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Memorandum

Delaware Chancery Court Dismisses *McDonald's* Derivative Lawsuit On Demand Futility Grounds and Director Oversight Claims For Failure To State A Claim

March 9, 2023

On March 1, 2023, the Delaware Chancery Court dismissed the derivative lawsuit asserting various breach of the duty of oversight claims against former officers and the board of global fast-food company McDonald's Corp. relating to allegations of sexual harassment and misconduct at the company. *In re McDonald's Corp. S'holder Derivative Litig.*, No. 2021-0324, 2023 WL 2293575 (Del. Ch. Mar. 1, 2023). The Court's March 1 decision follows Vice Chancellor Laster's widely covered January 26, 2023 opinion holding that officers, in addition to directors, have a duty of oversight under Delaware law.[1] In his March 1 opinion, VC Laster held that plaintiffs had not stated a claim against the Director Defendants: (i) for failing to take action to address "red flags" indicating that sexual harassment and misconduct was occurring at the company; and (ii) for certain executive employment decisions made by the board. In a separate order also issued on March 1, VC Laster dismissed the entire case, including claims against the company's Global HR Head, David Fairhurst, under Rule 23.1 for failure to plead that demand was excused.

Plaintiffs Failed To State a Red-Flags Claim Against the Director Defendants for Breach of the Duty of Oversight

VC Laster dismissed plaintiffs' claim that the Director Defendants breached a duty of oversight under the second prong of *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), a so-called "Red-Flags Claim." VC Laster explained that "[a]lthough they have pled facts supporting an inference that red flags came to the attention of the Director Defendants, they have not alleged facts supporting a reasonable inference that the Director Defendants acted in bad faith in response to those red flags."[2]

VC Laster stated that plaintiffs pled facts supporting an inference that by the end of 2018, the Director Defendants were on notice of problems at the company with sexual harassment and misconduct that had caused or threatened

[1] For more on this decision, please see our January 30, 2023 memorandum, *Delaware Court of Chancery: Corporate Officers, Not Just Directors, Can Be Liable for Duty of Oversight Violations*.

[2] While a prong-one *Caremark* claim concerns whether the directors utterly failed to implement any reporting or information system or controls, a so-called "Information Systems Claim," a prong-two or "Red-Flags Claim" concerns whether the directors consciously failed to monitor or oversee such a system or controls, thus disabling themselves from being informed of risks or problems requiring their attention. Generally, a Red-Flag Claim involves allegations that a board's information system generated red flags indicative of wrongdoing but the directors failed to take action in response.

to cause the company harm, which satisfied the first element of their Red-Flags Claim. These facts included, among other things, that there had been a second round of coordinated EEOC complaints, a ten-city strike, a Congressional inquiry, and the Director Defendants learned in December 2018 that Fairhurst had personally engaged in acts of sexual harassment.

However, VC Laster stated that plaintiffs' claim fell short regarding the Director Defendants' response to the red flags. VC Laster noted that while plaintiffs did plead facts supporting an inference that until the end of 2018, the Director Defendants operated in business-as-usual mode, the Court found that at the end of 2018 their attitude changed when management began taking action and the Director Defendants began focusing on harassment and misconduct. By June 2019, the company was taking a number of responsive steps that included, among other things, hiring outside consultants; revising the company's policies; implementing new training programs; providing new levels of support to franchisees; and setting up an employee hotline. VC Laster noted that in November 2019, the board also terminated Easterbrook without cause after learning of his improper relationship with an employee, and terminated Fairhurst with cause after learning that he had violated the terms of his "Last Chance Letter."

Pointing out that the pleading-stage record showed that the Director Defendants responded to the red flags, VC Laster concluded that it was not possible to infer that they acted in bad faith and that the breach of the duty of oversight claim must be dismissed.

The Business Judgment Rule Protected the Director Defendants' Affirmative Employment Decisions

With respect to the Director Defendants' affirmative decisions to: (i) promote Easterbrook to CEO; (ii) discipline Fairhurst rather than terminate him; and (iii) terminate Easterbrook without cause, VC Laster held that the business judgment rule protected each decision. VC Laster determined that "[n]one of the established situations in which enhanced scrutiny applies are present in this case, rendering that standard inapplicable." Rather than applying a heightened standard of review, the Court applied the business judgment rule. As VC Laster explained, the business judgment rule "recognizes that people can make mistakes, even when acting diligently, loyally, and in good faith" and "[u]nless a higher standard of review applies, the law provides no basis to challenge the director's good faith judgment, however misguided."

Entire Lawsuit Dismissed Under Rule 23.1

The Court issued two lengthy opinions related to the *McDonald's* derivative lawsuit: (i) the January 26 opinion denying the motion to dismiss filed by Fairhurst; and (ii) the March 1 opinion granting motions to dismiss by the Director Defendants. On March 1, the Court also issued a short order dismissing the *McDonald's* derivative lawsuit in its entirety, including the claims previously allowed to proceed against Fairhurst, on demand futility grounds. *In re McDonald's Corp. S'holder Derivative Litig.*, No. 2021-0324 (Del. Ch. Mar. 1, 2023) (Order Granting Dismissal Under Rule 23.1). VC Laster's dismissal of all claims in the case raises potential questions about the precedential weight of his January opinion on officer oversight liability.

The Court's demand futility ruling also highlights the challenges in bringing a derivative lawsuit focused on officer misconduct. As the decision to initiate litigation on behalf of the company falls squarely within the province of the board of directors, a plaintiff must plead a basis to excuse Rule 23.1's demand requirement before proceeding with such litigation. Here, plaintiff argued that demand should be excused because the Director Defendants faced a "substantial risk of liability" for their own oversight failures and affirmative decisions. Having dismissed the claims against the board, as described above, the Court declared that "the road to establishing demand futility that the plaintiffs sought to travel is closed." VC Laster's order reinforces that the demand futility requirement of Rule 23.1 remains a separate and independent hurdle that a derivative plaintiff must clear to prosecute officer oversight liability claims.

Key Takeaways

This decision reinforces the challenges of pursuing derivative litigation for officer misconduct. Although VC Laster in his January *McDonald's* opinion downplayed the likelihood of a flood of new employment-style breach of fiduciary claims because of "all of the protections associated with derivative claims apply," certain commentators nonetheless opined the decision would do just that. With his March 1 motion to dismiss opinion and separate Rule 23.1 dismissal order, VC Laster bolsters his earlier statement that the derivative requirements will act as a backstop against a flood of new lawsuits. Given the challenges of pleading demand futility related to officer misconduct against an independent board, any increase in claims more likely will take the form of Section 220 "books and records" demands and derivative demands made to boards, than derivative complaints seeking to plead demand futility.

Treatment of "mission critical" risk. VC Laster also addressed an outstanding question raised by his January *McDonald's* decision, related to whether and to what degree the "mission critical" language from *Marchand v. Barhill*, 212 A.3d 805 (Del. 2019) applies in the context of officer oversight claims. The January *McDonald's* opinion did not use this language. VC Laster last week opined that "[t]o plead a Red-Flags Claim, a plaintiff does not have to plead that the red flags (or a single, striking red flag) concerned 'mission critical' risks." VC Laster stated that in *Marchand*, the Court used the "mission critical" phrase just once and only when analyzing the Information-Systems Claim. VC Laster explained that, unlike this case, *Marchand* did not address a Red-Flags Claim. VC Laster nevertheless noted that a mission critical risk may affect the Court's bad faith analysis, stating that "if a red flag concerns a central compliance risk, then it is easier to draw an inference that a failure to respond meaningfully resulted from bad faith."

Good faith efforts, not perfect results, are required. Noting evidence suggesting that actions taken by the company in 2019 did not solve the harassment and misconduct problems at the company, VC Laster stated that "[w]hether the response fixed the problem is not the test. Fiduciaries cannot guarantee success, particularly in fixing a sadly recurring issue like sexual harassment. What they have to do is make a good faith effort."

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