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Case No. 7145-VCN

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE CHINA AUTOMOTIVE SYSTEMS INC. DERIVATIVE LITIGATION	:	**CONSOLIDATED C.A. No. 7145-VCN**

MEMORANDUM OPINION

Date Submitted: May 6, 2013
Date Decided: August 30, 2013

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NOBLE, Vice Chancellor

I. INTRODUCTION[1]

Plaintiffs Arthur Garnett and David J. Tearle (the "Plaintiffs") bring this derivative action on behalf of Nominal Defendant China Automotive Systems, Inc. ("China Automotive" or the "Company") alleging breaches of fiduciary duty, insider trading, and unjust enrichment against Defendants Hanlin Chen ("Chen"), Qizhou Wu ("Wu"), Bruce Carlton Richardson ("Richardson"), Robert Tung ("Tung"), and Guangxun Xu ("Xu") (collectively, the "Defendants"), the five members of China Automotive's board of directors (the "Board").[2]

Specifically, the Plaintiffs assert that the Board as a whole, as well as Richardson, Tung, and Xu as the members of the Company's Audit Committee, breached their fiduciary duties both by failing to maintain adequate accounting controls and by utilizing improper accounting and audit practices, leading to the Company's issuance of false and misleading statements.[3] The Plaintiffs also contend that Chen and Wu breached their fiduciary duties by selling stock of the Company while in possession of material, non-public information.[4] In addition, the Plaintiffs allege that the Defendants were unjustly enriched by continuing to receive remuneration from the Company at the time of these fiduciary breaches,[5]

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[1] The facts are taken from the Plaintiffs' Verified Consolidated Shareholder Derivative Complaint (the "Complaint" or "Compl.").
[2] Compl. ¶ 3.
[3] *Id.* ¶¶ 109-15.
[4] *Id.* ¶¶ 119-23.
[5] *Id.* ¶¶ 116-18.

and that Chen and Wu were further unjustly enriched by retaining the proceeds from their alleged insider trading.

The Defendants have moved to dismiss each of the Plaintiffs' derivative claims under Court of Chancery Rule 23.1 for failure to make a demand on the Board or to establish demand futility through allegations of particularized facts. They assert that the allegations of the Complaint fail to show that a majority of the Board would have been interested, lacked independence, or faced a substantial threat of personal liability in considering a stockholder demand. Alternatively, the Defendants have moved under Court of Chancery Rule 12(b)(6) to dismiss the Complaint for failure to state a claim.

Because the Court concludes that demand, which was not made, is not excused under Rule 23.1, this action must be dismissed.

II. BACKGROUND

A. *The Parties*

The Plaintiffs are, and have been at all relevant times, owners of China Automotive common stock.[6] A publicly traded company since 1999,[7] China Automotive is a Delaware corporation with its headquarters in Jingzhou City in the

[6] *Id.* ¶¶ 12-13.
[7] *Id.* ¶ 2.

People's Republic of China (the "PRC").[8] The Company manufactures and sells power steering systems and other automotive components.[9]

The Defendants are the current members of the Board.[10] Chen, who owns a majority of the Company's common stock along with his wife,[11] has been Chairman of the Board since March 2003.[12] Wu, who became Chief Executive Officer in September 2007, has served as a director since 2003.[13] Three directors—Richardson, Tung, and Xu—comprise the Company's Audit, Compensation, and Nominating Committees. Richardson, the chair of the Audit Committee, and Xu, the chair of the Nominating Committee, have served as directors since December 2009.[14] Tung, the chair of the Compensation Committee, has served as a director since September 2003.[15]

B. *The Alleged Misstatements*

The Plaintiffs complain of the Board's (and the Audit Committee's) failure to oversee accounting practices at China Automotive, insider trading by Chen and Wu, and the unjust enrichment of the Defendants during these alleged breaches of

[8] *Id.* ¶ 14.
[9] *Id.* ¶¶ 1, 2, 14.
[10] *Id.* ¶¶ 15-19.
[11] *Id.* ¶¶ 43, 102. At times the Plaintiffs allege that Chen controls "almost 55.5%" of the common stock, *id.* ¶ 43, and at other times the Plaintiffs allege that Chen owns "approximately 64%" of the common stock. *Id.* ¶ 102. Although these allegations are inconsistent, each alleges that Chen had majority control of China Automotive's stock.
[12] *Id.* ¶ 15.
[13] *Id.* ¶ 16.
[14] *Id.* ¶¶ 18, 17.
[15] *Id.* ¶ 19.

fiduciary duty. Central to these claims is how the Company accounted for convertible notes it issued on February 15, 2008, (the "Convertible Notes") in a series of annual and quarterly Securities and Exchange Commission ("SEC") reports filed by China Automotive from May 12, 2009, through October 23, 2012, the date the Complaint was filed (the "Relevant Period").[16] The Plaintiffs allege that these public disclosures were materially false and misleading because they:

(1) "improperly accounted" for the Convertible Notes;

(2) "failed to account properly for operating expenses and other charges against income";

(3) failed to disclose "material deficiencies in [the Company's] internal controls";

(4) incorrectly stated the Company's financial results;

(5) failed to disclose "that the Company's financial results were not prepared in accordance with Generally Accepted Accounting Principles ("GAAP")"; and

[16] The Plaintiffs use this definition in the Complaint, *id.* ¶ 3, and the Defendants use this definition in their briefs. Opening Br. in Supp. of Defs.' Mot. to Dismiss the Consolidated Compl. 3 n.2.

(6) failed to disclose that the Company's former auditor, Schwartz Levitsky Feldman LLP ("SLF"), a Canadian firm, "was not licensed to conduct audits" in the PRC.[17]

The alleged result of these misstatements and omissions was an "inflated" price of the Company's stock during the Relevant Period.[18]

C. *The Financial Statements*

On March 17, 2011, the Company announced that it would need to restate its financial statements for fiscal year 2009 and its unaudited financial statements for the first three quarters of 2010 to correct its accounting for the Convertible Notes.[19]

The Company reported that the "Convertible Notes contain an embedded conversion feature that allows for an adjustment to the conversion price in the event that the Company issues equity securities at a price lower than the original conversion price."[20] In its announcement, the Company explained that Accounting Standard Codification 815, which governed the accounting of the Convertible Notes:

> requires issuers [like the Company] to bifurcate the embedded conversion options from the convertible notes and, starting on January 1, 2009, to record such conversion options as derivative liabilities valued at fair value. Thereafter, any gain or loss in the fair

[17] Compl. ¶ 4.
[18] *Id.* ¶ 5.
[19] *Id.* ¶ 68. China Automotive also stated that it would not file its Form 10-K annual report for fiscal year 2010 on time.
[20] *Id.*

> value of the derivative should be recorded in the company's income statement at the end of each reporting period.[21]

After a review, the Audit Committee concluded that "[d]ue to the complexities of the accounting treatment of [the Company's] convertible notes, the Company inappropriately accounted for the embedded conversion feature and the associated gain or loss on changes in fair value for the derivative."[22]

The necessary adjustments reduced China Automotive's net income for the year ending December 31, 2009, by $43 million, and increased its net income for the year ending December 31, 2010, by $19 million.[23] The Plaintiffs also allege that the eventual restatement contained additional corrections to operating expenses, "increasing costs and further reducing profits."[24] The initial disclosure on March 17, 2011, about the need to restate certain financial statements, according to the Plaintiffs, caused China Automotive's shares to fall that day by $1.42, or by approximately 14%, to close at $8.81.[25]

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[21] *Id.*
[22] *Id.*
[23] *Id.* ¶¶ 10, 68.
[24] *Id.* ¶ 10.
[25] *Id.* ¶ 69. On March 18, 2011, the Company revealed that it had received a notification letter from NASDAQ, the stock exchange on which China Automotive common stock was traded, indicating that it was not in compliance with NASDAQ's Listing Rules requiring the timely filing of SEC periodic reports. *Id.* ¶ 70. The Company explained that it was "reviewing the complex accounting treatment" of the Convertible Notes and would file its annual report and amended quarterly reports within the 60-day period to regain compliance with NASDAQ Listing Rules. *Id.* ¶ 70. According to the Plaintiffs, on the first trading day following this additional disclosure, March 21, 2011, China Automotive's share price fell a further 20 cents to $8.61 per share. *Id.* ¶ 71.

D. *Alleged Wrongdoing by the Defendants*

The Plaintiffs frame the accounting misstatements and omissions, at least in part, as a direct product of their allegations that SLF, the Company's auditor, was not licensed "to audit books and records"[26] in the PRC and that the Defendants knew it was not licensed.[27] The Plaintiffs assert that Richardson, Tung, and Xu, as members of China Automotive's Audit Committee, failed to maintain sufficient oversight of the Company's accounting practices, presumably including the auditing by SLF.[28] More specifically, the Plaintiffs contend that these three directors had knowledge of "confidential and proprietary information"[29] because of their positions on the Board and the Audit Committee. These positions also allegedly gave them the "power and influence to cause"[30] the Company to issue materially misleading financial statements, meaning that the Audit Committee's actions caused the Company to "fail[] to disclose material facts to shareholders during the Relevant Period."[31]

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[26] *Id.* ¶ 72.

[27] *Id.* ¶ 8. As alleged in the Complaint, SLF resigned as China Automotive's auditor in December 2010, *id.* ¶ 72, some three months before the Company announced in March 2011 that it would restate certain financial statements. *Id.* ¶ 68. This timeline undermines the Plaintiffs' claim that SLF resigned only after China Automotive disclosed its receipt of a notification letter from NASDAQ that purportedly revealed for the first time that SLF was not a licensed auditor in the PRC. *Id.* ¶ 72.

[28] *Id.* ¶¶ 79, 96-98.

[29] *Id.* ¶ 29.

[30] *Id.* ¶ 30.

[31] *Id.* at ¶ 97. The Plaintiffs further contend that Richardson, Tung, and Xu, as members of the Company's Compensation Committee, wrongfully "approved compensation and financial plans" with knowledge that the plans were "based on artificially inflated stock prices." *Id.* ¶ 99.

According to the Plaintiffs, the review of China Automotive's 2009 and 2010 financial statements in March 2011 by PricewaterhouseCoopers Zhong Tian CPAs Limited Company, which replaced SLF after its resignation in December 2010,[32] determined that SLF had failed to account properly for the cost of the conversion feature and change in fair value of the Convertible Notes as a charge against income.[33] For instance, in 2009, while China Automotive's stock price rose from approximately $2 per share to approximately $20 per share, the conversion price of the Convertible Notes allegedly remained fixed instead of reflecting the change in stock price.[34]

Collectively, the Defendants are alleged to have "either caused the issuance of materially misleading statements or failed to timely correct such statements" in breach of their fiduciary duties.[35] Individually, during the Relevant Period and while the Company's stock price was "inflated,"[36] two Defendants—namely, Board Chairman Chen and CEO Wu—allegedly sold part of their personal holdings of China Automotive stock.[37]

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[32] *Id.* ¶ 72.
[33] *Id.* ¶ 73.
[34] *Id.* ¶ 73.
[35] *Id.* ¶ 79.
[36] *Id.* ¶ 9.
[37] *Id.* ¶¶ 43, 81-82.

Whatever the actual sales figures,[38] the Plaintiffs allege that Chen and Wu "misrepresented the financial posture of the Company" to "sell personally held stock at artificially inflated prices."[39] In particular, Wu's positions as a director and as CEO allegedly provided him with "material adverse information about the Company" that, instead of disclosing, he used "to secure financial gains for himself."[40] But, although in one paragraph the Plaintiffs claim that the Defendants together sold over $40 million in Company stock,[41] nowhere in the Complaint are any allegations of particularized facts naming the other three members of the Board—Richardson, Tung, or Xu—as persons who sold stock in China Automotive during the Relevant Period.[42]

III. CONTENTIONS

The Plaintiffs plead three causes of action. First, the Plaintiffs allege the Defendants breached their fiduciary duties as directors of China Automotive through their inadequate oversight of the Company's accounting practices and their

[38] The purported dollar amount of these sales by the named Chen and Wu varies widely throughout the Complaint—from an earlier claim that Chen and his wife sold almost $10 million of Company stock while Wu sold in excess of $13 million, *id.* ¶ 43, to a later allegation that Chen sold stock in excess of $596,000 while Wu sold approximately $4,804,865, *id.* ¶¶ 81-82.
[39] *Id.* ¶ 80.
[40] *Id.* ¶ 81.
[41] *Id.* ¶ 9.
[42] In contrast to the Court's reasonably inferring that the Complaint alleges insider trading by Chen and Wu, despite inconsistent allegations of how much common stock they sold, the Court now cannot reasonably infer, even when viewing the allegations of common stock sales amounting to $40 million by all Defendants in favor of the Plaintiffs, that the Complaint supports an allegation of insider trading against Richardson, Tung, or Xu.

issuance of misleading financial statements that improperly valued the Convertible Notes.[43] According to the Plaintiffs, the Defendants knew, or should have known, that the Company's statements about its financial condition contained material misstatements or omissions; moreover, they did not act to correct these improper misrepresentations.[44] The Plaintiffs seek damages for the alleged breaches of fiduciary duty.[45]

The Plaintiffs next claim that Chen and Wu breached their fiduciary duties by engaging in insider trading. The Plaintiffs claim that Chen and Wu sold Company stock on the basis of their knowledge of material, non-public information. Supporting this theory is the Plaintiffs' allegation that sales of the Company stock by Chen and Wu were "unusual in size and scope" compared to previous trading practices.[46] As a remedy, the Plaintiffs seek the imposition of a constructive trust over any profits obtained by the alleged insider trading.[47]

Finally, the Plaintiffs assert that the Defendants were unjustly enriched by continuing to receive compensation from the Company while in breach of their fiduciary duties. The Plaintiffs seek disgorgement of all profits, benefits, and other

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[43] The Plaintiffs also allege a related, and subsidiary, breach of fiduciary duty by the Compensation Committee members, *id.* ¶¶ 99, 109-15, as well as a claim of failure to remedy, *id.* ¶ 85.
[44] *Id.* ¶ 112.
[45] *Id.* ¶ 114.
[46] *Id.* ¶¶ 103, 105.
[47] *Id.* ¶ 123.

compensation that the Defendants wrongfully obtained.[48] In addition, the Plaintiffs claim that Wu was unjustly enriched "by his receipt and retention of proceeds that he received from sales of China Automotive [stock] during the Relevant Period," which, according to the Plaintiffs, also warrants disgorgement.[49]

In response, the Defendants moved to dismiss the Complaint under Court of Chancery Rule 23.1, asserting that the Plaintiffs have failed to plead with particularity facts which establish demand futility. The Defendants contend that the Complaint: (1) fails to allege particularized facts demonstrating that a majority of the Board faced a substantial threat of personal liability if suit were filed; and (2) fails to allege particularized facts demonstrating that a majority of the Board was either interested or lacked independence to be able to consider a demand.[50]

IV. ANALYSIS

The Plaintiffs concede that they did not make a demand on the Board before filing their Complaint.[51] Court of Chancery Rule 23.1 requires in derivative actions that "[t]he complaint . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the

[48] *Id.* ¶ 118.
[49] *Id.* ¶ 85. The Plaintiffs do not specifically seek disgorgement of Chen's alleged insider trading profits.
[50] The Defendants alternatively and independently seek dismissal of the Plaintiffs' claims under Court of Chancery Rule 12(b)(6) for failure to state a claim. Because this ruling on the motion under Rule 23.1 is dispositive, the Court need not address the motion under Rule 12(b)(6).
[51] *Id.* ¶ 89.

effort." The Plaintiffs' pleadings "must comply with stringent requirements of factual particularity"—a complaint filled with "conclusory statements or mere notice pleading" is not enough.[52]

The Court's inquiry under Rule 23.1 is limited to "the well-pled allegations of the complaint,"[53] which are taken as true.[54] All reasonable inferences from non-conclusory allegations in the Complaint are to be drawn in favor of the Plaintiffs, but the Court does not have to accept conclusory allegations unsupported by particularized facts.[55]

If stockholders do not demand that the directors pursue a claim of the corporation, then the stockholders may only pursue a derivative suit to assert the claim if "pre-suit demand is excused because the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation."[56] Under

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[52] *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).
[53] *Guttman v. Huang*, 823 A.2d 492, 499 (Del. Ch. 2003).
[54] *See Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988).
[55] *See In re Nat'l Auto Credit, Inc., S'holders Litig.*, 2003 WL 139768, at *8 (Del. Ch. Jan. 10, 2003).
[56] *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008). That stockholders pursuing a derivative claim do not make demand on the board of directors—*i.e.*, the complaint purports to allege particularized facts establishing demand futility—must be expected in meritorious derivative actions. As the "business judgment rule and demand excusal are 'inextricably bound,'" *Rattner v. Bidzos*, 2003 WL 22284323, at *7 (Del. Ch. Sept. 30, 2003) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)), plaintiffs in a derivative complaint who make a demand imply they are unable to allege with particularity that at least half of the directors are interested, not independent or facing a substantial threat of personal liability. In other words, actually making demand on the corporation indicates that the stockholder plaintiffs are unable to rebut the presumption of the business judgment rule, which shields the business decisions of the board from judicial second-guessing as a matter of director discretion. *Aronson*, 473 A.2d at 812 ("[The business judgment rule] is a presumption that in making a business decision the directors

Delaware case law, the test for whether demand is excused depends on whether the derivative complaint alleges that the current board of directors took wrongful action or wrongfully took no action.

Where "a derivative plaintiff challenges an earlier board decision made by the same directors who remain in office at the time suit is filed,"[57] the Court must decide under *Aronson v. Lewis* "whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[58]

On the other hand, where "the subject of the derivative suit is not a business decision of the board"—for instance, a claim of inadequate oversight of the corporation's accounting practices—the Court must determine under *Rales v. Blasband* "whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[59]

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of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

[57] *In re China Agritech, Inc. S'holder Deriv. Litig.*, 2013 WL 2181514, at *15 (Del. Ch. May 21, 2013).

[58] *Aronson*, 473 A.2d at 814.

[59] *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

Delaware case law focuses on three circumstances in which a director is not entitled to deference when considering a demand: if the director is interested, if the director is not independent, or if the director faces a substantial threat of personal liability.[60] Because a "majority vote is required to prevail on a board motion to cause the corporation to accept a demand," the derivative complaint must allege with particularity that at least half of the directors do not pass the appropriate *Aronson* or *Rales* test, which would excuse demand.[61]

Directors are interested for the purposes of demand futility if they "appear on both sides of a transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing."[62] If there is no self-dealing, the alleged corporate action needs to provide a benefit or cause a detriment that is material to the director.[63]

A director may lack independence in the demand futility context if the director is so "beholden"[64] to the interests of another—most commonly a large or controlling stockholder—that the independence of the director's "discretion would

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[60] *See, e.g.*, *Desimone v. Barrows*, 924 A.2d 908, 928 (Del. Ch. 2007); *see also China Agritech*, 2013 WL 2181514, at *16 (citing *Rales*, 634 A.2d at 934).
[61] *Beneville v. York*, 769 A.2d 80, 86 (Del. Ch. 2000) (identifying the key question in the board's ability to respond to a demand as whether "the impartial directors . . . have the power unilaterally to cause the corporation to act on the demand").
[62] *Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002) (quoting *Aronson*, 473 A.2d at 812).
[63] *Id.* (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 363 (Del. 1993)); *see also In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999) (locating the test for materiality within "the context of the director's economic circumstances").
[64] *Aronson*, 473 A.2d at 815.

be sterilized."[65] The alleged existence of a controlling, majority stockholder itself does not establish demand futility, even if the director was first elected with the support of the controlling stockholder.[66] Instead, there must be a sufficient "nexus" between the alleged controller and controlled party such that, based on the allegations of particularized facts in the complaint, the court "can reasonably infer that the board members . . . are acting at the direction of the allegedly dominating individual or entity."[67]

In addition to excusal by alleging with particularity that half of the board is interested or lacking independence, so too can demand be excused by alleging with particularity that at least half of the directors "face[] a sufficiently substantial threat of personal liability as to the conduct alleged in the complaint to compromise their ability to act impartially on a demand."[68] "Except in 'egregious circumstances,' the 'mere threat' of personal liability does not constitute a disabling interest for a director considering a derivative plaintiff's demand."[69] But, showing a substantial threat of personal liability does not require a plaintiff "to demonstrate a reasonable

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[65] *Rales*, 634 A.2d at 936.
[66] *See Aronson*, 473 A.2d at 815, 816, (explaining that "[i]t is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence").
[67] *Heineman v. Datapoint Corp.*, 611 A.2d 950, 955 (Del. 1992); *see also Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004) (explaining that a director's independence may be challenged by particularized allegations suggesting "a relationship . . . of a bias-producing nature").
[68] *Desimone*, 924 A.2d at 928.
[69] *Rattner*, 2003 WL 22284323, at *9 (quoting *H-M Wexford LLC v. Encorp, Inc.*, 2003 WL 21254843, at *14 (Del. Ch. May 27, 2003)).

probability of success on the claim,"[70] as the plaintiff "need only 'make a threshold showing, through the allegation of particularized facts, that [its] claims have some merit.'"[71] The particularity requirement embedded within Rule 23.1 ensures that "only derivative actions supported by a reasonable factual basis proceed."[72]

The *Rales* test for demand futility applies here because the Plaintiffs "do not challenge any particular business decision" by the Defendants.[73] Therefore, for demand to be excused, the particularized allegations of the Complaint must create a reasonable doubt that, at the time the action was filed, three of the five directors on the Board could not have acted impartially in considering a demand. The Plaintiffs have alleged insider trading by only Chen and Wu,[74] who also happen to be the only two directors who the Plaintiffs argue lacked independence because of their positions with China Automotive, which were purportedly their "principal professional occupations."[75] Even if these allegations show that Chen and Wu could not have considered demand impartially, which the Court need not address now, then the Plaintiffs would still be required to allege with particularity that one of the other three directors—Richardson, Tung, or Xu—was interested, lacked independence, or faced a substantial threat of personal liability. In other words,

[70] *China Agritech*, 2013 WL 2181514, at *16.
[71] *Id.* (quoting *Rales*, 634 A.2d at 934).
[72] *In re Dow Chem. Co. Deriv. Litig.*, 2010 WL 66769, at *6 (Del. Ch. Jan. 11, 2010).
[73] *Guttman*, 823 A.2d at 499.
[74] Compl. ¶¶ 119-123.
[75] Pls.' Answering Br. in Opp'n to Defs.' Mot. to Dismiss the Consolidated Compl. ("AB") 21.

unless the Plaintiffs have alleged with particularity that at least one of these three directors could not have impartially considered a demand, then the Court must find that demand is not excused.

Since these three directors (along with the rest of the Board) are primarily implicated by their allegedly inadequate oversight of the Company's accounting practices (and their related actions on the Compensation Committee), the Court will address those claims in the Complaint first. The Court will then consider the insider trading claims, before concluding with the unjust enrichment claims.

A. *Accounting Oversight Claims*

The Plaintiffs assert that the Defendants breached their fiduciary duties by "failing to adequately manage and oversee" China Automotive's financial accounting and reporting procedures.[76] According to the Plaintiffs, each Defendant "faces a substantial likelihood of liability in this action because of [the] failure, as a director, to assure that reliable systems of controls were implemented and functioning effectively to prevent the Company from issuing materially misleading statements."[77]

In addition, the Plaintiffs argue that Richardson, Tung, and Xu each face a substantial threat of personal liability from their roles on both the Audit Committee and the Compensation Committee. As members of the Audit Committee, those

[76] Compl. ¶ 90.
[77] *Id.* ¶ 93.

three directors were purportedly responsible "for preparing, reviewing, and discussing China Automotive's financial statements with management and independent auditors [and] . . . for discussing China Automotive's internal audit function and reviewing reports concerning the Company's operation of internal controls."[78] Because Richardson, Tung, and Xu were "directly involved in preparing or reviewing such materially false and misleading statements," according to the Plaintiffs, the Audit Committee directors breached their fiduciary duties, and thereby would have been subject to a substantial threat of personal liability, when they either "knowingly or recklessly issued materially false and misleading statements that conflicted with facts known by them at the time."[79]

At the heart of the Plaintiffs' allegations about these three directors is a *Caremark* claim[80]—a claim that the Board, particularly the Audit Committee,

[78] *Id.* ¶ 96.
[79] *Id.* ¶ 97.
[80] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

The Plaintiffs also contend that the Company's issuance of false and misleading financial statements during the Relevant Period was predicated upon the Audit Committee's decision to hire and retain SLF as the Company's auditor, which the Committee was allegedly "aware" was "not licensed by the PRC to conduct corporate audits in China." Compl. ¶ 8. According to the Plaintiffs, this lack of PRC license meant that "SLF could not provide comprehensive or complete audits on behalf of Chinese companies trading in markets in the United States." *Id.* ¶ 8. The Plaintiffs argue in their brief that this decision of the Board and Audit Committee, with knowledge of SLF's lack of license, was an "intentional disregard of Defendants' fiduciary duties" such that they have asserted a claim beyond the typical failure to monitor boundaries of *Caremark*. AB 26.

Accepting as true the Complaint's particularized allegations and viewing all reasonable inferences in favor of the Plaintiffs, the Court concludes that any non-*Caremark* claim about the Board's or Audit Committee's choice of auditor lacks merit. First, the Plaintiffs argue that SLF was "unqualified" to be China Automotive's auditor, AB 8, and that the Audit Committee knew

failed to monitor adequately the Company's accounting practices. Because this theory of fiduciary duty breach requires a plaintiff to show that "the directors knew that they were not discharging their fiduciary obligations"—*i.e.*, bad faith—as a "necessary condition[] predicate for director oversight liability,"[81] it has been

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SLF was "not capable[] [or] qualified," *id.* 23. But, in the Complaint, the Plaintiffs only allege that SLF failed to account properly for the Convertible Notes under GAAP. Compl. ¶¶ 4, 44, 67, 91. They do not allege that SLF was unqualified under GAAP or that any Defendants knew SLF was unqualified under GAAP, thereby removing these unalleged issues from the Court's consideration here. *See Guttman*, 823 A.2d at 499. This conclusion makes the Plaintiffs' claims about SLF's Chinese accounting expertise of little consequence. The issue instead appears to be SLF's qualification to account for the Convertible Notes under GAAP, and the Board's knowledge of its qualifications, which the Plaintiffs have not contested by any allegations of particularized facts.

Second, the Plaintiffs have not alleged with any particularity that the Company selected SLF because of how it would account for the Convertible Notes or with knowledge that SLF's intended accounting would be incorrect under GAAP. There are no particularized allegations of bad faith or an irrational decision-making process about the initial hiring or continued use of SLF, so those director decisions are matters of director discretion under the business judgment rule. *See Caremark*, 698 A.2d at 967; *see also Aronson*, 473 A.2d at 812.

It is also worth noting that, after arguing that the Plaintiffs have put the PRC's auditor licensing requirements at issue by attaching to their Answering Brief an opinion from a related federal securities lawsuit against China Automotive that discusses this issue, the Defendants offered an exhibit (a law firm memorandum) filed by SLF in that lawsuit and suggested that the Court here may take judicial notice of it as a "publicly filed document[]." Reply Br. in Further Supp. of Defs.' Mot. to Dismiss the Consolidated Compl. 7 n.4, (citing *In re Career Educ. Corp. Deriv. Litig.*, 2007 WL 2875203, at *9 (Del. Ch. Sept. 28, 2007)). The exhibit purports to show that the PRC changed its foreign auditor licensing requirements in March 2011, which would not only be well after the Company first hired SLF, but also after SLF resigned—indicating that, absent some alleged prescience by the Defendants, they would have been unable to know that SLF would one day be an unlicensed auditor in the PRC, let alone to have made that decision in bad faith. Because the Court has discretion to decline to take judicial notice of an adjudicative fact, D.R.E. 201(c), unless it is "requested by a party and supplied with the necessary information," D.R.E. 201(d), and because neither party here has requested that the Court take judicial notice of the PRC's auditor licensing requirements or provided sufficient documentation, the Court declines to take judicial notice of the proffered exhibit.

[81] *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). *See also Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243, 244 (Del. 2009) (identifying a "vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties" such that a Delaware court's inquiry should not be whether directors "did everything that they (arguably) should have done" under their fiduciary duties, but should instead be "whether those directors

considered "possibly the most difficult theory in corporation law"[82] to support a stockholder derivative action. This prerequisite showing of bad faith can be made by alleging with particularity a "sustained or systematic failure of the board to exercise oversight,"[83] but this Court has provided additional guidance on more concrete ways in which a plaintiff may seek to plead a *Caremark* claim with particularity.

For example, in *Caremark* cases involving the board's oversight of the corporation's accounting practices, this Court has suggested demand might be excused if a plaintiff alleges particularized facts that at least half of the directors had knowledge of specific "red flags"—such as personal knowledge of a series of detailed, third-party reports "suggesting potential accounting improprieties."[84] Or, a plaintiff could plead particularized allegations of fact about the board's auditing system by claiming "that the company lacked an audit committee[] [or] that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work."[85] Furthermore, the particularized allegations

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utterly failed to attempt" to satisfy their fiduciary duties); *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006) (explaining that bad faith can be shown by, but is not necessarily limited to, situations "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act").

[82] *Caremark*, 698 A.2d at 967.

[83] *Stone*, 911 A.2d at 372 (quoting *Caremark*, 698 A.2d at 971).

[84] *Ash v. McCall*, 2000 WL 1370341, at *4, *15 (Del. Ch. Sept. 15, 2000).

[85] *Guttman*, 823 A.2d at 507.

may introduce facts about the direct and personal "involvement in the preparation of the financial statements" by at least half of the directors.[86] By contrast, this Court has consistently found that just being a director on the committee where the alleged wrongdoing is "within [its] delegated authority" does not give rise to a substantial threat of personal liability under *Caremark* without supporting allegations of particularized facts showing bad faith.[87] These examples demonstrate how this Court has been proactive in articulating a framework for how a derivative *Caremark* complaint may have enough merit to survive scrutiny under a demand-futility analysis, and this guidance provides a lens through which the Court can now examine the particularized allegations of the Complaint. Equally important as what is alleged with particularity is what is not alleged with particularity.

As an initial matter, the Plaintiffs plead conclusory allegations that the Defendants knew "confidential and proprietary information" about the Company[88] and that, as directors, they had the "power and influence to cause" the issuance of allegedly misleading financial statements.[89] A mere statement that the Defendants

[86] Rattner, 2003 WL 22284323, at *12.
[87] *South v Baker*, 62 A.3d 1, 17 (Del. Ch. 2012) (citing *In re Goldman Sachs Gp., Inc. S'holder Litig.*, 2011 WL 4826104, at *22-23 (Del. Ch. Oct. 12, 2011); *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 126-28 (Del. Ch. 2009); *Desimone*, 924 A.2d at 938; and *Rattner*, 2003 WL 22284323, at *12-13).
[88] Compl. ¶ 29.
[89] *Id.* ¶ 30.

"caused"[90] the filing of the allegedly misleading financial statements with the SEC is not, without more, a particularized allegation of fact.[91] Nowhere within the Complaint are allegations of particularized facts about the Defendants' knowledge of any "red flags."[92] Nothing is alleged about any specific deficiencies of the Company's or Audit Committee's internal financial controls during the Relevant Period. And, the Complaint lacks particularized allegations about any Defendant's conscious disregard of Board or Committee meetings or responsibilities.[93]

Even the purportedly particularized allegations suggesting that Richardson, Tung, and Xu face a substantial threat of personal liability as the Audit Committee are not much more than a conclusory statement of an alleged failure to carry out the Committee's responsibilities assigned in its charter.[94] The Plaintiffs do allege that all five directors attested to the misleading financial statements by signing one

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[90] *See, e.g.*, *id.* at ¶ 65.

[91] *See Citigroup Inc.*, 964 A.2d at 133 n. 88 ("Pleading that the director defendants 'caused' or 'caused or allowed' the Company to issue certain statements in not sufficient particularized pleading to excuse demand under Rule 23.1.").

[92] *See Ash*, 2000 WL 1370341, at *15.

[93] *See Guttman*, 823 A.2d at 507.

[94] Compl. ¶¶ 25-26, 96. The Plaintiffs pled equally non-particularized allegations in support of their assertion that Richardson, Tung, and Xu face a substantial threat of personal liability as Compensation Committee members for their purported disregard of the responsibilities assigned to the Committee in its charter. *Id.* ¶¶ 27-28, 99. This theory is a type of *Caremark* claim because the Plaintiffs argue that the Compensation Committee took "no action to curtail or penalize their fellow Board members" for the alleged "illegal stock sales" that the Committee "could not have missed . . . given its size, scope, and blatancy." AB 25. The Plaintiffs did not allege with particularity facts showing bad faith by the Committee, a showing of which is a "necessary condition[] predicate" to personal liability under *Caremark*. Moreover, the Plaintiffs did not allege with particularity facts supporting any other theory of breach of fiduciary duty, so the Compensation Committee does not face a substantial threat of personal liability. *Stone*, 911 A.2d at 370.

of the SEC filings at issue,[95] but these allegations of fact, even viewed in the light most favorable to the Plaintiffs, contain no particularized allegations that the directors knew the statements were wrong, or in some other way failed to secure adequate internal controls. Likewise, the Complaint does not allege with particularity any direct or personal involvement by the Defendants in the Company's preparation of its financial statements, in the Board's or Audit Committee's review of SLF's auditing of the financial statements,[96] or in any other capacity by which the Court could reasonably infer that a majority of the Defendants had any knowledge that their actions or inactions were harmful to the corporation or a breach of their fiduciary duties.[97] Mere membership on the Audit Committee is not enough for the Court to infer bad faith.[98]

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[95] Compl. ¶ 94.

[96] The Plaintiffs suggested the Audit Committee as a whole, or at least Richardson as its chair and designated financial expert under Sarbanes-Oxley, should be held to a heightened standard of constructive knowledge about the Company's financial statements. *In re China Automotive Sys. Inc. Deriv. Litig.*, C.A. No. 7145-VCN, at 36 (Del. Ch. May 6, 2013) (TRANSCRIPT) ("Tr."). The Court declines to entertain this argument because it does not support a claim under Delaware corporate law. The Audit Committee's oversight of SLF's esoteric accounting for the Convertible Notes is not, as Plaintiffs argued, AB 24, equivalent to the "deliberate violation of a stockholder approved stock option plan" where the court inferred that the conduct alleged (backdating stock options) could not have been "anything but an act of bad faith." *Ryan v. Gifford*, 918 A.2d 341, 358 (Del. Ch. 2007). The Court here cannot infer bad faith from the non-particularized allegations of the Complaint; thus, the Court cannot characterize, as the Plaintiffs argued, the alleged "ignorance" as a "sustained or systematic failure of the Board to exercise oversight," AB 27.

[97] *See Rattner*, 2003 WL 22284323, at *12. Moreover, the Plaintiffs have not alleged with particularity why it was unreasonable for the Board or the Audit Committee to rely on SLF's auditing of China Automotive's financial statements under GAAP. *See* Tr. at 49.

[98] *See South*, 62 A.3d at 17.

In sum, the Plaintiffs have not alleged particularized facts, in the manner prescribed by Court of Chancery Rule 23.1, showing bad faith or a "sustained or systematic failure of the board to exercise oversight."[99] Therefore, the Plaintiffs have not alleged a particularized *Caremark* claim that has merit.[100] And, the Plaintiffs have not alleged with particularity any other theory by which the Audit Committee members—Richardson, Tung, and Xu—may have faced a substantial threat of personal liability.

Absent a substantial threat of personal liability for Richardson, Tung, and Xu, the Plaintiffs could still show demand futility by particularized allegations that these three Defendants were unable to consider a demand impartially because they were interested or not independent. No allegations in the Complaint suggest that these three directors were interested or conflicted by receiving a material benefit.[101] The alleged insider trading was by Chen and Wu, not the other directors. Similarly, in broad conclusory allegations, the Plaintiffs claim that the entire Board is "beholden" to Chen because of his majority common stock ownership.[102] By itself, that Chen has majority control of China Automotive's stock alone does not demonstrate demand futility without particularized allegations that the Board acted

[99] *Stone*, 911 A.2d at 372 (quoting *Caremark*, 698 A.2d at 971).
[100] *See Rales*, 634 A.2d at 934.
[101] *See Orman*, 794 A.2d at 23.
[102] Compl. ¶ 102.

at the control of Chen,[103] and the Complaint does not include such allegations of particularized fact.

Because the Plaintiffs have not alleged particularized facts showing that any of Richardson, Tung, or Xu were interested, not independent, or facing a substantial threat of personal liability at the time the derivative Complaint was filed,[104] these three directors—representing a majority of the Board—were entitled to consider demand. Therefore, under Rule 23.1, demand is not excused.[105]

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[103] *See Heineman*, 611 A.2d at 955.

[104] The Complaint can be said to have a paucity of particularized facts. The Plaintiffs declined the opportunity to inspect China Automotive's books and records under 8 *Del. C.* § 220, suggesting at oral argument that "you don't get much of anything" from a § 220 request of a Delaware corporation with its headquarters in the PRC, although they recognized that the Company might be "different." Tr. at 48. This Court has recognized the possible value of a § 220 suit in providing the basis for allegations of particularized facts in a derivative action. *See, e.g.*, *South*, 62 A.3d at 17; *Rattner*, 2003 WL 2284323, at *14; and *Guttman*, 823 A.2d at 504; *see also* Donald F. Parsons, Jr. & Jason S. Tyler, *Docket Dividends: Growth in Shareholder Litigation Leads to Refinements in Chancery Procedures*, 70 Wash. & Lee L. Rev. 473, 514-24 (2013) (identifying how, in response to the race to the courthouse that typically produces a first-filed complaint filled with sparse allegations, this Court has suggested creative procedural approaches to encourage the use of a § 220 action before a stockholder plaintiff files a derivative complaint). The potential futility of a § 220 suit in a derivative suit where no preceding § 220 request was made does not make for a persuasive argument. Stockholder plaintiffs must remember that § 220 is by no means the only way by which they could seek to adduce that demand should be excused.

[105] For similar reasons as above, because the Plaintiffs have not alleged particularized facts showing that Richardson, Tung, or Xu were interested, not independent, or facing a substantial threat of personal liability in their capacity as members of the Compensation Committee, demand is also not excused for those claims. Accordingly, demand is not excused for the related failure to remedy claim.

B. *The Insider Trading Claims*

The Plaintiffs next allege a breach of fiduciary duty by Chen and Wu when they sold "personally held stock at artificially inflated prices"[106] with knowledge of "material adverse information about the Company."[107] Delaware courts have long been willing to recognize this type of insider trading as a breach of fiduciary duty.[108]

Independent of whether the Plaintiffs have pled with particularity that Chen, Wu, or both, engaged in insider trading (which the Court does not now consider), at no point have the Plaintiffs alleged or argued that Richardson, Tung, or Xu engaged in, or gained a material benefit from, any insider trading; therefore, they were not interested and did not face a substantial threat of personal liability for these claims. Moreover, there are no further allegations about a lack of independence for these claims. Thus, since none of Richardson, Tung, or Xu was interested, lacking independence, or facing a substantial threat of personal liability under the particularized allegations of the Complaint, a majority of the Board survives scrutiny under the demand futility analysis.

Under Court of Chancery Rule 23.1, the Plaintiffs have not demonstrated that demand should be excused.

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[106] Compl. ¶ 80.
[107] *Id.* ¶ 81.
[108] *See Brophy v. Cities Service Co.*, 70 A.2d 5, 7-8 (Del. Ch. 1949).

C. *The Unjust Enrichment Claims*

The Plaintiffs have not alleged with particularity that any of Richardson, Tung, or Xu was unjustly enriched from purported breaches of their fiduciary duties or other wrongful conduct. Instead, the unjust enrichment claims are premised on the purported misstatements, which do not support a *Caremark* or other breach of fiduciary duty claim, and the alleged insider trading, which implicates only a minority of the Board. Under the same analysis of demand futility for the preceding *Caremark* claim, the Plaintiffs have failed to allege under Rule 23.1 a reasonable doubt of the capacity of a majority of the Board to consider impartially a demand for pursuit of the unjust enrichment claims.

V. CONCLUSION

For the foregoing reasons, this action is dismissed as to the Plaintiffs with prejudice. An implementing order will be entered.