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# Delaware Court of Chancery Holds for the First Time that Corporate Officers Owe a Duty of Oversight

On January 26, 2023, the Delaware Court of Chancery in *In re McDonald's Corp. Stockholder Derivative Litigation* declined to dismiss a derivative breach of fiduciary duty claim against a corporate officer and for the first time held that corporate officers owe a duty of oversight.

Plaintiffs alleged that McDonald's Corporation's directors, its former CEO, and its former head of human resources, David Fairhurst, breached their fiduciary duties to the company. Analyzing the claims against Fairhurst, the court held that the Plaintiff sufficiently pled that Fairhurst "ignored red flags about sexual harassment at the Company, resulting in harm that manifested itself outwardly through lawsuits and attendant reputational harm." The court also ruled allegations that Fairhurst personally "committed multiple acts of sexual harassment" and "that under Fairhurst's watch, the human resources department ignored complaints about the conduct of co-workers and executives" were sufficient to constitute knowing misconduct at the pleading stage. The court further held 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."

In the decision, Vice Chancellor Laster held that officers have "an obligation to make a good faith effort to put in place reasonable information systems" and cannot "consciously ignore red flags indicating that the corporation [is] going to suffer harm." This oversight duty had previously been applied only to corporate directors. According to the Vice Chancellor, the duty might be limited based on an officer's role and areas of responsibility within the corporation.

## IMPLICATIONS

Vice Chancellor Laster's decision in *McDonald's* is not binding precedent in the Court of Chancery or the Delaware Supreme Court and it is possible that other Delaware courts, including the Delaware Supreme

Court, may disagree with the reasoning and conclusions in *McDonald's* or narrow its scope. Notwithstanding that this issue is likely to develop further, there are a number of topics that Delaware corporations and their boards might wish to consider:

- *McDonald's* continues a trend in the Delaware courts to expand the scope of oversight claims. Although *Caremark* itself noted that oversight claims are "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," Delaware courts in recent years have increasingly declined to dismiss oversight claims against directors at the motion to dismiss stage.
- Although *McDonald's* might encourage stockholder plaintiffs to file oversight derivative claims against officers, those derivative actions will face serious challenges in many cases. Specifically, a stockholder plaintiff will need to plead that pre-suit demand is excused based on at least half of the board of directors lacking independence or facing a substantial likelihood of liability. This should remain a high threshold hurdle in most cases. Even where demand is excused against directors based on the substantial likelihood of liability standard, this should not mean that claims against officers automatically proceed past the demand excusal stage. For example, in *In re Boeing Company Derivative Litigation*, although allowing oversight claims against directors to proceed, the Court of Chancery dismissed oversight claims against officers because the derivative plaintiffs had not pled demand excusal with particularity, including that the board was "beholden to or dominated by the Boeing officers."
- If the principle of officer oversight duties becomes more broadly accepted, the scope of those duties will likely develop further. *McDonald's* assumed that a key issue for consideration would be the officer's area of responsibilities, including whether they were company-wide or divisional, or, for some situations, whether a red flag was "sufficiently prominent" that an officer would have oversight duties outside of that officer's areas of responsibility. But the decision did not address how this standard should be reconciled with other Delaware cases limiting director oversight responsibilities to "mission critical" aspects of the corporation's business or holding that allegations of mismanagement or poor business judgment are insufficient to allege a breach of fiduciary duty.
- The *McDonald's* decision might encourage stockholders to seek corporate books and records pertaining to officers. Delaware cases have generally limited books and records requests to board-level documents, with a recent decision noting that "[f]ormal board-level documents are often the beginning and end of a Section 220 production where a plaintiff aims to investigate whether directors exercised proper oversight." Delaware cases have also emphasized that books and records proceedings contemplate a "discrete set of books and records" intended to be "much less extensive than would likely be produced in discovery." Officers will necessarily have access to a far greater volume of documents and communications than directors, and permitting books and records requests concerning allegations of officer breaches of oversight duties would impose heightened burdens on and risks to corporations.
- Similarly, the *McDonald's* decision might encourage stockholders to make litigation demands on boards concerning officer oversight claims. This could require boards to engage in costly and burdensome investigation of claims.
- When renewing directors and officers (D&O) policies, boards should consider what coverage is available associated with possible officer oversight claims. To the extent that *McDonald's* emboldens stockholder plaintiffs to assert additional claims, increases in policy costs may occur.
- In August 2022, the Delaware General Assembly amended Section 102(b)(7) of the Delaware General Corporation Law to allow corporations to include in their certificate of incorporation a provision exculpating certain categories of officers (not just directors) from liability for breaches of the duty of care. However, the amendment extends only to direct claims (such as class actions), not derivative claims, and does not extend to duty of loyalty claims or claims for intentional misconduct. Such exculpation thus may be inapplicable to oversight claims, which are generally

grounded in a breach of the duty of loyalty, and, as recognized in *McDonald's*, require proof of bad faith. Nonetheless, the willingness of the court in *McDonald's* to expand potential officer liability will likely cause boards of Delaware corporations to consider whether to propose amending their certificates of incorporation to allow for officer exculpation, including because this may be a necessary and appropriate step to attract and retain high-caliber officers.

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