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Delaware Court of Chancery Dismisses Duty of Oversight and Care Claims Against Directors

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In our [February 14, 2023 Stay Current](#), we discussed a Delaware Court of Chancery decision allowing shareholder derivative claims to proceed against a corporate officer for alleged oversight duty failures stemming from harassment and misconduct.¹ Now, just over a month later, the Court in the same action has dismissed claims against nine current and former directors. In doing so, the Court reaffirmed the principle that to successfully plead a breach of the duty of oversight, there must be facts alleged sufficient to support an inference of bad faith, rather than just allegations of inadequate or even grossly negligent conduct. In addition, the Court rejected separate breach of fiduciary duty claims that challenged certain Board decisions connected to officer misconduct. The Court reasoned that the decisions were protected by the business judgment rule and that any duty of care claims that were implicated by the Board's process in reaching those decisions, even if sufficiently pled, would be exculpated. Finally, the Court of Chancery dismissed a corporate waste claim based on compensation paid to the CEO when he was terminated without cause, finding that it was not so extreme to support a pleading stage inference of bad faith.

The Allegations

Company shareholders alleged that nine current and former directors of the company breached their fiduciary duties by failing to adequately respond to red flags about the company's "toxic culture" of harassment and misconduct.² The plaintiffs also alleged that the directors breached their fiduciary duties by taking various employment-related actions. These included promoting the company's now-former CEO, despite being aware that he was engaged in conduct in violation of company policy, electing to discipline the company's now-former Chief Global People Officer, in lieu of terminating him, and eventually terminating the CEO without cause and allegedly without conducting a meaningful investigation.³ The plaintiffs also alleged the Board's decision to terminate the CEO without cause and provide him with a separation agreement and payment constituted corporate waste.⁴

The Decision

Turning first to the Board's duty of oversight, the Court noted that what plaintiffs had pled was not an Information-Systems Claim, i.e., a claim that the Board failed to establish systems and controls to monitor and address risks, but rather a Red-Flags Claim where a plaintiff "must plead particularized facts that the board knew of evidence of corporate misconduct—the proverbial red flag—yet acted in bad faith by consciously disregarding its duty to address that misconduct."⁵ Importantly, the Court clarified that to plead a Red-Flags Claim, a plaintiff need not allege that the red flags concerned "mission

critical risks”.⁶ The Court observed that the “mission critical risks” concept evolved from the Delaware Supreme Court decision in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019), which concerned an “Information-Systems Claim” based on a board that allegedly lacked the requisite information system and controls.⁷ As the Court explained, the considerations for Red-Flags Claims and Information-Systems Claims are distinct:

The *Marchand* decision actually holds that when directors fail to make any effort to establish an information system to address central compliance risks, then that failure supports an inference of bad faith. ... Outside of central compliance risks, including essential or mission critical risks, a plaintiff will have difficulty rebutting the business judgment rule where officers or directors have made a good faith decision regarding the level of monitoring resources, if any, to assign to a risk. The concept of central compliance risks, including essential or mission critical risks, does not play a similar role for a Red-Flags Claim. If an officer or director learns of evidence indicating that the corporation is suffering or will suffer harm, then the officer or director has an obligation to respond. ... [A]n inference of bad faith is more likely when a red flag concerns an essential or mission critical risk, but a Red-Flags Claim is not dependent on the signal relating to an essential or mission critical risk.⁸

Turning to the facts alleged, the Court explained that when alerted to various red flags at the company regarding the sexual harassment and misconduct at issue, the directors took a number of concrete steps to respond, such that they “elevated the importance of addressing sexual harassment and misconduct as an enterprise risk.”⁹ These steps, among others, included hiring of outside consultants and counsel to advise the Company on policy changes and training programs, setting up new reporting hotlines for employees, producing guides for franchisees on best practices and recommendations for establishing and maintaining a safe and respectful workplace, and ending mandatory arbitration of harassment and discrimination claims.¹⁰ The Court emphasized that “[w]hether the response fixed the problem is not the test,” as “[f]iduciaries cannot guarantee success.”¹¹ All that was required was that the board “make a good faith effort” to address the red flags, which the Court determined the Board had done.¹² In light of that effort, the Court concluded it was not possible to infer that the directors acted in bad faith, and therefore the claim for breach of the duty of oversight failed.

The Court then explained that the plaintiffs’ personnel-related allegations fell short for similar reasons. The Court analyzed the directors’ conduct under the business judgment rule standard, explained as follows:

That standard of review presumes that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Unless a plaintiff rebuts one of the elements of the rule, the court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation’s objectives. Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty.¹³

Applying this standard, the Court noted that the plaintiffs did not rebut any of the presumptions of the business judgment rule in challenging the defendants’ employment decisions for the CEO and Chief

Global People Officer.¹⁴ In particular, the Court observed that: (1) there were no allegations that any of the defendants were personally interested in the decisions they made; (2) there were no allegations that any director defendant was not independent; and (3) the Board had the authority to authorize exceptions to corporate policy.¹⁵ The Court acknowledged that while there were “many reasons to disagree” with the directors’ decisions, it was “not reasonably conceivable” that those decisions were made in bad faith and therefore plaintiffs had failed to rebut any of the business judgment rule’s presumptions.¹⁶

The Court also rejected the plaintiffs’ assertion that the Board’s decision to terminate the CEO without cause was a self-interested attempt to protect itself from liability. The Court again noted that no one on the Board had an interest in the decision or was otherwise not independent. Moreover, the Court found that plaintiffs’ suggestion that the director defendants terminated the CEO without cause to “keep things quiet and protect themselves” was insufficient to overcome the presumption that the director defendants had acted in good faith, as the Court found the directors “did not face a threat of liability for their response to the issues of sexual harassment and misconduct.”¹⁷ In reaching that conclusion, the Court of Chancery observed that “[t]he business judgment rule recognizes that people can make mistakes, even when acting diligently, loyally, and in good faith,” and that even accepting “that the Director Defendants made a bad decision in November 2019 by not conducting a more meaningful investigation and not terminating [the CEO] for cause, that does not mean that the Director Defendants breached their duties.”¹⁸ Pointing to prior no-fault termination cases, the Court stated that “the defendants could have rationally believed in subjective good faith that an amicable termination without cause was in the best interests of the Company.”¹⁹ The Court also held that allegations concerning the speed and thoroughness of defendants’ investigation into the CEO’s conduct implicated the duty of care, which was not actionable pursuant to an exculpation clause in the company’s charter.²⁰ Lastly, the Court rejected plaintiffs’ claim that the defendants’ decision to terminate the CEO without cause and provide him with a separation agreement constituted waste. The Court acknowledged that “reasonable minds could disagree” with the defendants’ decision to terminate the CEO and provide him with a separation agreement, but stated that the bargain was “not so out of whack as to constitute waste.”²¹

Conclusion

While the Court of Chancery’s previous ruling expressly held for the first time that corporate officers owe a duty of oversight, this decision reaffirms the robust protections the business judgment rule can provide officers and directors of Delaware corporations in their efforts to address red flags as part of their duty of oversight. In sum, if officers’ and directors’ decisions in response to red flags are done “loyally, in good faith, and on an informed basis,” absent any personal interest or lack of independence, those decisions should be protected from fiduciary duty claims based on the business judgment rule.²² The decision also clarifies that a duty of oversight claim premised on red flags does not need to relate to a “mission-critical” risk and that evaluation of such claims at the pleading stage will turn on what good faith efforts the Board made to address the red flags.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following New York lawyers:

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¹ Kevin C. Logue, Kevin P. Broughel & Zachary Melvin, *Delaware Court of Chancery Expressly Holds that Corporate Officers Owe a Duty of Oversight*, Stay Current, Feb. 14, 2023, <https://www.paulhastings.com/insights/client-alerts/delaware-court-of-chancery-expressly-holds-that-corporate-officers-owe-a>

² *In re McDonald's Corp. Stockholder Litig.*, No. 2021-0324-JTL, 2023 WL 2293575, at *3-11 (Del. Ch. Mar. 1, 2023).

³ *Id.* at *10-11.

⁴ *Id.*

⁵ *Id.* at *15 (quoting *Reiter v. Fairbank*, No. 11693-CB, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016)).

⁶ *Id.* at *16.

⁷ *Id.*

⁸ *Id.* at *17.

⁹ *Id.* at *21.

¹⁰ *Id.* at *20-21.

¹¹ *Id.* at *21.

¹² *Id.*

¹³ *Id.* at *22 (internal quotations and citations omitted).

¹⁴ *Id.* at *26-27.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at *28.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* at *29.

²¹ *Id.* at *3.

²² *Id.* at *17.

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