

DELAWARE COURT FINDS CORPORATE OFFICERS HAVE DUTY OF OVERSIGHT AND SEXUAL HARASSMENT CAN BE A BREACH OF THE DUTY OF LOYALTY

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OVERVIEW

On 26 January 2023, the Delaware Court of Chancery (the Court) issued an important decision for corporations and their officers, finding for the first time that corporate officers—not just directors—owe a fiduciary duty of oversight. However, the Court held that an officer's duty of oversight generally applies only as to matters within the officer's areas of responsibility.¹ The Delaware courts have consistently held that officers owe the same fiduciary duties as directors, and this decision clarifies that those duties include the duty of oversight. The Court further held—again for the first time—that sexual harassment by an officer constitutes bad faith conduct that breaches the duty of loyalty to the corporation.²

Corporations should take note of this decision and ensure that they have the proper systems in place to promptly detect, report, and appropriately remedy misconduct.

FACTUAL BACKGROUND

In re McDonald's Corporation Stockholder Derivative Litigation (McDonald's Fairhurst) is a derivative lawsuit (i.e., a claim filed by a company's stockholders alleging harm to the company) against McDonald's directors and officers, including David Fairhurst, the company's former executive vice president and global chief people officer. The stockholder plaintiffs alleged that Fairhurst allowed a “toxic culture to develop at the Company that turned a blind eye to sexual harassment and misconduct” by ignoring red flags, thereby acting in bad faith and breaching his duty of loyalty.³ The stockholder plaintiffs asserted similar allegations against nine of the company's directors, claiming the directors were aware of a problem with sexual harassment and misconduct at the company, which they consciously ignored.⁴

Officers Have a Duty of Oversight

The duty of oversight, first established for directors in *Caremark*,⁵ requires directors (and now officers) to (i) make a good faith effort to ensure that corporations have implemented proper reporting systems, and (ii) appropriately address “red flags” suggestive of corporate wrongdoing. Oversight liability arises from the duty of good faith, a subsidiary element of the duty of loyalty and requires a showing of bad faith on the part of the officer or director.

The *McDonald's Fairhurst* stockholders cited a lengthy list of red flags that Fairhurst allegedly ignored, including numerous complaints about sexual harassment and misconduct filed by employees with the Equal Employment Opportunity Commission, coordinated walkouts and strikes by employees in multiple cities protesting the company's culture relating to sexual harassment, and an inquiry by U.S. senators about sexual harassment and workplace safety.⁶

Fairhurst moved to dismiss the oversight claim arguing that the Court's prior rulings created a duty of oversight only for directors, not officers. The Court rejected Fairhurst's argument, citing its decision in *Gantler v. Stephens* that "the fiduciary duties of officers are the same as those of directors" and finding that officers, too, owe a duty of oversight.⁷

The Court clarified an important limitation to an officer's duty of oversight—it applies only to the officer's areas of responsibility. Officers are required to make a good faith effort to establish information systems only within the areas of their responsibility and "generally only will be responsible for addressing or reporting red flags within their areas of responsibility."⁸ So, while "the CEO and Chief Compliance Officer likely will have company-wide oversight portfolios, other officers generally have a more constrained area of authority."⁹ The Court noted an exception to this limitation for "sufficiently prominent" or "particularly egregious" red flags, which "might require an officer to say something even if it fell outside the officer's domain."¹⁰ It cautioned that an "officer who receives credible information indicating that the corporation is violating the law cannot turn a blind eye and dismiss the issue as 'not in my area.'"¹¹

Fairhurst argued that plaintiffs had not alleged sufficient facts to support an inference that he acted in bad faith, and thus, plaintiffs had not met their pleading burden with respect to a claim for a breach of the duty of oversight, were it to apply to officers.¹² However, the Court rejected this argument, finding that plaintiffs' allegations supported a reasonable inference that Fairhurst was aware of potential issues with sexual harassment and misconduct and acted in bad faith by consciously ignoring them.¹³ The Court also pointed to Fairhurst's own alleged acts of sexual harassment in reaching its decision, finding 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."¹⁴

Interestingly, the Court reached a different decision on a subsequent motion to dismiss the stockholder plaintiffs' oversight claim against the company's nine directors. The Court found that while the directors were aware of the company's problem with sexual harassment, they took sufficient action to address it and therefore did not act in bad faith and breach their duty of oversight.¹⁵ Instead, the defendants, working with company management, hired outside consultants, revised company policies, implemented new training programs, provided new levels of support to franchisees, and took other steps to establish a renewed commitment to a safe and respectful workplace.¹⁶

Sexual Harassment as a Breach of the Duty of Loyalty

In the decision pertaining to Fairhurst, the Court also found that plaintiffs put forth sufficient allegations to support a claim that Fairhurst breached his fiduciary duty of loyalty by allegedly engaging in sexual harassment.¹⁷ Fairhurst had allegedly done so on three separate occasions, ultimately resulting in his termination in November 2019.¹⁸ The Court held that, "[w]hen engaging in sexual harassment, the harasser engages in reprehensible conduct for selfish reasons," which harms the company "by violating company policy, violating positive law, and subjecting the Company to liability."¹⁹ "By doing so, the fiduciary acts in bad faith and breaches

the duty of loyalty.”²⁰ In other words, selfish conduct that harms the corporation, such as sexual harassment, is bad faith conduct that breaches the duty of loyalty.

IMPLICATIONS AND KEY TAKEAWAYS

The *McDonald's Fairhurst* decision follows an increase in *Caremark* claims in the Court, as well as an increase in fiduciary claims against officers. However, *Caremark* claims remain the most difficult fiduciary duty claims for a plaintiff to bring for a number of reasons:

- First, cases like *McDonald's Fairhurst* are highly contextual, with this one coming on the heels of a years-long scandal related to the company's culture relating to sexual harassment.
- Second, *Caremark* cases require plaintiffs to plead specific allegations of bad faith, which is often a difficult task and generally requires the plaintiffs to first bring a Section 220 books-and-records demand.
- Third and finally, plaintiffs must either make a pre-suit litigation demand or plead that such a demand would be futile because at least half of the board lacks independence or faces a substantial likelihood of liability. This is a difficult bar to meet and often results in dismissal of derivative suits.

We expect to see further legal developments regarding the duty of oversight, which should bring some clarity to the questions left unanswered by *McDonald's Fairhurst*. For instance, if an officer reports a red flag but no action is taken, will the officer still face oversight liability? What makes a red flag “particularly egregious” to require an officer to report even if outside the officer's area of responsibility? Will red flags differ for officers and directors?

This decision is particularly important in the employment context. Indeed, *McDonald's Fairhurst* has brought sexual harassment into the arena of fiduciary duties. This may lead to significant liability for corporations with inadequate information and reporting systems regarding sexual harassment and misconduct allegations. Plaintiffs may be more inclined to bring derivative suits for breach of the fiduciary duty of oversight, particularly where an officer is alleged to have personally engaged in sexual misconduct.

Additionally, premiums for D&O insurance (which, subject to policy terms and conditions, insures directors and officers against claims of fiduciary duty breaches) have increased significantly for many companies over the past few years, and if the *McDonald's Fairhurst* decision leads to a marked increase in direct or derivative claims against officers—or even a perceived risk of such an increase—those premiums could continue to grow.

At minimum, *McDonald's Fairhurst* should persuade corporations (and their boards and officers) to ensure they are adequately prepared for such suits from a risk management, reporting, and compliance perspective by taking the following steps:

- Ensure directors, officers, and others in supervisory roles are clearly informed of and trained on the company's reporting systems and protocol (including how and when to report to the board).
- Consider creating a policy (if one does not already exist) on officer oversight obligations, including how officers should document their knowledge of and responses to red flags (including to the board).
- Consider how officers' areas of responsibility and duties are defined and documented, given that oversight liability will be confined to those areas, except in the case of “egregious” red flags.

- Ensure there are appropriate anti-harassment and anti-discrimination policies, practices, and trainings and reporting, investigation, and compliance policies and systems in place. These could include, for example, creating a hotline for employee complaints, conducting training for human resources personnel on proper investigation procedures and best practices, conducting separate trainings for supervisors on their reporting obligations, etc.
- Consider revising certificates of incorporation to add clauses exculpating senior officers from personal liability for monetary damages in connection with breaches of their fiduciary duty of care (but note that such clauses will not protect from oversight or sexual harassment fiduciary duty claims because officers cannot be indemnified for breaches of the duty of loyalty or bad faith conduct; in addition, officers may not be exculpated in connection with derivative proceedings).
- Confirm, in view of relevant law regarding a company's legal ability to indemnify for derivative settlements, that the company's D&O insurance program has adequate "Side-A" coverage (including, if appropriate, separate "Side A-only" insurance policies) to indemnify directors and officers against derivative lawsuits claiming fiduciary breaches.
- Officers and directors should also pay close attention to processes and limitations on "Side-B" coverage under the D&O insurance policy, which provides reimbursement to the company for directors' and officers' legal expenses in defending covered claims.

K&L Gates lawyers will continue monitoring developments related to the *McDonald's Fairhurst* decision and are available to answer any questions you may have.

FOOTNOTES

¹ In re McDonald's Corp. Stockholder Deriv. Litig. (*McDonald's Fairhurst*), No.2021-0324-JTL, 2023 WL 387292 at *2 (Del. Ch. Jan. 26, 2023).

² *Id.* at *4–5.

³ *Id.* at *55.

⁴ In re McDonald's Corp. Stockholder Deriv. Litig. (*McDonald's Directors*), No.2021-0324-JTL, at *1 (Del. Ch. Mar. 1, 2023).

⁵ In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).

⁶ *McDonald's Fairhurst*, 2023 WL 387292 at *55–56.

⁷ *Id.* at *27.

⁸ *Id.* at *42.

⁹ *Id.* at *41.

¹⁰ *Id.* at *2, *42.

¹¹ *Id.* at *42.

¹² *Id.* at *3.

¹³ *Id.* at *4.

¹⁴ *Id.*

¹⁵ *McDonald's Directors* at *1–3.

¹⁶ *Id.* at *2, *44.

¹⁷ *McDonald's Fairhurst* at *62.

¹⁸ *Id.* at *3, *58.

¹⁹ *Id.* at *5, *62–63.

²⁰ *Id.* at *5.

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