What The 3rd McD's Ruling Means For Claims Against Officers

By **Gail Weinstein, Philip Richter and Steven Epstein** (March 24, 2023)



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In the third pleading-stage decision in In re: McDonald's Corp. Stockholder Derivative Litigation, issued by the Delaware Court of Chancery on March 1, the court dismissed Caremark claims against David Fairhurst, the former head of human resources of McDonald's Corp., that asserted that he had breached his oversight duties in connection with the allegedly rampant sexual harassment problem at the company.

In an earlier pleading-stage decision, the court had rejected dismissal of these claims after finding it reasonable to infer that Fairhurst had violated his Caremark duties.

The court's dismissal of these claims in the third decision was based on the procedural defense of demand futility — and indicates that plaintiff stockholders bringing Caremark claims against officers are not likely to be successful in most cases unless the board also violated its Caremark duties or otherwise was not independent and disinterested with respect to the alleged misconduct.

Background

Certain stockholders of McDonald's brought claims against Fairhurst, as well as McDonald's former CEO and the McDonald's directors, asserting Caremark claims in connection with a sexual harassment problem at the company that had led to numerous U.S. Equal Employment Opportunity Commission claims and fines, employee walkouts and lawsuits, and inquiries from a U.S. senator.

The plaintiffs alleged that Fairhurst and the CEO had fostered an extreme party atmosphere at the company, with excessive drinking and sexual harassment; that Fairhurst himself had engaged in sexual harassment of employees; that the CEO had engaged in prohibited relationships with employees; and that the board had not responded in a timely or sufficient manner to red flags that the problem existed.

The CEO settled the claims against him, agreeing to return the $105 million severance he had received when he was terminated without cause.

In the first decision in the case, issued in January, the court rejected dismissal of the claims against Fairhurst, holding, for the first time, that Caremark duties apply not only to directors but also to officers, and holding that the plaintiffs had pled valid claims that Fairhurst had breached his Caremark duties.

In the second pleading-stage decision in the case, issued March 1 (the same day as the third), the court dismissed the claims against the directors, finding that once they knew of the problem they took action — albeit arguably deficient action — to address it. The court, while broadening the commonly understood parameters for applicability of Caremark, emphasized that bad faith is required for liability under Caremark, which creates a high bar for success by plaintiffs.

In the third decision, as noted, the court dismissed the claims against Fairhurst — reasoning that, because in the second decision the claims against the directors were dismissed, there was now no basis on which the plaintiffs could plead demand futility.

Demand Futility

Caremark claims are derivative claims — that is, they are claims asserting corporate wrongdoing that are brought by plaintiff stockholders on behalf of the corporation.

Given that, as a general matter, shareholder derivative suits represent a fundamental encroachment on the managerial authority and discretion of a company's board, shareholder plaintiffs bringing derivative claims must either make a demand on the board to bring the claims or establish that such a demand would have been futile because a majority of the directors in place at the time the demand would have been made could not have exercised independent and disinterested business judgment in responding to the demand.

Under the Zuckerberg test for demand futility established by the Delaware Supreme Court in 2021, one of the bases on which directors can be found not capable of independent judgment with respect to such a demand is where the directors themselves would face a substantial likelihood of liability on the claims that are the subject of the demand.

The other bases for demand futility under the Zuckerberg test are that the director received a material personal benefit from the alleged misconduct; or that the director lacks independence from someone who received a material personal benefit from the alleged misconduct or who faces a substantial likelihood of liability on the claims that are the subject of the demand.

In McDonald's, the plaintiffs had not made a demand on the board and argued that demand would have been futile because nine of the directors faced a substantial risk of liability for the claims that the plaintiffs had asserted against them for failure to oversee the sexual harassment problem at the company, and that those claims were so intertwined with the claims against Fairhurst that the directors could not have acted in a disinterested manner in responding to the demand to bring litigation against Fairhurst.

The court explained that, as the court in the second decision had dismissed the claims against the directors, they no longer faced any likelihood of liability. Therefore, the court wrote, "[f]or purposes of this case, the road to establishing demand futility that the plaintiffs sought to travel is closed." The claims were dismissed with prejudice but (as required under Court of Chancery Rule 15(aaa) against the named plaintiffs only.

Impact of the McDonald's Decisions on Caremark Cases

A Further Increase in Caremark Cases

Caremark cases already have proliferated in the past few years, and the McDonald's decisions are likely to accelerate that trend.

The first decision established that Caremark duties of oversight apply not only to directors but also to officers.

The second decision established that Caremark duties apply not only to a what the court has referred to as "mission critical risks" but, depending on the facts, may apply to other key

risks even if not rising to the level of mission-critical. It indicated that sexual harassment — and presumably similar issues, such as, say, discrimination — that previously have been considered primarily as giving rise to employment-related claims rather than fiduciary duty claims are mission-critical risks for most companies.

Indeed, the court stated that "maintaining workplace safety … [and] tak[ing] care of the corporation's workers" are mission-critical, as employees do the work that creates the company's value.

We note that, in McDonald's, the court did not focus at all on the damage to the company that resulted from the sexual harassment problem, while in other cases in which the court has found potential Caremark liability the corporate catastrophes that resulted from the alleged lack of oversight had led to loss of human lives and safety, as well as very significant financial and reputational damage, usually creating an existential kind of crisis threatening the company's very survival.

Claims Likely Against Both the Board and Officers

The court's first decision, establishing that Caremark duties apply to officers, is consistent with a general trend over the last several years of court decisions outside the Caremark context that have expanded potential liability for corporate officers. The decisions may result in greater focus by officers and directors on the benefits of amending the company's charter to provide for exculpation of liability for officers, as is now permitted under recently amended Delaware General Corporation Law Section 102(b)(7)).

Notably, however, such exculpation would not apply to Caremark claims against officers — as, under the new amendment to Section 102(b)(7), the charter cannot be amended to exculpate officers for derivative claims.

A Very High Bar to Success for Plaintiffs on Caremark Claims

As the court emphasized in the first and second decisions, a director or officer breaches Caremark duties only if the director or officer acted in bad faith — that is, with scienter, which involves a knowing and intentional failure of oversight. A failure of oversight due to negligence or stupidity does not support a Caremark claim.

In addition, as the third decision underscores, Caremark claims, being derivative, are subject to all of the usual defenses to derivative claims, including the demand futility defense.

Claims Unlikely to Succeed If Board Acted Properly

As illustrated by the third decision, Caremark claims brought by stockholders against officers are likely to be dismissed at the pleading stage, based on the demand futility defense, if the Caremark claims against the directors are dismissed.

Thus, unless the directors appear to have breached their Caremark duties, or the directors are otherwise not independent and disinterested with respect to the misconduct at issue, Caremark claims against the officers probably will be dismissed at the pleading stage, even if the officers appear to have breached their Caremark duties.

Possible Routes After Dismissal of the Claims on Demand Futility Grounds

After a dismissal on demand futility grounds, an officer or director like Fairhurst would face potential liability only if (1) the board on its own, or after receiving a stockholder litigation demand, decides to bring a claim; or (2) other stockholders bring suit, asserting a different basis for demand futility than the original plaintiffs had asserted.

Another potential route is a motion by the original plaintiffs, under Court of Chancery Rule 30(b), to reopen the case. This route is available only in the limited circumstances that, post-dismissal, there is newly discovered evidence relating to the grounds on which demand futility was found — in the McDonald's case, for example, if there were newly discovered evidence indicating that the directors had faced a substantial likelihood of liability.

We note that, on March 21, the Court of Chancery, in Lebanon County Employees' Retirement Fund v. Collis, rejected a Rule 30(b) motion to reopen the Caremark case against officers and directors of AmerisourceBergen Corporation, finding that the newly discovered evidence the plaintiffs offered — which was a newly filed complaint by the U.S. Department of Justice against the AmerisourceBergen officers and directors — did not meet the requirements of Rule 30(b). The Collis court ruled that the filing of the DOJ complaint was "new evidence" rather than "newly discovered evidence"; and, in any event, that it was not sufficiently material that it would probably change the court's previous outcome.

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