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Business Counseling Update

Delaware Chancery Court Holds for First Time That Corporate Officers Owe Duty of Oversight to Corporation

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In In re McDonald's Corporation Stockholder Derivative Litigation, C.A. No. 2021-0324-JTL (the "Derivative Litigation"), the Delaware Chancery Court held for the first time that officers of a corporation have the same fiduciary duty of oversight to such corporation as corporate directors. Defendant David Fairhurst served as the Executive Vice President and Global Chief People Officer of McDonald's Corporation from 2015-2019. In that role, he was responsible for establishing and maintaining a safe and respectful work environment for all employees. However, the stockholder plaintiffs' complaint alleged that during the defendant's tenure, McDonald's experienced numerous events involving workplace sexual harassment. These allegations included Fairhurst himself engaging in multiple acts of sexual harassment, the human resources department turning a blind eye to sexual harassment complaints resulting in retaliation against accusers, and worker strikes across multiple cities to attempt to call attention to the sexual harassment problems at McDonald's. As a result, McDonald's had multiple lawsuits filed against it including the Derivative Litigation.

BACKGROUND AND PROCEDURAL HISTORY

In the Derivative Litigation, the plaintiffs sued the defendant derivatively on McDonald's behalf, alleging he breached his fiduciary duties, including his duty of oversight, owed to McDonald's by permitting a culture to develop that condoned sexual harassment and other similar misconduct. As part of their complaint, the plaintiffs claimed that the defendant breached his duty of oversight by ignoring "red flags" regarding sexual harassment at McDonald's and failing to address and report those red flag incidents to more senior management and/or the board of directors. The defendant moved to dismiss the plaintiffs' duty of oversight claim under Rule 12(b)(6) for failure to state a claim upon which relief can be granted. In his motion to dismiss, the defendant asserted that Delaware law did not recognize a duty of oversight for corporate officers comparable to the duty of oversight owed by directors. The defendant additionally claimed that even if a duty of oversight applied to corporate officers, the plaintiffs failed to allege facts sufficient to state a claim against him.

The fiduciary duty of oversight was first explained in In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996). The duty requires a good faith effort by directors to make sure:

> information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

In Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court stated that Caremark set forth two types of claims for violation of the duty of oversight: "Information-Systems Claims" and "Red-Flags Claims." "Information-Systems Claims" can be found where directors "utterly failed to implement any reporting or information system or controls." "Red-Flags Claims" result where directors implement reporting or information systems but "consciously fail[] to monitor or oversee its operations thus disabling themselves from being

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informed of risks or problems requiring their attention." The plaintiffs in the Derivative Litigation pled a "Red-Flags Claim."

OUTCOME AND SUMMARY OF ANALYSIS

The Chancery Court held that corporate officers do indeed owe their respective corporations a fiduciary duty of oversight. In so finding, the court stated that the plaintiffs had alleged facts sufficient to establish that there were red flags regarding sexual harassment at McDonald's. Additionally, the plaintiffs set forth facts supporting a reasonable inference that that the defendant knew about the red flag incidents. Whether the defendant violated his duty of oversight, the court opined, depended entirely upon whether the defendant acted in bad faith by ignoring and failing to address and report the red flag incidents.

The Chancery Court began its good faith analysis by stating the well-known maxim that officers and directors are presumed to have acted in good faith on behalf of their respective corporations absent an inference demonstrating bad faith. A complaint, the court continued, must plead facts sufficient to support an inference of bad faith on the part of a director or officer.

Here, the court found the complaint pled facts sufficient to support an inference of bad faith on the part of the defendant. The complaint alleged that the defendant engaged in two separate acts of sexual harassment in December 2016 and November 2018, after which the defendant was disciplined and signed a "last chance" agreement with McDonald's. The defendant was then subsequently terminated with cause in November 2019, presumably due to violating his last chance agreement. Additionally, the complaint cited statements from McDonald's employees indicating that the human resources office routinely turned a blind eye to sexual harassment complaints, resulting in retaliation against accusers. It was also alleged that the defendant and the CEO at the time promoted a "party atmosphere" at McDonald's Chicago headquarters, where employees drank alcohol and committed acts that made female employees uncomfortable. In 2016 and 2018, McDonald's employees, in concert, filed numerous EEOC complaints alleging sexual harassment. Both of these concerted complaint filings lead to mass employee walkouts across multiple U.S. cities. All of these allegations in conjunction led the Chancery Court to conclude that the defendant knew about the red flags and chose to consciously ignore them. Thus, an inference of bad faith on the part of the defendant was sufficiently pled.

Having found that the plaintiffs sufficiently pled a "Red-Flags" claim, the Chancery Court denied the defendant's motion to dismiss the plaintiffs' claim for a violation of the duty of oversight by the defendant.

CONCLUSION AND LESSONS FOR CORPORATIONS

For the first time, the Derivative Litigation established a duty of oversight for officers of Delaware corporations. The decision requires that officers establish adequate information or reporting systems that provide the officer with timely and accurate information to make informed, good faith decisions. The Chancery Court also noted that this requirement is particularly applicable in an officer's area of expertise. Any failure in this regard on the part of the officer may subject the officer to future derivative liability.

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