

The Court of Chancery Holds That Corporate Officers, Like Directors, Owe a Duty of Oversight

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> See page 3 for key points

On January 25, 2023, Vice Chancellor Laster of the Court of Chancery issued a significant decision, finding as a matter of first impression that corporate officers owe a duty of oversight akin to the oversight duties owed by corporate directors under *In re Caremark International Inc. Derivative Litigation* (*Caremark*). In *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. No. 2021-0324-JTL (Del. Ch.) (Jan. 25, 2023), the court denied a motion to dismiss, concluding that plaintiffs adequately alleged that McDonald's global chief people officer breached his oversight duties by ignoring red flags regarding workplace misconduct and engaging in such misconduct himself.

The decision addresses several notable issues. While the court ruled that corporate officers have oversight duties that mirror the two prongs of *Caremark* — *i.e.* (i) good faith effort to put in place reasonable information and reporting systems and (ii) action in response to red flags — the decision leaves open questions regarding the specifics of these duties and their practical application. The case was subsequently dismissed on other grounds, so it remains to be seen if the Delaware Supreme Court will have an opportunity to weigh in these open issues in the near future.

Key Aspects of the Motion to Dismiss Ruling

Corporate officers owe oversight duties. The court rejected the officer's primary argument that officers do not owe oversight duties.

- In its analysis, the court drew heavily on the *Caremark* decision itself, holding that a duty of oversight is also owed by corporate officers. The court stated that “[t]he same policies that motivated [the Court] to recognize the duty of oversight for directors apply equally, if not to a greater degree, to officers.”¹
- The court coupled this reliance on the policies of *Caremark* with existing Delaware Supreme Court case law holding that officers owe the same fiduciary duties as directors. Specifically, the court noted that “[t]he Delaware Supreme Court has held that under Delaware law, corporate officers owe the same fiduciary duties as corporate directors, which logically includes a duty of oversight.”² The court also pointed to academic authorities, decisions outside of Delaware and the general obligations of corporate officers as agents of the board of directors as additional sources supporting the conclusion that officers have oversight duties.

The scope of an officer's oversight duties is context driven. The court further highlighted that, “[a]lthough the duty of oversight applies equally to officers, its context-driven application will differ.”³

- “Some officers, like the CEO, have a company-wide remit,” the court explained, while “[o]ther officers have particular areas of responsibility, and the officer's duty to make a good faith effort to establish an information system only applies within that area.”⁴
- By way of example, the court noted that “the Chief Financial Officer is responsible for financial oversight and for making a good faith effort to establish reasonable information systems to cover that area,” while “[t]he Chief Legal Officer is responsible for legal oversight and for making a good faith effort to establish reasonable information systems to cover that area.”⁵

¹ *Id.* at 2.

² *Id.*

³ *Id.* at 41.

⁴ *Id.* at 2.

⁵ *Id.* at 41.

- The court also noted that “[a]n officer’s duty to address and report upward about red flags also generally applies within the officer’s area” but stated that “a particularly egregious red flag might require an officer to say something even if it fell outside the officer’s domain.”⁶

Pleading a breach of an officer’s oversight duties requires allegations of disloyal conduct amounting to bad faith. As with traditional *Caremark* duties of directors, “establishing a breach of the officer’s duty of oversight requires pleading and later proving disloyal conduct that takes the form of bad faith.”⁷ In other words “[t]he officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore red flags.”⁸

- For instance, to plead a “red flags” claim: “a plaintiff must plead facts supporting an inference that the fiduciary knew of evidence of corporate misconduct. The plaintiff also must plead facts supporting an inference that the fiduciary consciously failed to take action in response. The pled facts must support an inference that the failure to take action was sufficiently sustained, systematic, or striking to constitute action in bad faith. A claim that a fiduciary had notice of serious misconduct and simply brushed it off or otherwise failed to investigate states a claim for breach of duty.”⁹
- With respect to the specific allegations in this case, the court concluded that plaintiffs had pled the existence of red flags indicating that sexual harassment occurred at the company and also alleged facts supporting a reasonable inference that the officer knew about the red flags. Based in part on allegations that the global chief people officer had engaged in acts of sexual harassment himself, the court held that plaintiffs had stated a claim that the officer acted in bad faith by consciously ignoring red flags of sexual harassment, which caused the company harm.

Oversight claims against officers are derivative. Notably, the court highlighted that oversight claims remain derivative. Therefore,

“the board controls” the “claims unless a stockholder can plead demand futility or show wrongful refusal,” which the court described as “the bulwark” against oversight claims against officers.¹⁰

- In the court’s words, “[t]he oversight duties of officers are an essential link in the corporate oversight structure. The bulwark against the 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.”¹¹
- The court also implied that holding that officers have their own oversight duties might allow boards of directors to hold officers accountable for officer-level conduct without directors “facing oversight liability themselves.”

Well-pled allegations of sexual harassment constitute a breach of the duty of loyalty. Further, the court concluded that, under Delaware law, the allegations of the officer’s acts of sexual harassment “constituted a breach of duty in themselves.”¹²

- Specifically, the court stated that “[w]hen a fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, the fiduciary acts in bad faith” and that “a CEO or other corporate officer who uses a position of power to harass, intimidate, or assault employees clearly acts for a purpose other than that of advancing the company’s interests.”¹³
- Therefore, the court held that allegations of conduct such as sexual harassment, which is engaged in for selfish reasons, support an inference that the fiduciary acted in bad faith and disloyally and states a claim for breach of fiduciary duty.

⁶ *Id.* at 2.

⁷ *Id.*

⁸ *Id.* at 3.

⁹ *Id.* at 54 (citing *See Lebanon Cnty. Empls.’ Ret. Fund v. AmerisourceBergen Corp.*, 2020 WL 132752, at *20 (Del. Ch. Jan. 13, 2020)).

¹⁰ *Id.* at 36.

¹¹ *Id.* at 37.

¹² *Id.* at 5.

¹³ *Id.* at 61.

Key Points

The *McDonald's* decision addresses several significant topics important for both corporate officers and their boards of directors that are worth highlighting, and there are lessons to be drawn from it for corporations and their officers.

- For the first time, a Delaware court held that corporate officers “owe[] a duty of oversight,” which includes both “an obligation to make a good faith effort to put in place reasonable information systems” so that officers “obtain the information necessary to do [their] job and report to the CEO” and an obligation to not “consciously ignore red flags indicating that the corporation [is] going to suffer harm.”
- Notably, as with traditional Caremark duties of directors, pleading and ultimately establishing a breach of a corporate officer’s duty of oversight requires well-pled allegations of “disloyal conduct that takes the form of bad faith.” As with oversight claims against directors, appropriate processes and record-keeping are critical, so that officer oversight and reporting efforts are documented in response to any challenge to officer conduct.
- Application of an officer’s oversight duties is context driven, with different officers having varying scopes of oversight responsibility. For instance, “[s]ome officers, like the CEO, have a company-wide remit.” The court did not provide any specific guidelines or expectations about how officers should establish and document their oversight process. As a practical matter, the exact scope and contours of specific officer oversight duties may differ from company to company, and also within a company, officer to officer. How officers document their efforts may also vary. Future case law guidance may also help shed more light on the parameters of officer duties.
- Based on the court’s holding, including that “a particularly egregious red flag might require an officer to say something even if it fell outside the officer’s domain,” officers, like directors, should remain mindful of the big picture and mission-critical risks to the company and be able to demonstrate that they are not consciously ignoring red flags that could cause the company harm.
- Oversight claims against corporate officers remain derivative, so a stockholder can only bring a claim on behalf of the company by pleading demand futility or wrongful refusal, which the court opined may minimize the risk of oversight claims against officers. The court ultimately dismissed this action after concluding that the *McDonald's* board was capable of considering a demand relating to the officer, and thus, demand was not excused.
- In another novel holding, the court also held that allegations against a corporate officer of sexual harassment “constituted a breach of duty in themselves,” because “a CEO or other corporate officer who uses a position of power to harass, intimidate, or assault employees clearly acts for a purpose other than that of advancing the company’s interests.”

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