

## **Directors' Duties and Canada's *Corruption of Foreign Public Officials Act***

**by David Debenham\* (Partner, McMillan LLP)**

As a result of renewed efforts to enforce Canada's *Corruption of Foreign Public Officials Act* ("COFPA") and the most-recent proposed amendments to the Act earlier this year to extend jurisdiction to Canadian corporations' activities abroad, boards of directors, senior management, and internal auditors have been encouraged to renew their efforts to protect their companies from the legal and reputational risks associated with breaches of our anti-corruption legislation. As part of that effort one should consider the risk of shareholders' lawsuits against individual members of the Board when they appear to fail in their duty to prevent breaches of the COFPA. New case law from the United States suggests there may be some cause for concern in this regard. Those cases are *In Re Puda Coal Inc. Stockholders Litigation* ("Puda")<sup>i</sup> and *Rich v. Chong et al.* ("Rich")<sup>ii</sup>

These cases involve frauds by directors and not corruption of foreign governments by company agents abroad. However, they do have some important things to say about the obligations of company directors with respect to their obligation to prevent fraudulent or other illegal behaviour.

The underlying facts of *Puda* and *Rich* are simple and similar. They each start with a reverse merger. A privately held foreign company, in these cases Chinese companies, acquiring a publicly listed, but thinly traded, US corporation. In a reverse merger, the face of the foreign acquirer remains, while the target American public corporation appears to disappear, because the merged public corporation changes its name to that of the original, Chinese acquirer. The result is that you have what appears to be a Chinese corporation, but which is actually incorporated and publicly traded in the United States. The newly public "Chinese corporation" then raises additional equity on US markets through a public offering.

In *Rich*, Fuqi listed its shares on Nasdaq through a reverse merger and in 2009 raised \$120 million through a public stock offering. Less than a year later, the company said it found accounting errors and uncovered transfers of cash out of the company totaling more than \$130 million to entities that Fuqi has yet to verify were legitimate businesses. Fuqi's audit committee started to investigate, but its work stalled when management stopped paying the lawyers and accountants hired by the audit committee. In protest, the independent directors resigned from the board.

Shareholders sued the directors of Fuqi, including the independent directors. The essence of the shareholders' claim was a failure by the directors to exercise due diligence, in this case, by failing in their duty to monitor the corporation's activities and permitted more than \$130 million to disappear as a result. The court found that "...Fuqi had no meaningful controls in place. The board of directors may have had regular meetings, and an Audit Committee may have existed, but there does not seem to have been any regulation of the company's operations in China." The Judge noted that the independent directors had ignored several 'red flags' with respect to problems with internal controls and that directors did nothing to ensure that reporting mechanisms were accurate. The lack of internal controls was so bad that \$130 million was transferred out of the company in November 2010, but it was not found out by the directors until March of 2011. In such circumstances, the directors could be found liable to the corporation for negligent performance of their duties.

*Puda* is a similar case with similar findings. Here too, a Chinese company wished to become publically traded in the US. It therefore bought a publicly-traded US shell company, being Puda Coal Inc., through a reverse merger. The public company then nominally owned 90% of the purchasing Chinese operating company, in this case Shan Xi Coal, which operated exclusively in China. The two Chinese principals then took their position on the Board of Directors of both the parent, the public company, and the Chinese

operating company. The other three seats on the five-seat parent company were occupied by three independent directors. The two Chinese principals then connive to surreptitiously sell the parent company's interest in the Chinese operating company to themselves for nominal consideration, leaving the public company as a pure shell company without assets. The three independent directors eventually learn of the fraud and resign from the company and the shareholders of the US public company bring a lawsuit for a derivative action to sue in the company's name.

The Court noted that the directors' duty to exercise reasonable care, as well as their fiduciary duties to the public company, required the directors to make sure that the Chinese counterparts had simply not purchased an US vehicle, filled it with assets, sold a large amount of stock to the US investing properties, and then repatriated those assets right under the noses of the independent US Directors. In such circumstances, a reasonable director, acting in good faith, had an obligation to make sure there was a system of controls in place to make sure that the public company actually owned the assets and that they were real and operating assets owned by the company at all material times. The absence of such controls in a company with only one asset, being a Chinese operating company, meant that the directors had an obligation to both ensure legal ownership of that asset and physical operation of that asset by visiting the foreign plant. The independent directors' fiduciary duty also required an obligation to act on the company's behalf also meant that *when* the fraud was discovered, they had a obligation to investigate it, and if necessary, and prosecute it to recover the assets rather than simply abandon the company by resigning their positions when the company needed its independent directors most.

What are the implications of these decisions for Canadian directors in the face of the spate of increasing prosecutions under Canada's *Corruption of Foreign Public Officials Act*?

1. As part of their obligation to use reasonable care, the Directors of Canadian companies to have to make sure their companies have sufficient internal controls are in place to comply with anti-corruption legislation or face personal liability at the hands of shareholders' lawsuits for the reputational losses, drops in share value, and fines.
2. That the obligation will increase to the extent that employees are overseas, and beyond the ordinary day-to-day purview of domestic management. Indeed overseas inspection of internal controls may be required to ensure they are effective.
3. To the extent that one is operating in a jurisdiction that is prone to consider bribery of local officials as part of the local custom, the requirement a Director take a personal interest in ensuring anti-corruption legislation is complied with is going to be accelerated or intensified, rather than attenuated, by the distance these countries are from the home jurisdiction. This is of particular importance given that our own domestic anti-corruption legislation is being extended to the operations of Canadian corporations as they operate abroad.

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<sup>i</sup> *re Puda Coal, Inc., Stockholders Litig.*, C.A. No. 64676-CS (Del. Ch. Febr. 6, 2013).

<sup>ii</sup> *Rich v. Chong*, C.A. No. 7616-VCG (Del. Ch. Apr. 25, 2013).

\*David Debenham is a partner in the Ottawa office of the law firm of McMillan LLP, a national law firm with an office in China. He is a Certified Fraud Specialist, and the author of "Executive Liability and the Law", and "The Law of Fraud and the Forensic Investigator", both from Carswell Publications.