Has a Director's Duty of Loyalty Been Expanded?

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It is commonly known that corporate directors are subject to two duties: (i) the duty of care and (ii) the duty of loyalty. The duty of care requires, among other things, the director to investigate and take such actions as a prudent person would do under the circumstances. Under Delaware corporate law, the company can exculpate a director from personal liability for a breach of the duty of care by electing to include in its certificate of incorporation the benefits of Section 1.02(7) of the Delaware Corporate Law ("DGL"). The duty of loyalty requires the director to act in the best interests of the company and not adverse to the interests of the company. Section 1.02(7)(i) and (ii) of the DGL specifically prohibit the company from exculpating a director from personal liability for a breach of the duty of loyalty and for actions taken in bad faith. Most of the cases concerning breach of the duty of loyalty relate to self-dealing or matters of suspect director motivation, such as entrenchment. Recently, public shareholders have attempted to bring causes of action for a breach of a "duty of oversight."

This Alert discusses the recent Delaware cases related to the duty of oversight and a recent decision of the Delaware Chancery court in a derivative lawsuit brought by the shareholders of McDonalds.

Directors' Duty of Oversight under Delaware Law

A claim for breach of the "duty of oversight" in Delaware is sometimes referred to as a "Caremark" claim, referring to the landmark 1996 case on the subject.[1] According to the holdings of Delaware courts, to assert a Caremark claim a plaintiff must allege particularized facts supporting a reasonable inference that either (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.[2]

The McDonald's Shareholders' Allegations

In the *McDonald's* case, decided on March 1, 2023, McDonald's shareholders brought suit against the board of directors alleging that they breached their duty of oversight by ignoring red flags from 2015 to 2020 about a corporate culture that ignored sexual harassment and misconduct. More specifically, the shareholder plaintiffs alleged a series of events during 2018 that put the directors on notice of a threat to the company, including (1) a series of sexual harassment and retaliation complaints filed with the Equal Employment Opportunity Commission, (2) a ten-city nationwide strike by McDonald's workers, and (3) an inquiry from Illinois Senator Tammy Duckworth seeking to investigate issues of sexual harassment and misconduct. The shareholders also alleged that in December 2018, the directors learned that McDonald's Global Chief People Officer and head of worldwide human resources had engaged in an act of sexual harassment. During the investigation into the 2018 incident, the directors learned of a prior incident of sexual harassment by the Global Chief People Officer in 2016. The Global Chief People Officer also had been warned about his consumption of alcohol at company events. Thus, the claims asserted by the shareholder plaintiffs in *McDonald's* were based on the directors' failure to take appropriate responsive action to the sexual harassment and misconduct red flags they had became aware of.

The McDonald's Decision

Vice Chancellor Laster had no difficulty in concluding that the corporate culture at McDonald's from 2015-2018 presented red flags that required responsive active by the McDonald's board. Nevertheless, Vice Chancellor Laster dismissed the complaint because it failed to satisfy the Caremark requirement that the allegations permit a reasonable inference of bad faith by the directors. After noting the board's responsive actions, the Delaware Chancery court concluded it was not possible to infer that the director defendants acted in bad faith. To be successful in bringing a Caremark claim, the plaintiff must plead and prove that the directors acted in bad faith. The Delaware Supreme Court defined bad faith as "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.[3] Common among all three formulations of the definition of bad faith is an element of intent. To act in bad faith, the directors must have acted with *scienter*, with actual or constructive knowledge that their conduct was legally improper. Bad faith encompasses both an intent to harm and an intentional dereliction of duty.[4] The Delaware Chancery court highlighted that it is not enough to show that the directors responded in a weak, inadequate, or even grossly negligent manner. Moreover, depending on the directors' decisions, they are entitled to the protection under the Delaware business judgement rule. Stated more directly, the Delaware Chancery court concluded that if the directors make an objectively wrong decision, a Caremark claim cannot be maintained without evidence that the directors acted in bad faith since directors do not guarantee success or a favorable outcome but rather have to make a good faith effort.

Expansion or Narrowing of the "Duty of Loyalty"

It is interesting that the duty of oversight is categorized as a subset of the duty of loyalty rather than the duty of care, as logically, a failure of oversight would seem to fit under the duty of care as a failure to act as a prudent person would under the circumstances. Given that the duty of care can be exculpated (absent bad faith) in a Delaware corporation's certificate of incorporation pursuant to Section 102(7) of the DGL and many companies take advantage of the ability to exculpate directors from personal liability from a breach of the duty of care, shareholders have attempted to bring claims alleging the breach of the duty of loyalty. The Delaware Chancery Court in *McDonald's,* however, made it clear that to breach the "duty of oversight" as part of the duty of loyalty, which cannot be exculpated under Delaware law, the directors also had to have acted in bad faith. The requirement that directors must have acted in bad faith to breach the duty of oversight is an extremely high legal standard or burden to prove under Delaware law. And since directors are unable to avail themselves of exculpation of the duty of care under Delaware law if it has been determined the directors acted in bad faith, by requiring a bad faith standard for liability under the duty of oversight, the Chancery Court in *McDonald's* was (at least implicitly) recognizing that it does not matter from an exculpatory or burden of proof perspective whether the duty of oversight is viewed as a subset of the duty of loyalty or the duty of care.

Lessons from the *McDonald's* Case

Directors are well advised to be proactive in response to allegations of corporate wrongdoing or misconduct – particularly when the allegations concern the human resources department. Inaction will be judged more harshly in hindsight than good faith actions which ultimately prove to be ineffective. Directors should review information systems in the company to ensure that directors are receiving information concerning potential wrongdoing or misconduct in the company, and that such information is not failing to reach the director level.

For More Information

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1 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996). The Delaware Supreme Court subsequently approved the Caremark claim framework in *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

2 *In re McDonald's Corporation Stockholder Derivative Litigation*, --- A.3d ----, 2023 WL 2293575 at *14 (Del. Ct. Ch. 2023, *citing Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

3 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 99-100 (Del. 2006).

4 *McDonald's* at *25.