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# Delaware Chancery Court Extends Oversight Duties to Non-Director Corporate Officers

***Non-director officers may face liability for failing to properly oversee the corporation's affairs and ignoring "red flags" within their "areas of responsibility."***

**Key Points:**

- The McDonald's Corporation's response to allegations of sexual harassment at the company led to an SEC enforcement action and decision from the Delaware Court of Chancery expanding liability for officers under Delaware law and arguably under the federal securities laws.
- In *In re McDonald's Corporation Stockholder Derivative Litigation*, the Delaware Court of Chancery clarified that stockholders may hold non-director corporate officers liable for failures in oversight. Prior to this decision, the Delaware courts had expressly recognized oversight duties only for corporate directors.
- An officer's oversight duties include the obligation to report upward credible information that the company may be violating the law. Officers must also make "good faith" efforts to establish information systems to effectuate this reporting.
- A separate SEC enforcement action dealt with the response from the McDonald's board to the allegations of misconduct.
- Read together, *McDonald's* and the separate SEC enforcement action illustrate how the identification and resolution of corporate crises can create difficult disclosure issues for public companies and potential liability for corporate officers, underscoring the care that officers and directors should exercise in responding to allegations of corporate misconduct.

Last month, the Delaware Court of Chancery and the US Securities and Exchange Commission (SEC), each analyzed the response of the McDonald's board to allegations of serious misconduct by the company's most senior executives. On January 25, 2023, Vice Chancellor Laster issued an order in *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. No. 2021-0324-JTL (*McDonald's*) denying the defendants' motion to dismiss and holding that non-director corporate officers owe stockholders a fiduciary duty of oversight. Previously, on January 9, the SEC issued a cease and desist order against the company and Stephen Easterbrook, the company's former CEO.

The Delaware lawsuit followed the firing by McDonald's Corporation (McDonald's or the Company) of defendant David Fairhurst, the Company's former Executive Vice President and Global Chief People Officer. Certain McDonald's stockholders sued Fairhurst derivatively on behalf of the Company for breaching his duty of oversight by "allowing a corporate culture to develop that condoned sexual

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harassment and misconduct" and consciously ignoring "red flags regarding sexual harassment and misconduct at the Company."[1] The plaintiffs also alleged that Fairhurst breached his duty of loyalty by personally engaging in sexual misconduct.

The court recognized that *Caremark* imposes an "extremely high burden to state a claim for personal director liability," but noted that officers potentially have a "greater degree" of *Caremark* oversight duties than directors — suggesting that plaintiffs have a greater chance of surviving a motion to dismiss when bringing *Caremark* claims against officers instead of directors.[2] However, plaintiffs would first have to make a demand upon the board, or show that such a demand would be futile — a task that may be more difficult for a claim against a non-director officer.

## Background of a Director's Duty of Oversight and *Caremark* Claims

In then-Chancellor Allen's hallmark decision in *In re Caremark International, Inc. Derivative Litigation*, the court held that directors of a corporation owe stockholders the fiduciary duty of oversight.[3] Specifically, the *Caremark* court explained that the fiduciary duty of loyalty includes a duty to make a good-faith effort to ensure that "information and reporting systems exist in the organization that are reasonably designed to provide senior management and to the board itself timely, accurate information . . . concerning both the corporation's compliance with law and its business performance."[4] A director breaches this duty only if a stockholder plaintiff is able to demonstrate the director's "lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight."[5] In *In re Boeing Co. Derivative Litigation*, the court expanded *Caremark* oversight duties and required directors to "rigorously exercise [their] oversight function" with respect to *all* "essential and mission critical" aspects of the business.[6] The Delaware Supreme Court later clarified that claims for improper oversight under *Caremark* generally fall into two buckets: (1) claims that the board "utterly fail[ed]" to implement any kind of reporting or information system or controls; and (2) claims that the board failed to respond to "red flags indicating wrongdoing."[7]

## Rationale for Extending Oversight Duties to Non-Director Officers

In *McDonald's*, the court acknowledged that, although no Delaware judge had expressly held that officers owe oversight duties, the Delaware Supreme Court in *Gantler v. Stephens* stated that "the fiduciary duties of officers are the same as those of directors."[8] From a policy standpoint, Vice Chancellor Laster noted that those "responsible for managing the day-to-day affairs of the corporate enterprise" may in fact be better positioned than "part-time directors who meet a handful of times a year" to watch for and address red flags at the corporation.[9] Moreover, because officers are an essential link in the corporate oversight structure, holding them legally responsible for oversight will in turn assist directors in fulfilling their own oversight obligations.[10]

## The Scope of an Officer's Duty of Oversight

Although an officer's duty of oversight is "constrained [to that officer's] area of responsibility,"[11] the court noted that if a "red flag is sufficiently prominent," *any* officer "might have a duty to report upward."[12] Officers in possession of credible information "indicating that the corporation is violating the law cannot turn a blind eye."[13]

Critically, as was the case in *Caremark*, the court in *McDonald's* concluded that "oversight liability for officers requires a showing of bad faith," meaning that an officer must "consciously fail to make a good faith effort to establish information systems [or] consciously ignore red flags." Allegations that a defendant officer breached the duty of care is insufficient to support an oversight claim; instead, a plaintiff must adequately allege that an officer acted in bad faith or disloyally.[14]

## Plaintiffs Adequately Pled That Fairhurst Ignored Red Flags and Acted in Bad Faith

With respect to the specific conduct at issue in *McDonald's*, the court concluded that the plaintiffs' allegations supported an inference that Fairhurst ignored red flags about sexual harassment at the Company. As Global Chief People Officer, Fairhurst had "day-to-day responsibility" over human resources, including the obligation to promote a "safe and respectful environment," and was "supposed to have his ear to the ground and be knowledgeable about the Company's employees."[15] In October 2016 and May 2018, more than a dozen Company workers filed EEOC complaints alleging sexual harassment and retaliation.[16] In September 2018, McDonald's workers in 10 cities organized a one-day strike to protest the Company's failure to address sexual harassment. This protest resulted in Senator Tammy Duckworth sending a formal inquiry to McDonald's about the "multiple sexual harassment complaints made by employees."[17] For someone in Fairhurst's position, two rounds of "coordinated EEOC complaints," multiple walkouts and strikes protesting "problems with sexual harassment and misconduct," and several special meetings "devoted solely to [the] issues" of sexual harassment at McDonald's were "massive red flags."[18]

The court identified several factors supporting an inference that Fairhurst knowingly "acted in bad faith by consciously ignoring red flags." First, Fairhurst himself allegedly committed multiple acts of sexual harassment, even after being disciplined and given a "last chance."[19] The court detailed the egregiousness of Fairhurst's alleged personal misconduct, specifically pointing to allegations that Fairhurst "contributed to a party culture" by "frequenting local bars and [drinking] with staffers," and had "made inappropriate physical contact" with a female employee during a holiday party.[20] Second, the Company's human resources department allegedly ignored a number of complaints of sexual harassment. And Fairhurst, himself an alleged "serial harasser," oversaw the department and "consciously turn[ed] a blind eye" to red flags about sexual harassment and misconduct by others.[21] Finally, documents the Company produced in response to a stockholder's books and records demand did not reflect that Fairhurst took *any* action to report sexual harassment issues upward to the board.[22]

In addition to constituting a red flag that Fairhurst ignored, Fairhurst's own multiple acts of sexual harassment constituted a breach of his duty of loyalty. The court found that "if an officer or director personally engages in acts of sexual harassment, and if the entity suffers harm, then [the entity] should be able to assert a claim for breach of fiduciary duty in an effort to shift the loss . . . to the human actor who caused it."[23]

## SEC Imposed Penalties for Related Disclosure Failures

Although the court in *McDonald's* did not reference any parallel action by the SEC, two weeks before the court's order, the SEC released a settled cease and desist order charging the Company and Easterbrook, its former CEO and board member, because of allegedly misleading disclosures related to sexual misconduct at the Company.[24] Specifically, the SEC found that McDonald's terminated Easterbrook on November 1, 2019, after an independent internal investigation revealed that he had violated corporate policy by engaging in a personal relationship with an employee. At the time, Easterbrook told investigators that he did not engage in such relationships with any other employee. In his separation agreement, the Company and Easterbrook stipulated that Easterbrook's termination was "without cause" — allowing him to retain $47,534,341 in compensation. In SEC filings, McDonald's recommended that stockholders approve the separation agreement and described Easterbrook's misconduct as "limited to a single consensual relationship with another [] employee."

In July 2020, following a second internal investigation, McDonald's discovered that Easterbrook had, in fact, engaged in additional "inappropriate personal relationships" with other employees. According to the SEC, Easterbrook knew or was reckless in not knowing that failure to disclose the additional relationships would influence McDonald's disclosures to investors about his termination and compensation. The SEC determined that Easterbrook made false and misleading statements to investors about the circumstances of his termination, and charged him with violating Section 17(a) of the Securities Act, Sections 10(b) and 14(a) of the Exchange Act, and Exchange Act Rules 10b-5, 12b-20, and 13a-11. Additionally, the SEC found that McDonald's violated Section 14(a) of the Exchange Act and Exchange Act Rule 14a-3 by failing to disclose that it had used discretion to treat Easterbrook's termination as "without cause." Two commissioners dissented from the SEC's order.[25]

In the corresponding press release, SEC Director of the Division of Enforcement stated, "When corporate officers corrupt internal processes to manage their personal reputations or line their own pockets, they breach their fundamental duties to shareholders, who are entitled to transparency and fair dealing from executives. . . . By allegedly concealing the extent of his misconduct during the company's internal investigation, Easterbrook broke that trust with—and ultimately misled—shareholders."[26] Without admitting or denying the factual findings, McDonald's and Easterbrook settled the SEC's claims. In conjunction with the settlement, Easterbrook agreed not to serve as an officer or director of another corporation for five years and to pay a $400,000 civil penalty. The SEC did not impose a financial penalty against McDonald's, noting that it took "remedial action" by suing Easterbrook for breaching his fiduciary duties and for fraud. That lawsuit was eventually settled, with Easterbrook repaying his severance, prorated bonus, and proceeds from certain securities sales, forfeiting his equity awards and reimbursing the Company for its attorney's fees.

## Key Takeaways

- Following the *McDonald's* decision, non-director corporate officers may be named more frequently as defendants in derivative complaints alleging oversight failures, particularly when the corporation received, but failed to adequately respond to, repeated complaints of misconduct. However, potential plaintiffs would still need to either first demand the board take legal action against the non-director officer or plead why a pre-litigation demand would have been futile. Establishing demand futility may be more challenging if a claim is against only a non-director officer, because it is not obvious that directors face a substantial risk of personal liability from their decision on whether to bring the claim — a common argument that demand is excused for claims against directors. The court in *McDonald's* acknowledged this fact, although it did not expressly reach the demand futility issue.[27]

- The *McDonald's* decision reinforces the need for robust anti-harassment compliance programs and internal processes to ensure officers and directors receive regular reports about how the corporation is handling complaints of harassment.

- Boards should work closely with officers to adequately define each officer's duties and responsibilities, as those definitions may have important implications for an officer's oversight duties.[28]

- All officers may face liability for failing to report "sufficiently prominent" red flags, including potential misconduct perpetuated by other officers or employees, regardless of whether those red flags fall within the officers' specific areas of responsibility. To that end, boards should work with officers to develop an appropriate reporting structure and response protocol to address any such red flags.

- All public companies (not just Delaware corporations) should pay particularly close attention to the manner in which they conduct internal investigations of executive misconduct, and required disclosure of remediation, including the departure of officers or other key personnel due to alleged misconduct.

- Delaware law may limit the ability of a corporation to exculpate a non-director officer for oversight failures. Effective August 1, 2022, the General Assembly amended Section 102(b)(7) of the Delaware General Corporation Law to authorize corporations to exculpate officers (in addition to directors) for direct claims by stockholders premised on breaches of the duty of care.[29] However, as oversight liability is premised on the duty of loyalty, *Caremark* claims may not be subject to exculpation. In any event, exculpation is not authorized for "any action by or in right of the corporation," including derivative claims such as those in *McDonald's*. Separately, the *McDonald's* and SEC orders may cause boards to carefully reevaluate protections in officers' employment agreements (e.g., indemnification).

- Corporations should continue to expect stockholders to use pre-suit books and records demands to investigate whether non-director officers knew about red flags and took no action.

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**Endnotes**

[1] *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. No. 2021-0324-JTL at 1 (Jan. 25, 2023) [hereinafter *McDonald's*].

[2] *Id.* at 2, 23 45.

[3] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996).

[4] *Id.* at 970.

[5] *Id.* at 971.

[6] *In re Boeing Co. Derivative Litigation*, 2021 WL 4059934, at *24 (Del. Ch. Sept. 7, 2021) (denying defendant's motion to dismiss because airplane safety was "essential and mission critical" to Boeing's business, and plaintiffs adequately pled the Board failed to "rigorously exercise its oversight functions").

[7] *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[8] *McDonald's*, *supra* note 1, at 27 (citing *Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009)).

[9] *Id.* at 23.

[10] *Id.* at 36–37.

[11] *Id.* at 41 (noting that a "Chief Financial Officer is responsible for financial oversight and for making a good faith effort to establish reasonable information systems to cover that area . . . [but] the executive officer in charge of sales and marketing is not responsible for the financial reporting systems").

[12] *Id.* at 42.

[13] *Id.* at 41–42.

[14] *Id.* at 51.

[15] *Id.* at 56.

[16] *Id.* at 8.

[17] *Id.* at 9.

[18] *Id.* at 51–57.

[19] *Id.* at 58.

[20] *Id.* at 7, 9–10; Heather Haddon, *McDonald's Probe Into Ex-CEO Investigates HR Department, Coverups*, WALL ST. J, Aug. 25, 2020 (https://www.wsj.com/articles/mcdonalds-probe-into-ex-ceo-investigates-hr-department-cover-ups-11598398673).

[21] *McDonald's*, *supra* note 1, at 58.

[22] *Id.* at 59.

[23] *Id.* at 64.

[24] Stephen J. Easterbrook & McDonald's Corporation, No. 3-21269 (S.E.C. Jan. 9, 2023).

[25] Statement from Hester M. Peirce and Mark T. Uyeda regarding *In the Matter of Stephen J. Easterbrook and McDonald's Corporation* (S.E.C Jan. 9, 2023), https://www.sec.gov/news/statement/peirce-uyeda-easterbrook-mcdonalds-202301.

[26] Press Release, Sec. & Exch. Comm'n, SEC Charges McDonald's Former CEO for Misrepresentations About His Termination, Jan. 9, 2023, https://www.sec.gov/news/press-release/2023-4.

[27] *McDonald's*, *supra* note 1, at 36 ("The oversight duties of officers are an essential link in the corporate oversight structure. The bulwark against stockholders liberally asserting oversight claims against officers is not the invalidity of the legal theory. Rather, it is the fact that oversight claims are derivative, so the board controls the claim unless a stockholder can plead demand futility or show wrongful refusal. It is those doctrines, applied at the pleading stage under Rule 23.1, that minimize the risk of oversight claims against officers, not the absence of any duty of oversight.")

[28] In describing the scope of a non-director officer's duty of oversight, the court noted "of course, the board can tailor the officers' obligations and responsibilities." *McDonald's*, *supra* note 1, at 42.

[29] *Id.* at 49-50; Del. S.B. 273, 151st Gen. Assem., 84 Del. Laws ch. 377 (2022).