

## Chancery Court Declines To Dismiss Derivative Claims For Audit Committee Oversight Failure And Unjust Enrichment

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In *William Hughes, Jr. v. Xiaoming Hu, et al.*, C.A. No. 2019-0112-JTL (Del. Ch. April 27, 2020), the Delaware Court of Chancery (the “Court”) held that stockholder plaintiff’s failure to make a demand on the board of directors (the “Board”) was excused and therefore denied defendants’ motions to dismiss under Court of Chancery Rules 23.1 and 12(b)(6) derivative claims brought by plaintiff on behalf of Kandi Technologies Group, Inc., a public Delaware corporation based in China (the “Company”). The derivative claims alleged that the Board, acting through its Audit Committee (the “Committee”), breached fiduciary duties by failing to implement effective oversight of the Company’s disclosure and financial information reporting controls and procedures and that as a result Company officers were unjustly enriched.

The Company struggled with disclosure and financial information reporting controls and procedures for years before [plaintiff filed the complaint](#). In audits of the Company’s 2010, 2011 and 2012 financial statements, the Company’s independent auditor AWC (CPA) Limited (“AWC”) discovered that the Company recorded transactions with Kandi USA, a top customer owned by the son of Company CEO Xiaoming Hu (“Hu”), under different counterparty names including Eliteway Management (“Eliteway”) and failed to properly account for these as related party transactions. AWC also discovered large amounts of cash purportedly parked in officers’ and employees’ personal bank accounts, but failed to inquire why this was so, verify the cash actually existed or explore whether these constituted related party transactions required to be disclosed. AWC either did not report these issues to the Committee or provided to the Committee only high-level characterizations of these as audit risks and control risks.

In a Form 10-K filed in March 2014 (the “2014 10-K”), the Company acknowledged a material weakness that rendered its disclosure controls and procedures ineffective, attributing this to a lack of communication between the Company’s internal audit function and the Committee. The 2014 10-K described efforts to remedy this weakness, including annual re-evaluation of the Committee’s effectiveness and direct reporting by the Company’s internal audit function to the Committee rather than to the CEO.

In two meetings in May 2014 after the Company filed the 2014 10-K, each lasting less than an hour, the Committee purportedly reviewed and approved policies relating to oversight of related-party transactions and was led to believe it would receive and have the opportunity to review agreements

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with Eliteway. The Committee next met once in March 2015 and once in March 2016. Each meeting lasted less than an hour and included review of the Company's annual financial statements, along with other items. The Board (in 2015) and the Committee (in 2016) took separate actions by written consent to approve or ratify items within the Committee's purview not discussed during these Committee meetings. On April 12, 2016, the Board resolved to remove AWC as the Company's auditor. The Committee acted by written consent that same day to replace AWC, attributing this to Company management's determination that it was "in the best interest of the Company to change its independent auditors."

In November 2016, the Company disclosed it had engaged in material related-party transactions with Kandi USA using the tradename Eliteway. The Company's CFO then resigned and was replaced by the third CFO since 2014. In March 2017 the Company announced its financial statements from 2014 through Q3 2016 could not be relied upon and would be restated. The Company subsequently filed a Form 10-K (the "2016 10-K") disclosing that the Company lacked sufficient expertise regarding US GAAP and SEC disclosure regulations, disclosure of related party transactions and other matters.

The Court held that demand by plaintiff on the Board was futile under Rule 23.1 with respect to plaintiff's claim that the directors who comprised the Audit Committee and Hu (collectively, the "Director Defendants") breached fiduciary duties by failing to maintain an adequate system of oversight, disclosure controls and procedures, and internal controls over financial reporting. This ruling was based on the Court's determination that plaintiff pled sufficient facts to create a reasonable doubt whether the Director Defendants, who were four of the six directors who comprised the Board at the time the complaint was filed (the "Demand Board"), could exercise independent judgment when deciding whether to bring the litigation. A stockholder may bring derivative claims, the Court explained, only when (i) the stockholder has demanded the directors pursue the claims and the board has wrongfully refused, or (ii) the reviewing court determines demand would be futile and is excused because there is a reasonable basis to doubt whether a majority of the directors could exercise independent judgment when deciding whether to bring the litigation. To establish a reasonable basis to doubt whether a director could exercise independent judgment, a derivative plaintiff must plead particularized facts to demonstrate that the director faces a substantial likelihood of personal liability in connection with the derivative claims.

The Court held that plaintiff pled sufficient facts from which to reasonably infer that the Director Defendants faced a substantial likelihood of personal liability, citing the Court's *Caremark* decision for the proposition that directors may be liable for breach of duty of loyalty if they (1) fail to implement any reporting or information system or controls; or (2) having implemented such system or controls, consciously fail to monitor or oversee its or their operations. Plaintiff's assertions, the Court indicated, supported a reasonable inference of Board failure of oversight of the Company's financial reporting and financial information controls for reasons including: after the Company acknowledged and pledged to correct deficient internal controls in 2014, the Committee continued to meet infrequently and for too short periods of time, routinely overlooking important issues; the 2016 10-K disclosed that the Company lacked expertise in subject-matter areas critical to the Committee's performance of its responsibilities listed in the Committee's charter; and the Committee relied on management's determination and did not engage in independent oversight in replacing AWC as auditor. The Court also determined that from the Company's failure to provide materials requested by plaintiff under Section 220 of the Delaware General Corporation Law it could be reasonably inferred that Board and Committee oversight policies either did not exist or did not impose meaningful restrictions on Company management and insiders and that the Committee did not review agreements with Eliteway.

Defendants argued that plaintiff's claims should be dismissed because the Company in fact had an Audit Committee, a Chief Financial Officer, an internal audit department, a code of ethics, and an independent auditor that evidenced Board oversight of disclosure and financial reporting controls and procedures. Calling these "trappings of oversight", the Court rejected this argument and found that the complaint's allegations support the inference that the Board did not make a good faith effort to establish its own monitoring and reporting system and chose to rely entirely on Company management. The Court noted as "telling" the absence of documents that Company could have produced in response to plaintiff's Section 220 request that would have rebutted this inference.

The Court also rejected defendants' argument that they should not be subject to liability because the restatement of Company's financial statements announced in March 2017 had no effect on the Company's net income and that the Company did not suffer harm as a result. At the pleading stage, the Court indicated, plaintiff's allegation that the Company suffered certain specified incidental damages is sufficient to support a claim for relief for breach of duty of loyalty, even without quantifiable damages to net income.

The Court held further that demand on the Board was futile with respect to plaintiff's claim that Hu and the three CFOs who served prior to the March 2017 restatement announcement were unjustly enriched by increased bonuses and compensation based on artificially inflated Company valuation resulting from deficient oversight by the Director Defendants. To evaluate this claim, the Court reasoned, the Demand Board would have to investigate and assert litigation based on the same breaches of the duty of loyalty that are the subject of plaintiff's failure of oversight claim, making demand futile with respect to the unjust enrichment claim for the same reason as for the failure of oversight claim.

For the same reasons as its holding and denial of motion to dismiss under Rule 23.1, the Court denied defendants' motion to dismiss pursuant to Rule 12(b)(6) for failure to state a claim. The Court ruled that the standard for pleading demand futility under Rule 23.1 is more stringent than under Rule 12(b)(6) and therefore that its Rule 23.1 analysis also is dispositive of the Rule 12(b)(6) motion.

[William Hughes, Jr. v. Xiaoming Hu, et al., C.A. No. 2019-0112-JTL \(Del. Ch. April 27, 2020\)](#)

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