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Can You Resign from the Board of a Troubled Company?

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Two recent Delaware cases involving independent directors of corporations with foreign operations provide a powerful reminder that resigning from the board of directors of a troubled company may not be a simple matter. In both cases, Delaware chancery court judges denied the director defendants' motions to dismiss; if the allegations—primarily, that the directors of each company breached their duty of oversight—are proven at trial, the directors potentially could face personal liability. While nothing about these recent cases indicates a radical change in Delaware law, and while the standards for proving such a claim remain very high, both decisions offer important observations about the Delaware courts' expectations of directors.

These cases provide an opportunity for directors to consider how they might react if they discovered corporate malfeasance and how they might handle fundamental, irresolvable concerns or disagreements (whether with management or other directors) that may arise while serving as a director.

Ideally, a director should think through these and related issues prior to accepting a director position in a public or private corporation. Once a member of the board, a director must consider how to address such unfortunate circumstances if they do arise, including whether to resign as a director and, if so, how. These are not easy matters, and the answers largely will be determined by the individual facts and circumstances of the particular situation. Though the recent Delaware cases involve foreign corporations and allege rather egregious corporate misconduct, they are a useful starting point to consider directors' legal and ethical duties in this context.

THE DELAWARE CASES

The cases, *In re Puda Coal Stockholders' Litigation*[1] and *Rich v. Chong*,[2] involve allegations that the independent directors of Puda Coal and Fuqi International, respectively, breached their fiduciary duty of loyalty—in particular, the duty of Delaware directors to exercise reasonable oversight over the corporation and its activities.[3] The standard for breach of this duty was established by the landmark 1996 Delaware Chancery Court decision in *Caremark International Derivative Litigation*, which held that only "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."[4]*Caremark* sets a very high standard for plaintiffs who allege and hope to prove that director inattention resulted in economic loss or other corporate liability. For purposes of surviving a Rule 12(b)(6) motion to dismiss, however, a complaint need only state a claim upon which relief can be granted, assuming all the facts in the pleadings to be true. In both *Puda Coal* and *Rich v. Chong*, the courts found that the plaintiffs did meet this lower standard to survive the motion to dismiss.[5]

The facts in these two cases are colorful and extreme. Puda Coal is a Delaware company created through a reverse merger with a Chinese company that had its primary assets and operations in China. The plaintiffs alleged that the company's chief executive officer, who was also the chairman of the board, stole the assets of the company through a series of unauthorized transfers. The theft went unnoticed by the independent directors for 18 months until it was called to their attention by a third party. The independent directors, who constituted a majority of the board, attempted to pursue a lawsuit, but after being "stonewalled" in their investigation resigned from the board. Chancellor Leo E. Strine Jr., in his bench denial of the independent directors' motion to dismiss, was particularly critical of the independent directors for resigning at that point, effectively leaving Puda Coal "under the sole dominion of a person [the CEO/chairman] they believe has pervasively breached his fiduciary duty of loyalty," rather than causing the company to join the plaintiffs' lawsuit.[6] Strine opined that it might well be a breach of fiduciary duty on the part of the directors to simply resign upon discovering a flagrant crime by a corporate insider.[7]

Fuqi International, the company at issue in *Rich v. Chong*, is a Delaware company whose sole asset is stock of a Chinese jewelry company. Fuqi completed a U.S. public offering in 2009, but the next year it revealed problems with its 2009 financial statements, and in 2011 auditors uncovered the transfer—apparently unbeknownst to the board—of $130 million in cash out of the company during 2009 and 2010 to third parties located in China.[8] A stockholder suit in 2010 prompted the audit committee of the board to investigate, but the investigation was abandoned in 2012 due to management's failure to pay the fees incurred by the audit company's advisors. Fuqi also failed to hold annual stockholder meetings for several years despite a 2012 court order to do so upon petition from a stockholder. Subsequently, the independent directors of the company resigned. Vice Sam Chancellor Glasscock III suggested that, if the facts alleged in the complaint were true, the directors had ignored numerous red flags indicating seriously inadequate internal controls, and moreover, that the resignation of the independent directors may have constituted an abdication of their duties.[9] He pointed out that in such case the protections of the business judgment rule do not apply.[10] Glasscock emphasized that "the conscious failure to act, in the face of a known duty, is a breach of the duty of loyalty."[11]

In *Puda Coal*, Chancellor Strine expressed concern that Delaware appears to have been used as a place to incorporate shell entities with ineffective directors acting as enablers of corporate malfeasance.[12] Though it remains to be seen how these cases will ultimately play out as litigation continues, the dicta thus far should make independent directors of public companies think hard about whether they are fulfilling their fiduciary duties in an active, engaged manner and how they would handle situations involving corporate mismanagement, a fractured board or other fundamental crises of oversight and governance.

DUTY TO BE ACTIVE

Chancellor Strine emphasized in *Puda Coal* that Delaware requires active, engaged directorship. Recognizing that directors of companies with foreign operations may have a difficult task, he outlined at length some basic obligations, many of which could apply to all directors of public companies.

[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...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.... 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.... [Y]ou'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.... You have a duty to think.[13]

Chancellor Strine cautioned against accepting a board seat at a company in an industry or having operations, a language or a culture that a potential director may not fully understand.[14] Potentially, this creates a high bar for individuals who are considering becoming directors of offshore entities.

In order to avoid the kind of failure of directorship described in the alleged facts of *Puda Coal* and *Rich v. Chong*, potential directors should think carefully before they accept a board nomination. Appropriate due diligence by the potential director is paramount. The potential director should feel confident that he or she has a reasonable understanding of the company's business and operations, how it generates revenue, how its industry operates, and the legal and ethical environments in which it conducts business. Furthermore, as highlighted by these cases, potential directors would be wise to consider as well whether there are any signs of trouble in the company's recent past or potential problems in the near future. They should review the background of the company's management and, if they exist, control shareholders. Potential directors can review press and analyst reports on the company, company financial statements, organizational documents, and directors' and officers' insurance policies. Potential directors may wish to speak with current or former directors to get a sense for whether the board is functioning in an effective, collegial fashion and how management responds to concerns raised by the board. A potential independent director should meet with the independent chairman and/or lead director and be confident that he or she leads the board with professionalism and integrity. The potential director should also meet with the audit committee chair and the independent auditor to discuss the company's financial statements and the company's approach to its financial reporting obligations. If any directors have unexpectedly left the board in recent years, potential director candidates should inquire as to the circumstances prompting their resignations. In the two cases discussed above, management was unresponsive to directors' concerns when the alleged malfeasance finally came to light; their inability to effectively investigate or obtain answers from top executives led the independent directors ultimately to resign.

Potential directors should also consider the options that will be available in a crisis situation.[15] For example, they should be aware of anything unusual in the company's policies and procedures regarding director resignations, including any limitations in the company charter and/or bylaws. Director candidates may wish to inquire as to whether they are entitled to consult independent legal counsel or other advisors at the company's expense, including for advice as to resignation and director's duties, obligations and responsibilities. Moreover, director candidates should consider whether they are or could become dependent on the income from the directorship, to the point that the directors' fees potentially could compromise their independence in decision-making.

CONSIDERING RESIGNATION

When an independent director begins to feel that there is a fundamental divide, either between the director and the rest of the board, or between the nonexecutive directors and management, he or she must think carefully about what his or her duties as a director require. If there is no reason to believe that anything illegal or unethical is happening, but rather that the differences stem from an essential disagreement on the strategy or future of the company, the director should consider whether he or she can be an effective voice on the board or if he or she no longer is serving the interests of shareholders by being a dissenting board member. While healthy dissent and discussion are essential to the functioning of an effective board, fundamental and consistent disagreement may be only frustrating and disruptive to all parties.[16] If—perhaps with the advice of counsel—the director in such circumstances concludes that it is in the company's best interests for him to resign, it is likely that the director can and should do so amicably. Even in this context though, the director should obtain independent advice as to whether he or she has any obligation to make public disclosure of the circumstances involving his or her departure from the board.[17]

Once an independent director suspects or becomes aware of corporate malfeasance, the director's duties, obligations and responsibilities may change. As an initial step, the director should attempt to take reasonable steps to stop any ongoing legal or ethical violations. The director should consider engaging the board in discussions with attorneys and accountants to uncover the apparent violations and figure out the steps that need to be taken by the company and the board. Many of these decisions involve legal judgments, and the directors should be able to rely on the expertise of independent counsel in making any such determinations. The directors should also take steps to provide that the board's discoveries and actions are accurately and appropriately recorded in the board minutes.[18] If possible without exacerbating controversy, the director should try to have his or her concerns recorded consistently as the matter unfolds, to avoid any appearance or perception that the individual director, the independent directors, or the board as a whole, as applicable, might have acted inappropriately once the issue was discovered.

When a director's attempts to investigate an apparent problem are met with stonewalling by management or other directors, or when a director's efforts to cause the board to take action are met with intractable resistance, the director is likely to consider resignation as he or she likely will believe that his or her ability to effect change has been compromised. In such circumstances, the director should seek independent counsel experienced with board and governance matters and the applicable legal requirements; after all, as one commentator put it, "the danger of being perceived by regulators, the SEC, or a jury as one who has been drawn into wrongdoing can escalate very quickly."[19] This is particularly true not only because a director bears responsibility for his or her own actions and those of the board until his or her resignation takes effect, but also because "it will be unusual for a resigning director not to have accrued a degree of potential culpability for the issues(s) that eventually led to resignation since these types of matters often have a long fuse but tend to start in an anodyne way."[20] A resigning director should submit a written statement to the chairman of the board for circulation to the board and possibly to shareholders as well. When a director resigns in protest, any resignation letter to the company is required to be filed as an exhibit to the company's Form 8-K announcing the resignation.[21]

A director faced with intractable corporate malfeasance must consider whether a noisy resignation will harm the company more than it helps. Resigning noisily is a way of calling public attention to the company's problems—which may indeed be an effective way to bring the malfeasors to account for their actions—but also can harm the company and its various constituencies in the short- and long-term. Moreover, having resigned, the director no longer has any power to determine whether the illegal or unethical activity has in fact ceased, or to help the company recover from the effects of the purported malfeasance. The loss of a strong voice can weaken the remaining independent directors and even undermine the board's efforts to investigate and remedy the wrongdoing. Unfortunately (from the director's perspective), under certain circumstances, the director may have a duty to stay on the board for his or her full term if doing so may help minimize harm to the company and attendant losses to shareholders.

In both of the cases discussed above, the Delaware Chancery Court was critical of the independent directors' decision to resign. Chancellor Strine observed: "[T]here are some circumstances in which running away does not immunize you. It in fact involves breach of duty.... 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...do anything, but they simply quit, I'm not sure that that's a decision that itself is not a breach of fiduciary duty."[22]

Similarly, Vice Chancellor Glasscock commented in a footnote in *Rich v. Chong*: "It may be that some of the former independent directors...attempted to fulfill their duties in good faith.... Nonetheless, even though [two of them] purported to resign in *protest* against mismanagement, those directors could still conceivably be liable to the stockholders for breach of fiduciary duty.... I do not prejudge the independent directors before evidence has been presented, but neither are those directors automatically exonerated because of their resignations."[23] Both decisions found it "troubling that independent directors would abandon a troubled company to the sole control of those who have harmed the company."[24]

In the wake of *Puda Coal* and *Rich v. Chong*, it has been suggested that a director who discovers corporate malfeasance and cannot get management to respond has a duty to sue the company on behalf of the shareholders.[25] However, a suit by a director against management or other board members of a rogue company is guaranteed to be expensive and unpleasant and is likely not covered by directors' and officers' insurance.[26] Another option proposed by one commentator is that a director in that situation may support legal action taken by a plaintiffs' law firm.[27] Indeed, Chancellor Strine suggested near the end of his bench ruling that the stockholder plaintiffs and former-director defendants might actually have a commonality of interest as against the other defendants in the case and justice might be better served by joining together to bring the true malfeasors to account.[28]

In our view, it is unlikely that a litigation-related option will be the best choice for most directors, even those faced with corporate misconduct and intractable management. That said, directors in that unfortunate situation will have to consider carefully the individual circumstances and available options. Directors who have conscientiously fulfilled their duties at all times of their directorship—including with respect to the circumstances of their resignation, if they do resign—will have the benefit of the protections of the business judgment rule. Directors who prioritize their fiduciary duties to the stockholders and their personal integrity will, with the assistance of experienced legal counsel, find a path through any corporate crisis. In addition, sufficient diligence prior to accepting a directorship may permit a director to avoid the problem in its entirety.[29]

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Endotes:

1. C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013) (bench ruling), available at **www.davispolk.com/files/uploads/Puda_Coal_Transcript_Ruling.pdf**.

2. C.A. No. 7616-VDB (Del. Ch. April 25, 2013), available at **courts.delaware.gov/opinions/download.aspx?ID=188510**.

3. That the duty of oversight falls under the rubric of the duty of loyalty was clarified in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

4. ***In re Caremark Int'l Deriv. Litig.***, 698 A.2d at 959, 971 (Del. Ch. 1996).

5. *Rich v. Chong*, C.A. No. 7616-VDB at 3; *Puda Coal*, C.A. No. 6476-CS at 22 (transcript).

6. *Puda Coal*, C.A. No. 6476-CS at 16 (transcript).

7. Id. at 23 (transcript).

8. The facts are summarized at pages 2-3 and 38-40 of the *Rich* opinion.

9. *Rich v. Chong*, C.A. No. 7616-VDB at 38, 29-30.

10. The court noted that "the business judgment rule 'has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act.'" *Rich v. Chong*, C.A. No. 7616-VDB at 29 (citing ***Aronson v. Lewis***, 472 A.2d 805 (Del. 1984) at 811-13).

11. *Rich v. Chong*, C.A. No. 7616-VDB at 40.

12. *Puda Coal*, C.A. No. 6476-CS at 20 (transcript) ("[T]his is a troubling thing for Delaware, and this court has taken very seriously this—the use of Delaware entities.... I take very seriously our integrity.").

13. Id. at 17-18, 21-22 (transcript).

14. Id. at 22 (transcript).

15. See ACCA, "Discussion Paper: Resigning From a Board: Guidance for Directors," Dec. 2008 (ACCA Discussion Paper), available at **http://www.accaglobal.com/content/dam/acca/global/PDF-technical/corporate-governance/tech_tp_rfb.pdf**. It is a useful resource despite being written for U.K. company directors.

16. ACCA Discussion Paper, supra note 15, at 14.

17. Form 8-K has specific requirements for reporting director resignations and disagreements. For a useful monograph on these requirements, see Broc Romanek, "TheCorporateCounsel.net's Director Resignation & Retirement Disclosure Handbook," (2012), available at **www.thecorporatecounsel.net/GreatGovernance/member/Handbook/DirectorResignation.pdf** (subscription required).

18. See, e.g., Financial Reporting Council (U.K.), "U.K. Corporate Governance Code," Provision A.4.3 (Sept. 2012).

19. ACCA Discussion Paper, supra note 15, at 11 (citing Stephen J. Friedman, "Resigning From the Board," in Directors & Boards 20/2:30 (1996)).

20. ACCA Discussion Paper, supra note 15, at 11.

21. See Item 5.02(a)(2) of Form 8-K ("If the director has furnished the registrant with any written correspondence concerning the circumstances surrounding his or her resignation, refusal or removal, the registrant shall file a copy of the document as an exhibit to the report on Form 8-K.").

22. *Puda Coal*, C.A. No. 6476-CS at 23 (transcript).

23. *Rich v. Chong*, C.A. No. 7616-VDB at 31 n.138 (emphasis in original).

24. Id. at 31 n.138.

25. See Edward M. McNally, "Should Directors Sue Their Company for its Misdeeds?" Delaware Business Litigation Report, May 8, 2013, available at **www.delawarebusinesslitigation.com**.

26. See id.

27. See id.

28. *Puda Coal*, C.A. No. 6476-CS at 26 (transcript).

29. "Nothing in the world is more dangerous than sincere ignorance and conscientious stupidity." Martin Luther King Jr.