company's board must endeavor to bring its internal controls into compliance (and thereafter to comply) with applicable Delaware and federal laws.[44]

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[32] *Id.* at *1.
[33] *Id.* at *17.
[34] *Id.* at *20. For example, in 2008, the company reported revenue of $2.95 million and a net loss of $1.89 million to the Chinese government, but reported revenue of $45.24 million and net income of $9.83 million to the SEC. The *China Agritech* decision appears to be the first Delaware state court case to deal with the "implications of dramatic divergences between U.S. and Chinese regulatory filings." *Id.* at *19–20. The Vice Chancellor found that such divergences support a *Caremark* claim.
[35] *Id.* at *19–20. Section 10A(b)(2) of the Exchange Act requires an independent auditor to report directly to a company's board of directors if it believes that (1) an "illegal act" has occurred that materially affects the issuer's financial statements, and (2) management has not, either independently or as required by the board, yet taken "timely and appropriate remedial action." See *id.*
[36] *Id.* at *20.
[37] *Id.* at *21.
[38] *Id.* at *26.
[39] *Id.*
[40] *Id.* at *20–26.
[41] *Id.* at *26.
[42] *Chong*, 66 A.3d at 983 n.166.
[43] *Puda Coal*, Tr. at 21.
[44] *Chong*, 66 A.3d at 983–84, & n.169.

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