

Memorandum

Delaware Court of Chancery: Corporate Officers, Not Just Directors, Can Be Liable for Duty of Oversight Violations

January 30, 2023

In an important opinion that will have significant implications for derivative lawsuits arising from corporate crises, ESG issues and financial challenges, Vice Chancellor Laster on January 25, 2023 denied a motion to dismiss a derivative lawsuit alleging that the former head of human resources (“Defendant”) for global fast food company McDonald’s breached his fiduciary duties by (i) consciously ignoring red flags regarding sexual harassment and misconduct at the company and (ii) personally engaging in sexual harassment. *In re McDonald’s Corp. S’holder Derivative Litig.*, No. 2021-0324, 2023 WL 387292 (Del. Ch. Jan. 25, 2023).

Vice Chancellor Laster announced that “[t]his decision clarifies that corporate officers owe a duty of oversight[.]” rejecting Defendant’s contention that Delaware law does not impose obligations on corporate officers that are comparable to the duty of oversight articulated for directors in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

In concluding that Defendant owed a duty of oversight, the court explained that Defendant “had an obligation to make a good faith effort to put in place reasonable information systems so that he obtained the information necessary to do his job and report to the CEO and the board, and he could not consciously ignore red flags indicating that the corporation was going to suffer harm.”

Officers Owe Oversight Duties Comparable to Those of Directors

While acknowledging that “no Delaware decision has stated the proposition in so many words,” VC Laster concluded that “diverse authorities indicate that officers owe a fiduciary duty of oversight as to matters within their areas of responsibility.” Among others, VC Laster cited *Caremark* itself, the equating of officer duties with director duties in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), principles of agency, decisions from other jurisdictions and academic commentary.

VC Laster opined that the same policies that motivated Chancellor Allen to recognize the duty of oversight for directors in *Caremark*, applied equally, if not to a greater degree, to officers. The opinion reasoned that finding otherwise, that officers owe no oversight duties, “would undermine directors’ ability to fulfill their statutory obligation to direct and oversee the business and affairs of the corporation.” VC Laster explained that much as a junior manager with supervisory duties can report to a senior manager with supervisory duties, an officer with a

duty of oversight can report to a board of directors with a duty of oversight. VC Laster also observed that a board with oversight duties can hold an officer accountable for failing to fulfill the officer-level duty of oversight.

The Scope of an Officer's Oversight Duty

VC Laster found “that oversight liability for officers requires a showing of bad faith. The officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore red flags.”

Offering some guidance as to how a court should proceed when examining an officer's oversight duties, VC Laster stated that the duty is context-driven and its application will differ depending on the role. For example, some officers, like the CEO or CCO, will have a company-wide remit, while others are limited to particular areas of responsibility, reporting red flags only within their areas of responsibility. However, VC Laster cautioned that “a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain.”

Plaintiffs' Allegations Support an Oversight Claim Against Defendant

Noting that plaintiffs framed their oversight claim explicitly as a breach of the “duty of care by exercising inadequate oversight over enterprise risk management, and with regard to sexual harassment happening at the Company's franchises[,]” VC Laster stated that under Delaware's system of notice pleading, the court should ask whether the complaint contained a short, plain statement of facts sufficient to support a claim for breach of the duty of oversight. Identifying the applicable standard, the court stated:

“To plead a Red-Flags Claim that will survive a Rule 12(b)(6) motion, a plaintiff must plead facts supporting an inference that the fiduciary knew of evidence of corporate misconduct. The plaintiff also must plead facts supporting an inference that the fiduciary consciously failed to take action in response. The pled facts must support an inference that the failure to take action was sufficiently sustained, systematic, or striking to constitute action in bad faith. A claim that a fiduciary had notice of serious misconduct and simply brushed it off or otherwise failed to investigate states a claim for breach of duty.”

Finding that plaintiffs have asserted a “Red-Flags Claim,” VC Laster stated that plaintiffs described their oversight claim as resting on Defendant (i) knowing about evidence of sexual misconduct and (ii) acting in bad faith by consciously disregarding his duty to address the misconduct.

As to the first claim, the court found that plaintiffs identified a number of red flags, including coordinated complaints submitted to the Equal Employment Opportunity Commission, employee walkouts and protests about sexual harassment, and Congressional inquiries, indicating for pleading purposes that sexual harassment occurred at the company and supporting a reasonable inference that Defendant knew about the red flags. The court observed that Defendant was the executive officer with day-to-day responsibility for overseeing the human

resources function and promoting a safe and respectful environment, and was thus supposed to have his ear to the ground and be knowledgeable about the company's employees.

As for the plaintiffs' second claim, whether plaintiffs pleaded facts supporting an inference that Defendant acted in bad faith by consciously ignoring red flags, VC Laster explained that Delaware law presumes that directors and officers act in good faith, and a complaint must plead facts sufficient to support an inference of bad faith intent. Concluding that several factors support an inference of scienter, the court pointed to the allegations about Defendant's own participation in multiple acts of sexual harassment, for which he was formally reprimanded, to conclude that "[w]hen a corporate officer himself engages in acts of sexual harassment, it is reasonable to infer that the officer consciously ignored red flags about similar behavior by others." Further, VC Laster noted plaintiffs alleged that—under Defendant's leadership—the company's human resources department ignored complaints and that employees feared retaliation for reporting complaints.

Plaintiffs' Allegations State a Claim for Breach of the Duty of Loyalty as to Defendant's Own Acts of Harassment

The court also denied dismissal of plaintiffs' claim that Defendant's own acts of sexual harassment constituted a breach of the duty of loyalty. The court explained that an alleged harasser acts in bad faith and breaches the duty of loyalty because a harasser engages in sexual harassment for selfish reasons. The court concluded by noting: "Sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable."

Takeaways

Although the opinion suggests that a flood of new employment-style claims in the Chancery Court seems unlikely because "all of the protections associated with derivative claims apply," we expect that the opinion's application of oversight duties to corporate officers will lead to a bevy of new derivative demands, committee processes and lawsuits that companies will need to untangle. Corporate officers may find some comfort in the opinion's application of a "bad faith" standard for liability, rather than the lower gross negligence standard applicable for non-exculpated officer duty of care claims. There are several areas to consider as officers begin to confront new legal risks in this area:

- *Officer oversight standards will further develop:* The Court was clear that application of the duty of oversight to officers is context-driven, so further decisions will be needed to round out how these duties may apply to different companies and officers. Certain aspects of the opinion may be subject to further litigation, including application of the "bad faith" standard, as well as questions regarding what types of risks are subject to the oversight duty and which officers are responsible for them. Recent Delaware decisions have focused board oversight responsibilities on risks that are central, indeed "mission critical" to the company. The *McDonald's* opinion does not employ such language, and is already leading to questions about the breadth of potential officer oversight responsibilities.

- *Officers should assess what steps they can take to ensure oversight:* In addition to the oversight structures that many companies have put into place to ensure board oversight and reporting of material risks, corporate officers need to assess their role in this process and potentially take new steps to ensure that they are receiving necessary information and acting upon new facts that they learn about the business within their purview. This could potentially take the form of expanded executive risk committees, similar to such committees that have been established by many companies over the past few years to concentrate on business risk identification and reporting, as well as efforts by officers to establish more regular and quantitative reporting of risks within their chain-of-command.
- *Companies should re-evaluate officers' legal arrangements:* Companies should re-evaluate who are their corporate officers, and how those officers' employment and indemnification agreements and D&O insurance coverage is structured. Under Delaware law, officers are those appointed/removed by the board or so-designated under the charter and bylaws. Those officers should be covered under the company's D&O insurance program, and the company should evaluate whether changes to their employment and indemnification arrangements need to be made.
- *Companies should consider whether to amend their charters:* Such an amendment would exculpate officers for breaches of the duty of care under recent 2022 Delaware amendments. Effective August 1, 2022, Section 102(b)(7) of the Delaware General Corporation Law was amended to allow Delaware corporations to adopt exculpatory language in their certificates of incorporation limiting the personal liability of both directors and officers, including the president, CEO, COO, CFO, and CLO, among others.

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