Officer Fiduciary Duty Update:

Implications of In re McDonald's on Officer Fiduciary Duties

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Overview

<u>Agenda:</u>

- Director & officer fiduciary duty standards before the recent decision in *In re McDonald's Corp. Stockholder Derivative Litigation ("McDonalds")*
- Summary of *McDonald*'s and key findings
- New framework for officer liability
- Best practices for corporate officers going forward

Director & Officer Fiduciary Duty Standards Before *McDonald's*

<u>**Core Duties:**</u>

- **Duty of Care**: Directors and Officers ("Executives") must handle business affairs with the same level of care and diligence that an ordinary businessperson would under similar circumstances. They must also stay reasonably informed about the business and exercise their professional judgment based on adequate information and advice.
- **Duty of Loyalty**: Executives must place the corporation's interests above their own and avoid any conflicts of interest or self-dealing that may harm the corporation or its shareholders.

This "fiduciary" thingy really complicates pillaging a corporation.

Director & Officer Fiduciary Duty Standards Before *McDonald's* (continued)

Subsidiary Duties:

- **Duty of Good Faith**: Executives must act in the best interests of the corporation and its shareholders, and not engage in any fraudulent or illegal conduct.
- **Duty of Disclosure:** Executives must communicate honestly with shareholders and provide full and fair disclosure.
- **Duty of Oversight:** Directors must (i) make a good faith effort to ensure that corporations have implemented proper reporting systems, and (ii) appropriately address "red flags" suggestive of corporate wrongdoing.

Extension of Fiduciary Duties to Officers Before *McDonald's*

- In *Gantler v. Stephens*, the Delaware Supreme Court explicitly held that:
  - The officers of Delaware corporations, like directors, owe a fiduciary duty of care and a duty of loyalty.
  - The fiduciary duties of officers are the "same" as those of directors.

- Unclear what duties fall in the "same" category.
  - Duty of Oversight?

Caremark Cases

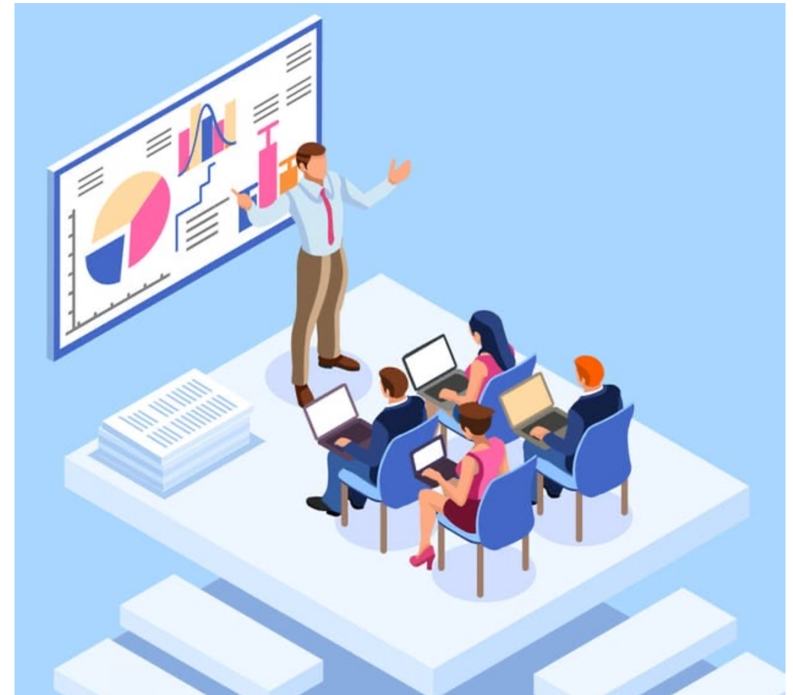
- *In re Caremark Int'l* established the test for imposing liability on directors for failing to properly discharge their duty of oversight. Claims may be brought under two different "prongs":
  1. <u>Information System Claims</u>. Failure to implement any reporting or information system or controls.
     - The board must have consciously failed to make a good faith effort to establish a board-level information and oversight system.
  2. <u>Red-Flags Claims</u>. Having implemented such a system or controls, failure to monitor or oversee its operations and disabling themselves from being informed of risks or other problems requiring their attention.
     - Requires a demonstration that (i) directors consciously disregarded evidence of red flag wrongdoing or misconduct **in bad faith**, and (ii) that the corporate trauma in question must be sufficiently similar to the red flag misconduct such that the board's bad faith and conscious inaction proximately caused the trauma.

Summary of the *McDonald's* Facts

- Defendant David Fairhurst, who served as Executive Vice President and Global Chief People Officer at McDonald's Corporation from 2015 until he was terminated for cause in 2019. Mr. Fairhurst was also responsible for the company's global human resources function.
- Stockholder plaintiffs sued Mr. Fairhurst in a derivative action on behalf of McDonald's, claiming that Mr. Fairhurst breached his fiduciary duty of oversight.
  - allowed a corporate culture to develop that fostered a toxic workplace environment permitting sexual harassment and misconduct
  - engaged in sexual harassment and misconduct himself
  - failed to report the purported misconduct to his superiors or address the HR violations that persistently occurred under his supervision, thereby consciously ignoring clear "red flags" (in addition to creating red flags through his own alleged misconduct).
- Mr. Fairhurst filed a motion to dismiss the oversight claim, asserting that the duty of oversight only applies to directors and does not extend to officers.

McDonald's: Legal Analysis

- *McDonald's* involved a "red-flags" claim.
- The court noted the practical reality that corporations are run on a day-to-day basis by **officers**, placing officers in the best position to see red flags.
- Since officers generate and collate information to pass to the board, officers must make a good faith effort to ensure information systems are in place.



Key Finding of the *McDonald's* Case: Expansion of the Duty of Oversight to Officers

- Ultimately, the *McDonald's* court concluded that the plaintiffs pleaded sufficient facts to state a "red-flags" claim for breach of the duty of oversight against Mr. Fairhurst regarding his own misconduct, as well as his conscious disregard of the ongoing and serious misconduct and human resources issues.
- This ruling expands the original *Caremark* holding that directors have a duty of oversight to the corporation.
- Limitations on an officer's duty of oversight →
  - The board has oversight duties regarding the whole corporation vs an officer only has a duty to establish information systems and to remediate red flag issues that arise within the scope of their authority
  - The officer must have acted in bad faith with a showing of scienter

New Framework for Officer Liability

- Duty of Oversight: corporate officers vs senior officers?
  - Based on language from the *McDonald's* opinion, a reasonable inference can be drawn that it applies to all corporate officers: "the officers are optimally positioned to identify red flags and either address them or report upward to ***senior officers*** [emphasis added] or to the board."
- §142(a) of the DGCL defines the term "officer" as "such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors."
- *In re Walt Disney Co. Derivative Litigation*, the court established a bright-line rule whereby officers and directors become fiduciaries only when they are officially installed, and receive "the formal investiture of authority that accompanies such office of directorship."
- Taken together, the fiduciary duty of oversight would seem to apply only to those officers specified in the bylaws or appointed by board resolution.
- Officers should be aware that their own misconduct—not simply their failure to monitor, report and address "red flags" raised by or about others—can give rise to a claim for breach of the duty of oversight against them.

Legal Implications and Consequences of Breaching Fiduciary Duties

- Executives may face personal liability for monetary damages, injunctive relief, disgorgement, rescission, or other remedies. They may also face criminal charges, civil penalties, or regulatory sanctions.
- These consequences may vary depending on the nature and severity of the breach, the harm caused to the corporation or its shareholders, and the availability of defenses or protections under applicable laws or contracts.

Best Practices Going Forward

Board Focus on Compliance Programs and Internal Processes

- Corporations should implement policies on officer oversight obligations, including how officers document their knowledge of and responses to red flags (including to the board).
- Corporations should ensure there are appropriate anti-harassment and anti-discrimination policies, practices, and trainings and reporting, investigation, and compliance policies and systems and that they are periodically reviewed.
- **Practice Tip:** Document all related actions, as litigation actions involving alleged breach of the duty of oversight are preceded by §220 books and records requests under the DGCL.
  - The corporation should be able to produce ample evidence that such officer made good faith efforts to properly execute his or her duty of oversight, including documenting: (i) that an oversight system was established, (ii) that the officer reviewed and discussed compliance issues, and (iii) that the officer followed-up on all red-flag issues, and addressed them, as needed.

Best Practices Going Forward

Officer Focus on Compliance Programs and Internal Processes

- Officers (in cooperation with the board) should ensure the corporation has implemented systems for information reporting and evaluation and that such systems meet the organization's needs and are designed to enable appropriate personnel to receive and act upon information.
- There is no "one size fits all" approach.
- Each officer should (i) identify the essential and mission-critical compliance with laws or regulatory mandates facing the corporation that are within the scope of the officer's authority and (ii) establish a monitoring system that timely and accurately brings this information to the officer's attention.
- Once the oversight system is in place, the officer should pay attention to any "red flag" issues that may evidence non-compliance, report that information superior(s), and take corrective actions to address the non-compliance.

Best Practices Going Forward

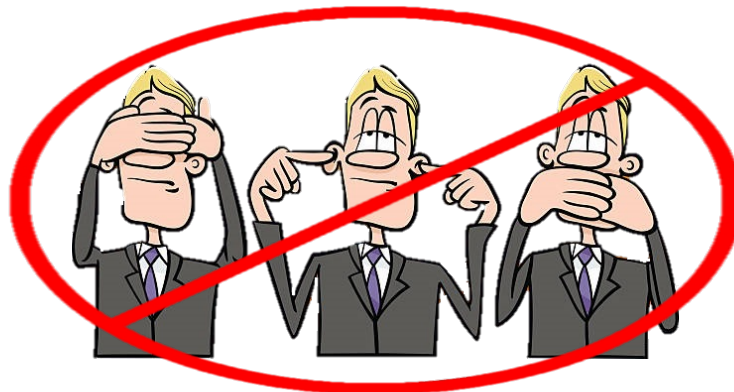
Establishing Clear Definitions of Officer Duties and Responsibilities

- As noted above, we expect the fiduciary duty of oversight to generally apply to those officers specified in the bylaws or appointed by board resolution.
- Corporate boards should implement policies that require documentation clearly identifying who is an officer of the corporation, the responsibilities and duties of such officer, and the scope and limitations of their oversight obligations, as well as their reporting lines and accountability structures.
- Employment agreements should also clearly define the officer's responsibilities and duties as this will have implications for the officer's oversight duties.

Best Practices Going Forward

Reporting Up

- Officers who serve as the day-to-day managers of a corporation 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.
- As agents, officers owe a duty to disclose relevant information that they know may affect the decisions of their principals and the board.
- Officers cannot turn a blind eye to "sufficiently prominent" or "particularly egregious" red flags out of the officer's scope → duty to report upwards.



Best Practices Going Forward

Evaluate Officer Exculpation Provisions in Charters and D&O Insurance Policies

- As of August 2022, §102(b)(7) of the DGCL permits a Delaware corporation to include an exculpatory provision in its certificate of incorporation that eliminates the personal liability of a director **or officer** for breaches of certain fiduciary duties. Officers may benefit from exculpation provisions in certificates of incorporation that limit their personal liability for monetary damages.
- However, §102(b)(7) <u>will not</u> apply to:
  - *Caremark* claims (including the duty of oversight)
  - Bad faith or intentional misconduct
  - Breaches of the duty of loyalty
  - Improper personal benefits
- Exculpation provisions are limited to direct claims brought by stockholders, not claims brought by the board or derivative claims.
- D&O Insurance Policies

Best Practices Going Forward

Evaluate Indemnification Provisions in Employment Agreements

- Officers may have contractual rights to indemnification or advancement from the corporation under their employment agreements.
- Corporations should review and evaluate these provisions carefully, as they may affect the corporation's ability to recover damages from officers who breach their fiduciary duties.
- Officers should review and negotiate the indemnification provisions of their Employment Agreements to ensure that they are adequately protected from liability claims arising from their service to the corporation.
    - Increased risk of oversight claims against Chief Compliance Officers and CEOs because of the broader scope of their oversight portfolio

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