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Insights

Delaware Duty of Oversight Extended to Officers – What about Indiana?

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Introduction

A recent decision out of Delaware sent ripples of concern spilling out of the Board Room and throughout the C-suite. On January 26, 2023, in *In Re McDonald's Corporation Stockholder Derivative Litigation*, the Delaware Court of Chancery issued an opinion that denied a motion to dismiss by the defendant corporate officer based on the court's determination that under Delaware law, corporate officers owe a duty of oversight. This ruling extends to corporate officers the duty imposed on directors under the court's *Caremark* decision issued in 1996, which held that directors have a duty to ensure a corporation maintains an information and reporting system covering the corporation's compliance obligations and that failure to maintain such a system under some circumstances may render a director liable for losses caused by non-compliance with applicable legal standards.[1] Under the *McDonald's* decision, corporate officers face similar personal liability if they fail to exercise proper oversight of the corporation's compliance obligations in their areas of responsibility.

Background

Certain McDonald's stockholders initiated a derivative lawsuit on behalf of the company alleging that former Executive Vice President and Global Chief People Officer David Fairhurst breached his fiduciary duties by allowing a corporate culture to develop that condoned sexual harassment and misconduct. Plaintiffs asserted that part of those duties included the *Caremark* duty of oversight, which required Fairhurst to make a good faith effort to establish a system of information gathering capable of generating the data points necessary to oversee and manage the company's human resources function.[2] Beyond his duty to create systems designed to aggregate the information required to execute his duty of oversight, plaintiffs alleged that those duties demanded he address or notify his superiors of any red flags regarding sexual harassment or misconduct within the company. The stockholders did not allege that Fairhurst failed to create a satisfactory information system, but rather that he breached his fiduciary duty when he consciously ignored red flags about sexual harassment and misconduct claims produced by the information system that he failed to report upward. Compounding those failures was Fairhurst's personal participation in sexual harassment with company employees.

The Decision

The court ruled that corporate officers owe a duty of oversight. The same principles that applied in *Caremark* to a board of directors apply equally to a corporate officer. Indeed, the mere fact that corporate directors owe a duty of oversight does not preclude that same duty from applying to officers. Although the duty of oversight applies equally to officers, that duty is context-specific, and its application differs from the similar duty imposed on directors. The court distinguished between the duty of CEOs (with company-wide oversight) and officers with particular areas of responsibility. In either context, the officer's duty to "make a good faith effort to establish an information system" applies within the officer's particular area of authority.[3] Moreover, an "officer's duty to address and report upward about red flags also generally applies within the officer's area, although a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain."[4] Establishing a breach of the officer's duty of oversight requires proving disloyal conduct that takes the form of bad faith.

In *McDonald's*, the court found that plaintiffs alleged facts sufficient to support a claim against Fairhurst for breach of the duty of oversight and loyalty because he knew about potential red flags, failed to act and personally engaged in acts of sexual harassment himself.

Application to Indiana Law

Like Delaware, officers under Indiana law owe a fiduciary duty to the corporation they serve. Indiana courts have long held that "directors and officers of a corporation act in a fiduciary capacity, and their acts must be for the benefit of the corporation."[5] In Indiana, an officer's duties are determined not by statute but "by the common law rules of agency," and an officer has a duty to provide relevant information to the principal (i.e., the officer's supervisor or the board of directors).[6] To fulfill this duty, officers must "use reasonable efforts to provide the principal with facts that the agent…should know when… the agent… has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal."[7] An officer's duty to provide information is not absolute and is qualified by the duty to obey the board of directors' lawful instructions.[8]

Nothing in Indiana caselaw to this point suggests officers have the type of duty of oversight imposed on officers in the *McDonald's* case. Nevertheless, Indiana courts have determined that officers are corporate fiduciaries. The rules of agency, which also apply to officers of a corporation, require officers to disclose pertinent information to their senior officers and, in some circumstances, to the board of directors. The Delaware Chancery Court based its *Caremark* decision, and now its *McDonald's* decision, on principles of fiduciary duties. Indiana courts have also looked to Delaware for guidance when Indiana's caselaw has not addressed a particular issue and, if and when this issue is presented to an Indiana court, may find these Delaware cases persuasive in determining how these issues should be addressed in Indiana.

Although Indiana courts have not yet imposed a *McDonald's*-like duty of oversight on officers, companies should be aware of the significance of the *McDonald's* decision and the impact it may have on the future of Indiana law when similar issues arise, as the Delaware Court of Chancery is a leading jurisdiction in the development of business law throughout the country and changes in the approach taken by Delaware courts with respect to fiduciary duties have found their way into Indiana corporate governance.

Key Takeaways

- Although the *McDonald's* decision did not alter existing Indiana law, Indiana businesses should consider creating internal information systems that are monitored by company board members and officers, which can produce data points useful in monitoring troublesome employee behavior such as a hostile work environment and in other areas of high risk to the corporation.
- If internal information systems reveal inappropriate employee behavior, company officers may have a fiduciary duty to take action to mitigate the behavior and report the action to supervisors if the behavior stems from actions taken by an employee under the officer's supervision.
- If the employee behavior is particularly egregious, company officers may have a fiduciary duty to report the incident to the board of directors, even if the employee responsible for the behavior is not under the officer's direct supervision.
- These standards of oversight will likely apply to any compliance responsibilities in the officer's areas of responsibility.

Update Regarding Standards Applied to Directors

On March 1, 2023, the same Chancery Court in the same litigation ordered the dismissal of actions against members of the McDonald's Board of Directors, essentially holding that the plaintiffs had not sufficiently pled facts arising out of the same hostile workplace allegations that would establish liability of the directors under the *Caremark* standards. The court also made clear that the common interpretation that the *Caremark* holding applied only to mission critical compliance issues was not persuasive and that a plaintiff did not need to plead such mission criticality to state a claim that would be heard. By dismissing the claims against the directors, the Chancery Court affirmed the vitality of the business judgment rule in protecting directors from decisions made in good faith even if those decisions prove to be faulty. This holding is consistent with Indiana's own standard of conduct applicable to directors of Indiana corporations that provides solid protection to directors who properly exercise their business judgment.

If you have questions regarding information found in this alert, please contact **Robert A. Greising**, **Charles O. Richert**, or any member of our **Business, Acquisitions, and Securities Practice**.

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[1] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).
[2] *Id.*
[3] *Id.*
[4] *In re McDonald's Corp. S'holder Derivative Litig.*, No. 2021-0324-JTL, 2023 WL 387292 (Del. Ch. Jan. 26, 2023).
[5] *Griffin v. Carmel Bank & Trust Co.*, 510 N.E.2d 178, 183 (Ind. Ct. App. 1987).
[6] *Levin v. Miller*, 900 F.3d 856, 862 (7th Cir. 2018).
[7] *Id*, quoting the Restatement (Third) of Agency § 8.11 (AM.LAW INST. 2006).
[8] *Id.*