

## Court of Chancery of Delaware: Clarifies for the First Time That Corporate Officers, Not Just Directors, Have a Duty of Oversight (Securities Law Alert)

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On January 25, 2023, the Court of Chancery of Delaware denied dismissal of a derivative action alleging that the defendant former head of human resources for a global fast food company breached his fiduciary duties by: (i) consciously ignoring red flags regarding sexual harassment and misconduct at the company (duty of oversight); and (ii) personally engaging in sexual harassment (duty of loyalty). *In re McDonald's S'holder Derivative Litig.*, 2023 WL 387292 (Del. Ch. 2023) (Laster, V.C.). Rejecting defendant's argument that Delaware law does not impose any obligation on officers that are comparable to the duty of oversight for directors established by *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the court announced that "[t]his decision clarifies that corporate officers owe a duty of oversight." While acknowledging that no previous Delaware decision has explicitly stated this proposition, the court stated that "diverse authorities indicate that officers owe a fiduciary duty of oversight as to matters within their areas of responsibility."<sup>[1]</sup>

### The Scope of an Officer's Duty of Oversight

Concluding "that oversight liability for officers requires a showing of bad faith[.]" the court explained that "[t]he officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore red flags." The court stated that the duty of oversight is context-driven and its application will differ depending on the officer's role. For example, some officers, like the CEO, will have a company-wide remit, while others are generally limited to particular areas, reporting red flags only within their areas of responsibility. The court cautioned, however, "a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain."

### Plaintiffs' Allegations Support an Oversight Claim Against Officer Defendant

As to the applicable standard, the court stated: "To plead a Red-Flags Claim that will survive a Rule 12(b)(6) motion, 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.”

The court found that plaintiffs asserted a “Red-Flags Claim” because plaintiffs described that defendant: (i) knew about evidence of sexual misconduct; and (ii) acted in bad faith by consciously disregarding his duty to address the misconduct. The court found that plaintiffs alleged a number of red flags, including coordinated EEOC complaints, employee strikes and Congressional inquiries, indicating for pleading purposes that sexual harassment occurred at the company and supporting a reasonable inference that defendant knew about the red flags. The court observed that defendant was the executive officer with day-to-day responsibility for overseeing the human resources function and promoting a safe and respectful environment, and was thus “supposed to have his ear to the ground and be knowledgeable about the Company’s employees.” As to bad faith, the court explained that Delaware law presumes that directors and officers act in good faith, and a complaint must plead facts sufficient to support an inference of bad faith intent. The court stated that several factors support an inference of scienter. In this regard, the court pointed to plaintiffs’ allegations that defendant engaged in multiple acts of sexual harassment and concluded that “[w]hen 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.”

**Plaintiffs Also Stated a Claim for Breach of the Duty of Loyalty Based on Officer Defendant’s Own Acts of Sexual Harassment**

The court also denied dismissal of plaintiffs’ claim that defendant’s own acts of sexual harassment constituted a breach of the duty of loyalty. The court explained that an alleged harasser acts in bad faith and breaches the duty of loyalty because a harasser engages in sexual harassment for selfish reasons, which conflicts with an officer’s duty of loyalty. The court concluded by noting: “Sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable.”

[1] Among these authorities, the court cited *Caremark*, *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (holding that officers’ fiduciary duties are the same as directors’ fiduciary duties), principles of agency, decisions from other jurisdictions, and academic commentary.

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