

Director resignation and fiduciary duties

A court decision raises questions about when directors cannot resign — i.e., ‘run away’ from problems.

BY DOUG RAYMOND

WHILE IT IS A commonplace that directors owe fiduciary duties to the corporation on whose board they serve, and to its stockholders, the decision of a director to resign from the board has generally not been regarded as subject to these duties. In general, a director has been free to resign from the board, so long as the corporation is not as a result left entirely without leadership.

This principle, which has sometimes resulted in a rush to the exits, resembling a game of musical chairs, was recently discussed in a bench opinion by Delaware Chancery Court Judge Leo Strine, in the case *In re: Puda Coal, Inc. Stockholders Litigation*. In this case the decision to resign was reviewed under the analysis adopted in the *Caremark* line of cases, and has special application to directors serving on boards of corporations with significant offshore operations.

Puda Coal Inc. was a Delaware corporation whose assets and operations were located in China. Puda Coal's chairman, who was a member of the board, allegedly had sold the corporation's assets without any payment to the corporation and had also engaged in other misdeeds. This theft was discovered by the corporation's audit committee roughly 18 months later, at which point the other directors, all of whom were independent, resigned. As a consequence, the resigning directors left the chairman, who they believed may have committed significant harm to the corporation, entirely in control.

Stockholder plaintiffs then brought a derivative action against the three independent directors, alleging that in resigning they had breached their fiduciary duty of loyalty. Under the *Caremark* line of cases, directors can breach their duty of loyalty if they fail to exercise sufficient oversight over the corporation to have confidence that it has acceptable

resources and reporting systems to ensure that information necessary for directors to fulfill their obligations is provided in a timely and adequate manner. A knowing failure to exercise this oversight can result in a breach of the directors' fiduciary duties.

In a bench opinion, Chancellor Strine rejected the directors' motion to dismiss, citing their failure to monitor the corporation's insiders, as well as their decision to "run away" upon learning of the alleged misdeeds. The

chancellor was particularly critical of the directors' decision to resign, noting that "there are some circumstances in which running away does not immunize you," and which may instead result in a breach of fiduciary duty.

This case has increased focus on the decision of a director to resign, and the implications of the duties of due care and loyalty on that decision. According to the court, these directors should have made sure, before resigning, that the corporation was in the hands of competent, independent directors. Their failure to do this, or, at the least, to ensure that the fox was not left in charge of the henhouse, could violate their fiduciary obligation to

ensure that there was proper oversight.

Puda Coal also criticized these directors for failure to exercise appropriate oversight over the business even before their decision to resign. For 18 months the board had not realized that significant assets of the business had been transferred without appropriate corporate approval. And during this time the directors had repeatedly filed statements indicating that the corporation owned assets that had, in fact, been sold by the chairman.

In finding basis for a claim of breach of duty, Chancellor Strine emphasized that a director cannot be a "dummy director," as in "a mannequin, somebody who allows themselves to be appointed to something without any serious effort to fulfill the duties." According to the chancellor, an independent director must be able to tackle the various challenges that come with being based in the United States when the corporation and its operations are located overseas, including the language and cultural and other differences that exist.

In addressing the independent directors under these circumstances, Chancellor Strine noted that "in order for you to meet your obligation of good faith, you better have your physical body in China an awful lot." A U.S.-based director must also make sure that there are systems of control in place to monitor the corporation's assets and operations. The chancellor opined: "If the assets are in Russia, if they're in Nigeria, if they're in the Middle East, if they're in China, [a director is] not going to be able to sit in [her] home in the U.S. and do a conference call four times a year and discharge [her] duty of loyalty. That won't cut it." In short, an independent director must effectively oversee the assets and operations of the corporation and supervise the people who manage the corporation to satisfy his or her fiduciary duties, regardless of where the corporation's assets are located.

The implications of *Puda Coal* are significant for directors of global businesses, particularly those primarily lo-

Continued on page 19



Doug Raymond is a partner in the law firm Drinker Biddle & Reath LLP (www.drinkerbiddle.com).

tion and responding to the ZPIC's requests. Further, due to the potentially serious consequences of a ZPIC audit, legal counsel should be notified immediately of any ZPIC audit. This will help you to determine how best to defend against the result and increase the chances of a favorable outcome following a ZPIC audit.

Is there insurance protection? Management liability policies are available to healthcare organizations to minimize the risk of exposure to rising regulatory scrutiny of purported healthcare fraud. While the policies vary by the insurer

A management liability policy can be a valuable asset if subject to a False Claims Act case.

and healthcare organization, a package of three types of coverage is typically offered: management liability; employment practices liability; and fiduciary and plan administration liability under the Employee Retirement Income Security Act.

Most forms provide coverage for a wide variety of forums, ranging from civil litigation to criminal prosecutions to formal administrative proceedings. For private and not-for-profit healthcare institutions, the market typically provides coverage for executives, employees and the organization, and provides explicit protection against suits, both civil and criminal, arising under the False Claims Act. Coverage usually includes defense costs along with plaintiffs' attorneys' fees as awarded in the case. As such, a management liability policy can be a valuable asset for a healthcare organization subject to a False Claims Act case. ■

The authors can be contacted at carol.zacharias@acegroup.com, jkelly@bassberry.com, and agrizzle@bassberry.com.

Director resignation

Continued from page 16

cated outside the U.S. As globalization increasingly leads to companies shifting their assets and operations to foreign countries, directors located in the U.S. must nonetheless provide effective oversight of the business. Based on *Puda Coal*, this may require more frequent travel to the corporation's operations,

the implementation and maintenance of systems of control designed for the particular challenges that the distance may present, and the willingness to confront linguistic, cultural, and other challenges that arise. ■

The author can be contacted at douglas.raymond@dbr.com. Alexander S. Meiseles, an associate with Drinker Biddle & Reath, assisted in the preparation of this column.



**CULTIVATE.
INNOVATE.
ACCELERATE.**

Business success is directly impacted by how well you align your corporate culture, manage change, growth and sustainable leadership.

Companies partner with Drexel LeBow Corporate and Executive Education for real return on organizational learning through practical tools and frameworks to gain immediate impact for their organization.

Visit for thought leadership insights:

LeBow.Drexel.edu/ExecutiveEd



DREXEL UNIVERSITY

LeBow

College of Business

Corporate and Executive Education