Cahill

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Delaware Court of Chancery Holds That Duty of Oversight Imposed on Directors Applies Equally to Officers

Since the landmark decision *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) ("*Caremark*"), Delaware courts have imposed on directors of companies the duties of loyalty, care, and oversight. In an important decision issued on January 25, 2023, the Chancery Court recognized that the duty of oversight imposed on corporate directors applies equally to officers and that corporate officers must (1) ensure that proper information and reporting systems exist within the corporation and (2) appropriately address or escalate "red flags" suggestive of wrongdoing.[1] The court ruled that the plaintiffs in the derivative stockholder litigation stated claims against McDonald's head of human resources both for his alleged failure to exercise proper oversight as a corporate officer, which required him to "address or report upward about any red flags regarding sexual harassment and misconduct at McDonald's," and for an alleged breach of the duty of loyalty, stemming from his own alleged sexual misconduct.[2] The court also held that like an officer's duty of oversight, establishing a breach of the officer's duty of oversight requires pleading, and later proving, bad faith.

I. Background

McDonald's stockholders sued David Fairhurst, McDonald's Executive Vice President and Global Chief People Officer, derivatively on the company's behalf, alleging that as the head of human resources, he breached his fiduciary duties by allowing a corporate culture to develop that condoned sexual harassment and misconduct. Plaintiffs alleged that during Mr. Fairhurst's tenure, the human resources department ignored complaints about employee misconduct, dozens of employees filed complaints with the Equal Employment Opportunity Commission ("EEOC") in 2016 and in 2018, employees staged walkouts in 2016 and 2018 to protest sexual harassment and misconduct at the company, and Mr. Fairhurst promoted a culture of excessive drinking and partying. The plaintiffs contended that Mr. Fairhurst breached his fiduciary duties by consciously ignoring red flags concerning sexual harassment and misconduct at the company and by personally engaging in inappropriate behavior.

Mr. Fairhurst moved to dismiss the breach of the duty of oversight claim, arguing that Delaware law did not impose an obligation on officers comparable to the duty of oversight on directors articulated in *Caremark*.[3] The

[1] *In re McDonald's Corp. Stockholder Derivative Litig.*, No. 2021-0324-JTL, 2023 WL 387292 (Del. Ch. Jan. 26, 2023).

[2] *Id*. at *1-2.

[3] *Id.* at *20-21 (citing *Caremark* and Martin Lipton & Theodore N. Mirvis, *Chancellor Allen and the Director*, 22 Del. J. Corp. L. 927, 939 (1997)).

Chancery Court denied his motion to dismiss, holding that the plaintiffs had stated claims for breach of the duties of oversight and loyalty.

II. The Chancery Court's Decision

In a lengthy decision, the Chancery Court explained that the same duties that apply to directors logically extend to corporate officers under Delaware law, federal Organizational Sentencing Guidelines (the "Federal Sentencing Guidelines"), and principles of agency law. The court explained that officers run the day-to-day aspects of the business and are optimally positioned to identify red flags and report them upward to the company's board of directors, which may meet only monthly or less frequently.[4] The court found that officers have greater knowledge and responsibility for areas under their control and receive higher levels of compensation.[5] The court observed that the Federal Sentencing Guidelines call upon high-level personnel, including executive officers, to undertake compliance and oversight obligations,[6] and it also observed that, under principles of agency law, officers have a duty to use reasonable efforts to support the principal (*i.e.*, the board) with material information relevant to the affairs entrusted to them.[7] Considering the alternative, the court reasoned that if officers did not have oversight obligations, boards may not be able to sue officers for a fiduciary breach where the officer's oversight failure resulted in harm to the corporation.[8]

The Chancery Court's opinion is not without limitations. The court held that an officer's duty of oversight is limited to the officer's areas of responsibility. For example, although the Chief Executive Officer and Chief Compliance Officer likely will have company-wide oversight portfolios, a Chief Financial Officer is responsible only for financial oversight "and for making a good faith effort to establish reasonable information systems to cover that area," and a Chief Legal Officer has responsibilities only for legal oversight.

With respect to Mr. Fairhurst, the Chancery Court held that the plaintiffs adequately pleaded that he had violated his duty of oversight because his role as Global Chief People Officer included oversight of the human resources function and that he had failed to address red flags concerning sexual harassment, including dozens of complaints about sexual misconduct made to the EEOC and an employee walkout protesting problems with sexual harassment.[9] The court further held that the plaintiffs must also—and did—plead facts supporting an inference that Fairhurst consciously ignored red flags and acted in bad faith.[10] Plaintiffs pleaded several facts supporting *scienter*, including that the company failed to address the EEOC complaints and other complaints made to human resources, employees feared making complaints due to the possibility of retaliation, and Mr. Fairhurst himself had engaged in at least three instances of alleged sexual harassment for which he was ultimately terminated for cause in 2019.[11] The

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[4] *Id.* at *12.

[5] *Id*. at *22.

[6] Under the Federal Sentencing Guidelines, "high-level personnel" are assigned responsibility for ensuring that the organization has an effective compliance and ethics program and "high-level personnel" include directors and officers in charge of major business or functions of the organization. Thus, officers are explicitly held to have oversight obligations under the Federal Sentencing Guidelines. *Id.* at *11-12 (citing *Lebanon Cnty. Empls.' Ret. Fund* v. *AmerisourceBergen Corp.*, 2020 WL 132752, at *21 (Del. Ch. Jan. 13, 2020) ("Officers also are fiduciaries in their capacities as agents who report to the board of directors.").

[7] *Id.* at *14-15 (citing *Lebanon Cnty. Empls.' Ret. Fund* v. *AmerisourceBergen Corp.*, 2020 WL 132752, at *21 (Del. Ch. Jan. 13, 2020) ("Officers also are fiduciaries in their capacities as agents who report to the board of directors.").

[8] *Id.* at *16.

[9] *Id.* at *26.

[10] *Id.* at *28.

[11] *Id.* at *28-29.

court found that these allegations were enough to support a reasonable inference that red flags existed and that Fairhurst consciously ignored them and acted in bad faith.

In a decision that may have far reaching ramifications, the Chancery Court also held that sexual harassment is itself a breach of the fiduciary duty of loyalty, and such a claim can be brought derivatively.[12] The court rejected Mr. Fairhurst's argument that such a breach requires subjective intent to harm the company, because bad faith also exists where there is a "conscious disregard," a "dishonest purpose," or behavior that violates law and company policy in a manner that could harm the company's business and subject it to liability.[13] The court dismissed concerns that the decision would open up the Chancery Court to a flood of employment litigation. [14] As Vice Chancellor Laster aptly summarized: "Sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable."[15]

III. Conclusion

The *McDonald's* decision clarifies a previously unresolved issue under Delaware law regarding officers' fiduciary duties. Although the decision has the potential to expand these fiduciary duties, Vice Chancellor Laster articulated several limitations to a breach of the duty of oversight claim against an officer.

First, the decision makes clear that the nature and scope of the duty of oversight is context-driven and dependent upon the officer's area of expertise. For officers who have a particular area of responsibility, the officer's duty to make a good faith effort to establish an information system and address or report upward red flags only generally applies within the officer's area. Although the Chancery Court held that an officer may have a duty to report "a particularly egregious red flag," even if it falls outside the officer's area of expertise, it still is to be determined what types of red flags a court will consider to be "particularly egregious."

Second, the Chancery Court expressly declined to adopt a less protective standard of care on officers—such as negligence or gross negligence—holding that oversight liability for officers requires a showing of bad faith. Delaware law remains relatively protective of officers, presuming that they act in good faith, and plaintiffs must plead facts supporting a contrary inference. The facts supporting a showing of bad faith and conscious disregard for red flags in the *McDonald's* decision were particularly egregious, including that the defendant himself allegedly participated in sexual harassment that was witnessed by over 30 employees. Whether less serious conduct may rise to the level of bad faith remains unclear and is sure to be the subject to future litigation.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Bradley J. Bondi (partner) at 202.862.8910 or bbondi@cahill.com; Joel Kurtzberg (partner) at 212.701.3120 or jkurtzberg@cahill.com; Sara Ortiz (counsel) at 212.701.3368 or sortiz@cahill.com; Lauren Perlgut (counsel) at 212.701.3558 or lperlgut@cahill.com; or Sophia Slade-Ilaria (associate) at 212.701.3294 or sslade-ilaria@cahill.com; or e-mail publications@cahill.com.

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[12] *Id.* at *29-30.

[13] *Id.* at *29.

[14] *Id.*

[15] *Id* at 30.