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DELAWARE COURT OF CHANCERY HOLDS THAT CORPORATE OFFICERS OWE A DUTY OF OVERSIGHT

To Our Clients and Friends:

On January 26, 2023, the Delaware Court of Chancery held, for the first time, that corporate officers owe a duty of oversight.^[1] Authored by Vice Chancellor J. Travis Laster, the decision denies a motion to dismiss under Rule 12(b)(6) of the Court of Chancery Rules but leaves open the possibility that the case will be dismissed under Rule 23.1 for failure to plead demand futility.^[2]

Background

This derivative litigation follows public allegations of misconduct by senior officers at a company and its franchises. Stockholders claim that the company's directors and officers are liable to the company for failing to oversee it in good faith. As relevant here, they allege that a senior officer responsible for human resources but not a member of the company's board of directors "exercised inadequate oversight in response to risks of sexual harassment and misconduct at the [c]ompany and its franchises."^[3] They also claim that the same officer "breached his fiduciary duties [of loyalty] by engaging personally" in the same type of misconduct.^[4]

The defendants moved to dismiss the complaint under Rule 23.1 for failure to plead demand futility and, in the alternative, under Rule 12(b)(6) for failure to state a claim upon which relief can be granted. The January 26, 2023 decision discussed here addressed only the senior officer's motion to dismiss under Rule 12(b)(6), leaving unresolved whether the complaint adequately pleaded demand futility—an issue that the court will decide at a later time.

Corporate Officers' Duty of Oversight

The Delaware Court of Chancery held that officers are subject to the same duty of oversight as directors. Although this is the first time the court has reached that conclusion explicitly, past rulings have suggested that officers owe the same fiduciary duties as directors.^[5]

This decision further reasoned that the duty of oversight owed by officers is evaluated under the same two-prong "*Caremark*" test that applies to directors.^[6] First, like directors, officers "must make a good faith effort to ensure that information systems are in place so that the officers receive relevant and timely information that they can provide to the directors."^[7] Second, officers "have a duty to address [red flags they identify] or report upward [to more senior officers or to the board]."^[8]

The court observed that oversight liability for officers, however, is more limited than that of directors in at least one important way: officers generally are liable only for overseeing their particular areas of

responsibility. This limitation applies under both prongs of the test for oversight liability. The obligation to establish reasonable information systems extends only to the area of an officer's responsibility.[9] Similarly, "officers generally only will be responsible for addressing or reporting red flags within their areas of responsibility."[10] The court observed that there might be exceptional circumstances, however, involving "egregious" or "sufficiently prominent" red flags that officers must report up, even outside their area.[11]

Like oversight liability for directors, "oversight liability for officers" arises from the duty of loyalty and thus "requires a showing of bad faith."[12] Allegations of gross negligence are insufficient.

Breach of Fiduciary Duty as Applied to Sexual Harassment Claims

Applying the above framework, the court went on to hold that plaintiffs had adequately alleged a claim that the company's senior human resources officer breached his duty of oversight "by consciously ignoring red flags" that indicated a culture of sexual harassment and misconduct in the workplace.[13] The court focused in particular on plaintiffs' allegations that the senior officer himself engaged in misconduct, finding that in such cases, "it is reasonable to infer that the officer consciously ignored red flags about similar behavior by others."[14] The court nonetheless recognized "record evidence" in 2019 and onwards that the senior officer was "part of the effort by [c]ompany management to address the problem of sexual harassment and misconduct."[15]

Finally, the court also separately held that fiduciaries "violate the duty of loyalty when they engage in harassment themselves."[16] The court reasoned that acts of sexual harassment are in "further[ance of] private interests" rather than "advancing the best interests of the corporation," and therefore are bad faith conduct that breaches the duty of loyalty.[17] If a fiduciary "personally engages in acts of sexual harassment, and if the entity suffers harm," then a plaintiff "should be able to assert a claim for breach of fiduciary duty in an effort to shift the loss that the entity suffered to the human actor who caused it."[18] The court concluded: "Sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable."[19]

Analysis

This decision breaks new legal ground, but is unlikely to change derivative litigation materially, at least at the pleadings stage. Courts have long recognized that officers owe fiduciary duties to the corporation they serve, similar to those that are owed by directors. And plaintiffs have long asserted claims for breach of those duties, including oversight claims, against officers.

From an employment law perspective, however, the decision carries the potential for broader implications. For the first time, the Court of Chancery has held that stockholders may bring suit against directors or officers of a corporation on the theory that sexual harassment constitutes a breach of fiduciary duty. Although there have long been legal remedies for claims of sexual harassment, this decision highlights a potential avenue for derivative claims based on such allegations, providing stockholders with potential recourse to hold corporate officers accountable for actions of sexual misconduct and bringing issues traditionally reserved for employment disputes into the arena of fiduciary duty law.

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Significantly, this decision in no way undermines the authority of boards of directors to evaluate whether suing officers is in the best interest of corporations. Therefore, derivative claims for oversight liability against officers should be dismissed under Rule 23.1 absent particularized allegations that it would be futile for the plaintiff to make a pre-suit litigation demand. Notably, Vice Chancellor Morgan T. Zurn recently dismissed derivative claims against officers based on the same reasoning.[20]

Finally, although the decision is most notable for its discussion of officer liability, it also underscores the Court of Chancery's preference for plaintiffs to seek books and records under Section 220 of the Delaware General Corporation Law before asserting derivative claims. The court recounts its decision to stay the case to allow intervenors to conduct an investigation through Section 220.[21]

Key Takeaways

- Although oversight liability for officers has now been expressly acknowledged, this decision is unlikely to have a significant impact on most derivative litigation at the pleadings stage. In many instances, derivative claims are subject to dismissal because the plaintiff did not satisfy the requirement of making a pre-suit litigation demand or pleading that a demand would be futile. The test for pleading demand futility is rigorous, and this decision does not alter it. Nonetheless, the court's novel findings as to liability for breach of fiduciary duty in the sexual harassment context may incentivize similar claims, at least where a fiduciary is alleged to have personally engaged in acts of sexual harassment.
- To preserve their independence, directors should be cautious about close personal or business relationships not only among themselves but also with officers. Plaintiffs can be expected to argue that such relationships, when they exist, impede directors' ability to render an impartial judgment as to whether it is in the best interest of a corporation to sue its officers.
- Corporations should evaluate how they document reporting and control efforts at the officer level. Although the process for documenting board oversight is well established, the documentation of officer oversight is sometimes less formal. Officers are particularly well advised to develop a system for documenting their responses to significant red flags, including in materials provided to the board of directors. Thorough documentation can show that officers discharged their obligations in good faith by addressing red flags.
- Oversight liability for officers will usually be confined to their areas of responsibility. For that reason, corporations should evaluate how they document the scope of officers' responsibilities.
- From an employment perspective, corporations should ensure they have appropriate anti-harassment and anti-discrimination policies and practices, including prohibitions of harassment, discrimination and retaliation, along with appropriate training, reporting, investigation, and compliance monitoring.
- This decision may renew discussions about whether corporations should utilize recent amendments to Section 102(b)(7) of the Delaware General Corporation Law to exculpate their officers against certain claims for breach of the duty of care. Although corporations should

consider amending their certificates of incorporation to add exculpatory clauses for officers, it should be understood that officer exculpation will not protect against oversight claims. As the court made clear, oversight claims against officers (as well as directors) are claims for breach of the duty of loyalty. Exculpatory provisions, however, concern the duty of care and cannot eliminate liability under the duty of loyalty. Exculpatory provisions for officers, moreover, do not apply to derivative litigation, which is the context in which oversight claims are most often litigated.

- Plaintiffs' firms are likely to increase efforts to investigate officer misconduct under Section 220, and these efforts could raise challenging disagreements over the proper scope of Section 220 demands. In many cases, board-level documents will provide information "necessary and essential" to assessing officer misconduct, as well as the board's ability to act in a corporation's best interests. Therefore, we do not believe that this decision warrants any expansion of the records that are typically available under Section 220.

[1] *See In re McDonald's Corp. S'holder Deriv. Litig.*, 2023 WL 387292, C.A. No. 2021-0324-JTL, at *1, *9 (Del. Ch. Jan. 26, 2023).

[2] Del. Ch. Ct. R. 12(b)(6); Del. Ch. Ct. R. 23.1.

[3] *In re McDonald's*, 2023 WL 387292, at *8.

[4] *Id.* at *28.

[5] *Id.* at *13 (citing *Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009)).

[6] *See, e.g., id.* at *10.

[7] *Id.* at *11.

[8] *Id.* at *12.

[9] *Id.* at *19.

[10] *Id.*

[11] *Id.* at *2, *42.

[12] *Id.* at *22, *24.

[13] *Id.* at *27.

[14] *Id.* at *2, *27.

[15] *Id.* at *28.

[16] *Id.* at *28.

[17] *Id.*

[18] *Id.* at *30.

[19] *Id.*

[20] See *In re Boeing Co. Deriv. Litig.*, 2021 WL 4059934, C.A. No. 2019-0907-MTZ, at *36 (Del. Ch. Sept. 7, 2021).

[21] *In re McDonald's*, 2023 WL 387292, at *8.



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