

Bodman PLC

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### Delaware Court of Chancery Establishes That the Duty of Oversight Extends to Officers

By: **Matthew A. Slipchuk**, Associate, **Kenneth R. Powell**, Member, and **Joseph R. Morrison**, Member, Business Practice Group

On January 25, 2023, the Delaware Chancery Court issued its ruling in *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. No. 2021-0324-JTL (Del. Ch. Jan. 26, 2023), holding for the first time that a corporate officer (not just directors) owes a duty of oversight to the corporation. This ruling expands the original *In re Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), holding that directors have a duty of oversight to officers as well.

The lawsuit in question concerned substantial allegations that McDonald's Global Chief People Officer, David Fairhurst, harmed the company by failing to adequately address, promoting a culture of, and personally committing, sexual harassment and other acts of workplace misconduct.

The stockholders claimed that Fairhurst breached his duty of oversight, which required him, among other things, to report up the chain of command "red flags" relating to sexual misconduct. The stockholders further alleged that Fairhurst's personal engagement in sexual harassment, which resulted in his termination in 2019, contributed to the toxic culture for which he was liable.

The Chancery Court denied Fairhurst's motion to dismiss, and held that, like directors of a company, corporate officers owe a duty of oversight that necessitates such officers:

1. Have systems to obtain information about things relevant to their duties ("**Information Systems**"), and
2. Not ignore "red flags" about issues relevant to their duties when they arise ("**Red Flag Obligations**").

Applying these standards, the court held that the stockholders had adequately stated a claim for breach of the duty of oversight because Fairhurst may have ignored "red flags" about sexual misconduct at McDonald's, thus surviving Fairhurst's motion to dismiss.

## **Bad Faith Standard Applies**

While the court did consider lessening the standard for officers, the court ultimately applied the same bad faith standard that applies to corporate directors in the context of an oversight liability claim. The court reasoned that, as with directors, corporations benefit from protecting officers against unjustified lawsuits and from attracting capable people to serve as officers as a means of justifying applying the same standard. The court did observe that oversight liability for officers is more limited than that for directors in one significant way: officers generally are liable only for overseeing their particular areas of responsibility. This limitation applies under both prongs: Information Systems and Red Flag Obligations.

The court's decision clarifies an important but previously uncertain area of Delaware law pertaining to officers' fiduciary duties. Boards and officers will undoubtedly consider the implications of this decision within their own organizations—including with regard to employment agreements and the protections available to officers, such as the indemnification of officers by corporations and through directors' and officers' insurance.

It is possible that Delaware corporations could begin to see an increase in claims alleging that officers have breached their oversight responsibilities. However, the court was not persuaded that this holding would result in a rush of stockholder litigation because an oversight claim is derivative and because of the limitations that are imposed on such claims in Delaware. Accordingly, the board controls the claim unless a stockholder can show that the board is disabled from considering a litigation demand. Moreover, corporations and their counsel may take some comfort in the court's determination that "bad faith" is required, rather than a lesser negligence standard.

### **Summary, Open Issues and Key Takeaways:**

- *In re McDonald's Corporation* expressly extends the duty of oversight to officers. Officers may be liable to the extent they do not implement Information Systems or address Red Flag Obligations.
- Will this trigger a flood of derivative litigation? The court was not persuaded that this holding will result in stockholder litigation, but that remains to be seen.
- Although document reporting and controls at the director level are well established, officers are well advised to document their responses to red flags, including in materials provided to the board of directors. Detailed documentation can help show that officers discharged their obligations in good faith by addressing red flags.

This case is still ripe, and we will continue to monitor and provide updates to the extent that the Chancery Court ruling is appealed. If you have any questions or concerns about the duty of oversight, please contact your Bodman attorney or one of the authors, Matthew Slipchuk, Kenneth Powell, or Joseph Morrison of Bodman's Business Practice Group. Bodman cannot respond to your questions or receive information from you without first clearing potential conflicts with other clients. Thank you for your patience and understanding.

**Matthew A. Slipchuk**  
313-393-7585  
[mslipchuk@bodmanlaw.com](mailto:mslipchuk@bodmanlaw.com)

**Kenneth Powell**  
734-930-2498  
[kpowell@bodmanlaw.com](mailto:kpowell@bodmanlaw.com)

**Joseph Morrison**  
734-930-2492  
[jmorrison@bodmanlaw.com](mailto:jmorrison@bodmanlaw.com)