

To Our Clients and Friends,

The December edition of our Insurance Industry Corporate Governance Newsletter provided a review of some of the key transactional and regulatory themes that we observed during the past year and some predictions to carry forward into 2023.

This month's edition focuses on a recently announced decision of the Delaware Court of Chancery that raises some potentially important questions about the fiduciary duties of corporate officers.

Delaware Chancery Court Ruling *In Re McDonald's Corp.*

In a January 25, 2023 decision (*In Re McDonald's Corp. S'Holder Litig.*, C.A. No. 2021-0324-JTL (Del. Ch. Jan. 25, 2023)), the Delaware Court of Chancery declined to dismiss claims that a corporate officer, who led the company's human resources function, breached his fiduciary duties by "allowing a corporate culture to develop that condoned sexual harassment and misconduct." The plaintiffs claimed that the officer breached a "Caremark" duty by consciously ignoring "red flags" signaling misconduct. Despite the fact that no prior Delaware case had applied *Caremark* duties to an officer, the court declined to dismiss the claims, finding as a general matter that corporate officers owe a duty of oversight to an equal, if not greater, extent than corporate directors.

In this case, the court held that the bad faith necessary to support a *Caremark* claim was supported by particularized factual allegations that the officer had himself engaged in acts of sexual harassment, making it reasonable to infer, in the context of a corporate culture that allegedly condoned sexual harassment, that he consciously ignored red flags about similar behavior by others at the company. Moreover, the court declined to dismiss the claim that the officer's misconduct itself constituted a breach of the duty of loyalty.

In one sense, the decision, although one of first impression in Delaware, is not surprising: the Delaware Supreme Court has squarely held that corporate officers owe the same fiduciary duties as corporate directors. However, applying to officers a fiduciary duty of oversight—itsself a judicially derived attribute of the duty of loyalty—is complex because, while the oversight role of directors is plenary and therefore relatively homogeneous, the comparable roles of officers are not. The court in *McDonald's* recognized the situational aspects of officers' oversight duties: "Some officers, like the CEO, have a company-wide remit. Other officers have particular areas of responsibility, and the officer's [*Caremark*] duty 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."

In addition to relying on the general proposition that officers owe the same fiduciary duties as directors, the court noted the additional duties officers owe as agents who report to the board of directors. According to the court, these duties include an obligation to provide information to a superior officer or the board where that information is material to the scope of the agent's duties. The court called this "an indispensable part of an officer's job" and "an essential link in the corporate oversight structure."

Will the *McDonald's* decision, if upheld, represent a sea change in the liability landscape? *Caremark* has not led to an avalanche of claims against directors, and such claims remain, in the words of the court in *Marchand*, “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” That difficulty stems in large part from the challenge of pleading facts sufficient to support a reasonable inference that the directors acted in bad faith. The day-to-day responsibility of officers, as compared to the significantly more limited role of the board, may provide greater opportunity to plead facts from which an officer’s bad faith may be inferred, especially when supported by materials obtained through books and records demands (which can be expected in this

context to seek emails and other management-level materials).

Given the likelihood that a *Caremark* claim against an officer will be accompanied by fiduciary duty claims against directors, it may be the unusual case in which adding a *Caremark* claim against an officer materially changes the overall liability picture. Nonetheless, the factual nature of these claims as applied to officers seems likely to make them inviting targets for plaintiffs’ lawyers.

Conclusion

The *McDonald's* decision will be much discussed by the corporate governance community in the coming weeks and months. While its precise implications and parameters, and its precedential effect, remain to be seen, we do note that it is likely to raise some particularly thorny questions about the roles and responsibilities of corporate officers charged with overseeing, managing and monitoring risk in complex organizations—such as large insurance groups.



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