

One Minute Memo®



Duties of Directors of Delaware Corporations with Overseas Assets or Operations

Chancellor Strine of the Delaware Chancery Court issued a bench ruling on February 6, 2013 in the case of *In re Puda Coal, Inc. Stockholders Litigation*, No. 6476-CS (Del. Ch. Feb. 6, 2013) highlighting the duties owed by directors of Delaware corporations with assets located in foreign countries. The plaintiffs were stockholders asserting derivative claims arising from losses the company suffered because its chief executive officer (also a director) sold the company's assets without authorization. The company's assets and operations were located in China.

In his bench ruling, Chancellor Strine articulated the oversight duties for directors of corporations with multinational operations. Because greater risks are often associated with assets or operations in foreign jurisdictions, directors must maintain a sharp focus, strong tools and the proper mindset to discharge their duties.

Chancellor Strine stated that for any Delaware corporation whose assets and operations were situated in a foreign location, in order to *minimally* meet their obligation of good faith, directors had to:

- Be physically present in the foreign location "an awful lot"
- Maintain a system of controls to make sure that the company actually owns the assets located overseas
- Have sufficient language skills to navigate the environment in which the company operates
- Retain accountants and lawyers who "are fit to the task" of maintaining a system of controls for the company and assisting the directors to navigate the challenges of operating globally

Chancellor Strine emphasized that directors need not be perfect. "You can be a dummy director. You just have to be an *active* dummy director." (emphasis added) If the director is trying but misses something, he or she gets credit for at least making a serious effort to fulfill their duties. This is particularly true for independent directors who are often chosen less for their industry experience and more for their ability to monitor those insiders who manage the company.

The Court pointedly focused on the duty of loyalty in this case, rather than the duty of care. With assets or operations located in other regions of the world, participating in a quarterly board conference call will not be sufficient to discharge the duty of loyalty. As the Chancellor stated, "That won't cut it. [T]here 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." Under Delaware law, exculpation of directors is not available for breaches of the duty of loyalty, so this is an issue of great personal importance to anyone serving on a board.

In China, for example, corporate authorization is often an area of risk for irregular transactions. The chairman of the board, general manager or other senior executives of a Chinese company may be the legal representative of the entity. Under Chinese law, a legal representative has the authority to act on behalf of the company without further authorization from the board, including executing legally binding agreements. As a corollary to this, directors of a Chinese company who are not the legal representatives may often take a passive role. Directors of Delaware companies operating in China or other foreign business environments must have an appreciation of the nuances of local law and custom, such as the perceived authority of officers operating in the foreign country, in order to effectively discharge their oversight duties.

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Citing Monty Python, the *Puda Coal* Court also stated that directors cannot simply “run away” (as the hapless Arthurian Knights attempted to do in the Monty Python movie, *The Search for the Holy Grail*) to avoid liability. Here, the independent directors became aware that the company’s chief executive had “stolen assets out from under the company.” Instead of causing the company to sue the officer or doing anything else to recover the assets, they simply resigned (leaving the company in the hands of the CEO who was in fact the principal suspected wrongdoer), hoping to immunize themselves from suit and also leave the company unable to bring the suit itself. Chancellor Strine rejected this approach and rejected the argument that demand was not excused under these circumstances - stating that such a result would leave Delaware subject to “totally legitimate ridicule.” Chancellor Strine denied the motion to dismiss the complaint asserted by these directors, holding that “[T]here are some circumstances in which running away does not immunize you. It in fact involves a breach of fiduciary duty.”

In re Puda Coal, Inc. Stockholders Litigation has important ramifications for directors of both public and private companies with any material foreign assets or operations. As companies move assets, people and operations to lower cost environments, their boards of directors should:

- Review internal systems to assure the company will comply with applicable legal and regulatory requirements
- Review systems that assure an adequate flow of information to the board
- Confirm that the board has a local presence
- Make sure that the board has resources to navigate the unique legal, cultural and linguistic challenges of the jurisdiction

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