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Practice Update

Delaware Court of Chancery Extends Oversight Obligations to Non-Director Corporate Officers

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In former Chancellor Allen's hallmark decision in *In re Caremark International, Inc. Derivative Litigation*, the Delaware Court of Chancery held that directors of a corporation owe stockholders the fiduciary duty of oversight. 698 A.2d 959 (Del. Ch. 1996). Specifically, the court held that a director's fiduciary duty of loyalty includes the duty to (1) ensure that corporate information and reporting systems provide senior management and the board with timely and accurate information "concerning both the corporation's compliance with law and its business performance"; and (2) address "red flags" that suggest wrongdoings or other failures within those systems that come to the board's attention.

However, on January 25, 2023, Vice Chancellor Laster issued an order in *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. No. 2021-0324-JTL (McDonald's) denying the defendants' motion to dismiss and holding, for the first time, that non-director corporate officers similarly owe stockholders a fiduciary duty of oversight.

This is significant because, over the last three decades, boards of directors alone bore the obligation to oversee their corporations. Indeed, the Delaware Supreme Court previously held that

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"*Caremark* articulates the necessary conditions for assessing *director* oversight liability." *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 365 (Del. 2006) (emphasis added); *see In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009) ("The Delaware Supreme Court made clear in *Stone* that *directors* of Delaware corporations have certain responsibilities to implement and monitor a system of oversight…") (emphasis added).

In his written decision, Vice Chancellor Laster noted that no Delaware judge had expressly held that officers owe similar oversight duties. He relied instead on the Delaware Supreme Court's prior statement that "the fiduciary duties of officers are the same as those of directors." *Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009). Vice Chancellor Laster reasoned that those "responsible for managing the day-to-day affairs of the corporate enterprise," namely, corporate officers, may in fact be better positioned than "part-time directors who meet a handful of times a year" to watch for and address red flags at a corporation. He also reasoned that holding corporate officers responsible for corporate oversight could result in better reporting from them to the board, allowing directors to better fulfill their own oversight obligations. Indeed, if an officer fails to report red flags to the board, directors may choose to sue the officer for breach of his or her duty of oversight.

Parameters of a Non-Director Corporate Officer's Oversight Obligation

Although Vice Chancellor Laster recognized that an officer's duty of oversight must necessarily be "constrained [to that officer's] area of responsibility," he noted that if a "red flag is sufficiently prominent," any or all company officers "might have a duty to report upward." In order to state a claim against a corporate officer, a plaintiff will still have to plead facts supporting an inference that "the fiduciary knew of evidence of corporate misconduct" and "that the fiduciary consciously failed to take action in response." That showing will be difficult if the alleged wrongdoing did not fall within the scope of the corporate officer's responsibilities.

In the *McDonald's* case, shareholders alleged that David Fairhurst, McDonald's Executive Vice President and Chief People Officer from 2015 until McDonald's terminated him in 2019, had a duty of oversight to ensure that the company provided a "safe and respectful workplace" for McDonald's employees. The shareholders alleged that Fairhurst and the CEO at the time, Steve Easterbrook, created a "boys' club" atmosphere where they and other McDonald's executives sexually harassed female employees.

During the time that Fairhurst was Vice President and Chief People Officer, there was a 30-city employee walkout, numerous EEOC complaints, and an inquiry letter from a United States Senator. The opinion concluded that shareholders had adequately alleged that Fairhurst knew as early as 2016 that there were potential problems with sexual harassment and misconduct at McDonald's. This finding was supported by the allegation that Fairhurst "contributed to a party culture" and engaged in sexual misconduct himself. As Vice Chancellor Laster explained, "sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable." Shareholders also adequately alleged that Fairhurst acted with bad faith by ignoring the many red flags. In fact, documents produced by the company in response to a shareholder books and records demand suggested that Fairhurst took no action to report sexual harassment issues to the board. On these facts, Vice Chancellor Laster concluded that shareholders will be permitted to pursue a *Caremark* claim against Fairhurst.

Key Takeaways

As a result of the *McDonald's* decision, non-director corporate officers may now be named as defendants in more derivative complaints alleging oversight failures. Note, however, that while the *McDonald's* decision may open the door for more officer-related derivative actions, *Caremark* claims still remain "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Caremark*, 698 A.2d at 967. In addition, shareholder plaintiffs will still need to either first demand the board take legal action against the officer or plead why a pre-litigation demand would be futile. Demand futility will be more challenging to prove against non-director officers because directors will not face the same risk of personal liability they face when the demand seeks a suit against the board.

Going forward, boards should work closely with senior management to adequately define each officer's duties and responsibilities in writing, as those limitations may impact the extent of their liability under *Caremark*. Relatedly, boards and senior management should make decisions regarding a reporting structure for officers who are exposed to information that might constitute a red flag of misconduct under *Caremark*. It is also wise for corporations to review their directors and officers insurance policies to ensure appropriate coverage is available going forward for officers named in *Caremark*-related actions.

Finally, while Delaware law allows a corporation to exculpate non-director officers for breaches of the duty of care, *Caremark* claims are based on the duty of loyalty and are not subject to exculpation. Corporations should consider the impact, if any, on their indemnification obligations to their officers in their employment agreements or otherwise.

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information contained in this Update without seeking the advice of legal counsel.