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Washington Legal Foundation
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2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302 wlf.org

Delaware Court of Chancery Decision Applies Duty of Oversight Liability to Corporate Officers

by Gregory A. Brower

In a case of first impression, the Delaware Court of Chancery recently clarified that, like corporate directors, corporate officers owe a duty of oversight to the corporation. *In re McDonald's Corporation Stockholder Derivative Litigation*, 2023 WL 407668 (Del. Ch. Jan. 25, 2023). This is the first time that a Delaware court has explicitly found that the same duty articulated in the 1996 *Caremark* decision concerning directors applies equally to officers. Indeed, the court went so far as to opine that "the same policies that motivated [the *Caremark* court] to recognize the duty of oversight for directors apply equally, if not to a greater degree, to officers." However, the court also confirmed that corporate officers, like corporate directors, breach this duty only when their conduct "takes the form of bad faith."

This decision arose in the context of a shareholders derivative suit against David Fairhurst, the former Executive Vice President and Global Chief People Officer of McDonald's Corporation, alleging that he had breached his fiduciary duty to the company by allowing a corporate culture that condoned sexual harassment and other related misconduct. Specifically, the complaint alleged that Fairhurst breached his duty of oversight by consciously ignoring red flags suggesting significant compliance problems. In addition, the complaint alleged that he also breached his duty of loyalty to the company by personally engaging in misconduct .

Fairhurst moved to dismiss the complaint, arguing that Delaware law does not recognize a duty of oversight for corporate officers as it does for corporate directors. He also argued that even if such a duty existed, the plaintiffs failed to sufficiently allege facts showing such a breach on his part. The court denied his motion, finding that even though Delaware decisions have only applied the duty of oversight to directors in the past, it does not necessarily follow that officers do not also owe such a duty. The court explained that "decisions recognizing director oversight duties confirm that directors owe those duties; those decisions do not rule out the possibility that officers also owe oversight duties." The court did, however, offer one caveat with respect to the importance of the context in which an officer's duty might arise: "Some officers, like the CEO, have a company-wide remit. Other 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 … although a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain."

As for Fairhurst's argument that even if he did have a such a duty of oversight, the plaintiffs' complaint nevertheless did not allege sufficient facts to make such a case against him, the court

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Gregory A. Brower is Chief Global Compliance Officer for Wynn Resorts. He also serves on WLF's Legal Policy Advisory Board and is a former U.S. Attorney.

disagreed. It found that the plaintiffs adequately pled such a claim based on a red flags theory in that the allegations contained sufficient evidence that under Fairhurst's watch, the company's human resources function turned a blind eye to complaints of sexual harassment. Moreover, the court went on to conclude that when "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." This unique aspect of the case—that the person in charge of HR was himself the subject of multiple allegations of misconduct—clearly played a role in the judge's decision.

While the facts of this case are somewhat unique, the decision is nevertheless instructive for two reasons. First, it clarifies that under Delaware law, directors *and* officers share the same duty of oversight when it comes to corporate compliance. Second, it provides a reminder to corporate officers of the importance of the following compliance fundamentals:

1. Maintaining an effective system for the reporting of misconduct and the timely review and appropriate investigation of such reports;
2. Utilizing an oversight system for reviewing how reports of misconduct are investigated and how findings of misconduct are handled;
3. Elevating certain reports of misconduct, particularly reports concerning executive officers, to the senior executive and board levels;
4. Taking appropriate action in response to findings of misconduct; and
5. Conducting regular risk assessments across the enterprise to identify new and evolving risks and allowing such assessments to inform changes to polices as appropriate.

This decision represents a continuing trend toward greater judicial and regulatory scrutiny of corporate compliance efforts, including the role of corporate officers in such efforts. While an appeal is likely and the Delaware Supreme Court will have the final word on the duty of oversight owed by corporate officers, this decision nevertheless deserves the attention of corporate officers of all types and across all industries.