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## Delaware Chancery Court Holds Corporate Officers Owe Duty of Oversight

### Vice Chancellor Laster Extends This Fiduciary Duty, Previously Recognized only as to Corporate Directors

On January 25, 2023, the Delaware Court of Chancery answered an important question of officer liability, holding for the first time that corporate officers owe a duty of oversight to the corporation. The opinion, *In re McDonald's Corporation Stockholder Derivative Litigation*, No. 2021-0324-JTL, 2023 WL 387292 (Del. Ch. Jan. 25, 2023), allows a group of shareholders to proceed with derivative claims against a former McDonald's officer. The decision by Vice Chancellor Laster follows previous Delaware rulings recognizing that corporate directors and general partners of partnerships owe duties of oversight or monitoring.

#### BACKGROUND

The litigation concerns allegations that McDonald's former Chief People Officer, David Fairhurst, harmed the company by promoting a culture of, and committing, sexual harassment and other workplace misconduct. After employees filed multiple class action lawsuits alleging systemic harassment and abuse within the company, shareholder plaintiffs filed a consolidated derivative action alleging that certain directors and officers had breached their fiduciary duties by allowing an environment of harassment and misconduct to persist. The shareholders alleged that Fairhurst owed a duty of oversight to the corporation and that he breached that duty by failing to address or report upward red flags regarding sexual harassment at the company. Plaintiffs further alleged that Fairhurst breached his duty of loyalty by personally engaging in acts of sexual harassment prior to his termination in November 2019.

Fairhurst moved to dismiss the claims against him. He argued that, as a corporate officer, he did not owe a duty of oversight. He also contended that plaintiffs failed to allege sufficient facts to state a claim that he breached the duty of loyalty or any alleged duty of oversight.



## THE DECISION

On January 25, 2023, the Delaware Court of Chancery denied Fairhurst's motion to dismiss, holding that, as an officer of the corporation, he owed a duty of oversight, and that plaintiffs had adequately pleaded that he breached the duty of oversight and the duty of loyalty.<sup>1</sup>

Acknowledging that no Delaware court had explicitly recognized a fiduciary duty of oversight for corporate officers, the court held that such a duty exists and could be inferred from existing authorities.<sup>2</sup> The court noted that Delaware has recognized duties of oversight since as early as 1963, when the Delaware Supreme Court established a "protective 'red flags' rule," under which directors could be liable for failing to remedy wrongdoing only if they had cause to suspect wrongdoing and deliberately chose not to act.<sup>3</sup> As the court explained, the red flags rule expanded into a full duty of oversight with the Delaware Court of Chancery's 1996 decision in *In re Caremark International Inc. Derivative Litigation*, which recognized a corporate director's duty to assure that an information gathering and reporting system exists to provide management and the board with material operating information, including for legal compliance.<sup>4</sup> The court concluded that the reasons for recognizing a duty of oversight for directors also support recognizing a duty of oversight for officers, who may have greater capacity to exercise oversight, who make day-to-day decisions about information reporting and addressing red flags, and whose actions are considered when assessing corporate culpability under the federal Organizational Sentencing Guidelines.<sup>5</sup> The court explained that the mere fact that corporate directors also have oversight duties does not foreclose officers from owing similar duties: "Just as a junior manager with supervisory duties can report to a senior manager with supervisory duties, so too can an officer with a duty of oversight report to a board of directors with a duty of oversight."<sup>6</sup>

As to the scope of a corporate officer's duty of oversight, the court concluded that each corporate officer's specific obligations will depend on context and the facts of the case.<sup>7</sup> For example, the court explained that although "the CEO and Chief Compliance Officer likely will have company-wide oversight portfolios, other officers generally have a more constrained area of authority" and "a constrained version of the duty" for certain oversight claims.<sup>8</sup> Moreover, while recognizing that exceptions for "sufficiently prominent red flags" might exist, the court explained that "officers generally only will be responsible for addressing or reporting red flags within their areas of responsibility."<sup>9</sup> And, according to the court, officers, like directors, "only will be liable for violations of the duty of oversight if a plaintiff can prove that they acted in bad faith and hence disloyally."<sup>10</sup>

Turning to the specific allegations against Fairhurst in the complaint, the court held that the shareholder plaintiffs sufficiently pleaded a claim against him for breach of the duty of oversight. The shareholder plaintiffs met their notice-pleading burden by alleging a series of events to support their contention that "Fairhurst [knew] about evidence of sexual misconduct and act[ed] in bad faith by consciously disregarding his duty to address the misconduct," thus allowing "a culture of sexual misconduct and sexual harassment" to develop at the company.<sup>11</sup> The court further held that the plaintiffs adequately alleged a breach of the duty of loyalty based on their allegations that Fairhurst himself engaged in sexual harassment.<sup>12</sup>

The Court of Chancery's opinion answers an important question by confirming that officers of Delaware corporations have a duty of oversight, and corporate officers should assess their oversight obligations in light of this ruling. Nonetheless, clients should expect further legal developments regarding the duty of oversight, ranging from future cases addressing whether officers of other forms of Delaware entities owe similar duties to disputes regarding limitation-of-liability provisions and indemnification agreements for corporate officers alleged to have breached the duty of oversight.



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<sup>1</sup> *In re McDonald's Corp. Stockholder Derivative Litig.*, No. 2021-0324-JTL, 2023 WL 387292, at \*9, 28, 30.

<sup>2</sup> *Id.* at \*9.

<sup>3</sup> *Id.* (citing *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963)).

<sup>4</sup> *Id.* at \*9–10 (citing *In re Caremark International Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996), and Martin Lipton & Theodore N. Mirvis, *Chancellor Allen and the Director*, 22 Del. J. Corp. L. 927, 939 (1997)).

<sup>5</sup> *Id.* at \*10–11.

<sup>6</sup> *Id.* at \*1.

<sup>7</sup> *Id.* at \*1, 18–19.

<sup>8</sup> *Id.* at \*19.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at \*25. The court also noted that the shareholder plaintiffs' claim for breach of the duty of oversight was a “Red-Flags” claim in the style of *Allis-Chalmers*. *Id.*

<sup>12</sup> *Id.* at \*28–30.