McDonald's Harassment Ruling And 'Mission-Critical Risk'

By **Gail Weinstein, Philip Richter and Steven Epstein** (March 13, 2023)



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In In re: McDonald's Corp. Stockholders Derivative Litigation, the Delaware Court of Chancery on March 1, at the pleading stage of litigation, dismissed the derivative claims brought against former and current directors of McDonald's alleging that they had failed to fulfill their duty of oversight, under the court's In re: Caremark International Inc. decision in 1996, with respect to rampant sexual harassment at the company.

Vice Chancellor J. Travis Laster agreed with the plaintiffs that so-called red flags had put the board on notice about the problem, but he dismissed the claims on the grounds that, once the directors learned of the issue, they took action to address it.

In an earlier decision in the case handed down on Jan. 25, Vice Chancellor Laster rejected the dismissal of the Caremark claims asserted against McDonald's former head of human resources, David Fairhurst, with respect to his purported lack of oversight of the sexual harassment problem, as well as his own alleged sexual harassment.

With the dismissal of the claims against the directors, the case will now proceed solely against Fairhurst.

Key Points

Expansion of Caremark

On the one hand, McDonald's appears to expand the potential for Caremark liability beyond the parameters that many legal analysts had understood to apply.

In the two decisions issued, the court articulated or clarified, for the first time, that: (1) Caremark duties of oversight apply not only to directors but also to officers; (2) Caremark duties apply not only to a company's so-called mission-critical risks, but, depending on the facts, may apply to other key compliance risks even if not rising to the level of mission-critical; and (3) sexual harassment and similar issues — and, indeed, "maintaining workplace safety … [and] tak[ing] care of the corporation's workers" — are mission-critical risks for companies, according to the March 1 decision.

High Bar to Caremark Liability

On the other hand, however — and perhaps most importantly as a practical matter — McDonald's reinforces that there is a high bar to a finding of Caremark liability, as it is only when directors or officers act in bad faith that Caremark liability arises.

Directors or officers who acted to address a problem once they learned of it generally would not be deemed to have acted in bad faith, even if the actions were insufficient or reflected poor decision making, so long as they were not so far off the mark as to suggest bad faith.

Background

Former CEO Stephen Easterbrook and Fairhurst allegedly engaged in and promoted a party-type atmosphere, with excessive drinking and sexual harassment, at the company and its restaurants.

In 2016, more than a dozen employees filed complaints with the U.S. Equal Employment Opportunity Commission, and employees engaged in a walkout in over 30 U.S. cities to draw attention to the complaints.

The company faced a second round of similar EEOC complaints in mid-2018, and company employees in 10 cities organized a strike to protest sexual harassment at the company. These 2018 events were covered in the national media and prompted an inquiry into the company from a U.S. senator.

In December 2018, the board received reports that, as verified by the company's compliance department, Fairhurst had engaged in sexual harassment and assault against employees.

The board's audit committee, following Easterbrook's recommendation, made an exception to its zero-tolerance policy for sexual harassment and permitted Fairhurst to continue in his position, but cut his bonus and had him sign a letter in which he agreed that he would cease the misconduct.

Also at this time, the board learned that Easterbrook had been engaged in more prohibited relationships with company employees than the board had already known about, negotiated a separation agreement with Easterbrook and terminated his employment without cause.

After learning that Fairhurst was continuing to engage in sexual harassment, the board terminated his employment for cause. Surveys of employees indicated that more than 75% of female employees had suffered sexual harassment at the company, per the decision.

Starting in late 2018, the management and board took action to address the sexual harassment problem at the company.

Company employees brought class actions alleging a failure of oversight, under Caremark, by Fairhurst and the board. At the pleading stage of litigation, in the January 2023 decision, Vice Chancellor Laster rejected the dismissal of the Caremark claims against Fairhurst, and, in the March 2023 decision discussed in this article, he granted dismissal of the Caremark claims against the directors.

The Court's Discussion

Red Flags

The court viewed the following as constituting sufficient red flags to have put the board on notice of the sexual harassment problem:

- The second round of EEOC complaints, the 10-city strike by employees to bring attention to the problem and the letter from a U.S. senator inquiring about the problem — which together constitute what the court called a "collective red flag"; and

- Fairhurst's own sexual harassment coming to light — which, standing alone, constitutes what the court called an "indisputable red flag." The court wrote, "When the head of human resources has engaged in multiple acts of sexual harassment, that is enough to put directors on notice of problems in the human resources area."

The Board's Actions

The court cited the following actions by the board, which took place throughout 2019, after it had clearly learned of the problem in late 2018:

Management reported to the board's strategy committee, and then the full board, about the issue and advised that teams of employees were proactively working to improve sexual harassment policies;

- The company retained an outside expert to revamp training programs;

- A hotline for employees was installed;

- Franchisees were required to sign a shared values commitment and were provided with a best practices guide;

- Listening sessions with employees were instituted;

- The company ended its mandatory arbitration policy for harassment and discrimination claims;

- An update to the board from management "identified a 'Respectful Workplace' as a 'New Risk Theme' at the 'Top Tier 2' level";

- The board terminated Easterbrook, albeit without cause;

- And the board terminated Fairhurst, with cause.

No Bad Faith by the Board

The court emphasized that Caremark liability will not arise unless the failure of oversight involved bad faith — that is, a conscious, knowing and intentional disregard of oversight duties.

"What [fiduciaries] have to do is make a good faith effort," the court wrote in the March 1 decision.

In this case, the directors "responded to the red flags regarding the toxic culture," and "[b]ecause of the effort they made, it is not possible to infer that [they] acted in bad faith."

The decisions as to what actions to take in response to a problem are classic business judgments as to which a majority-independent board is entitled to a presumption of good faith unless they lack any rationally conceivable basis, the court wrote.

Separation Agreement Did Not Constitute Corporate Waste

In addition to asserting Caremark claims, the plaintiffs argued that the separation agreement with Easterbrook constituted corporate waste, as it permitted the former CEO to receive a substantial severance payment notwithstanding his misconduct.

A transaction constitutes waste when it is so one-sided that no rational person acting in good faith could approve it.

The court explained that the decision to enter into the agreement was within the purview of the board's business judgment and did "not suggest a decision so extreme as to be inexplicable on any basis other than bad faith."

The court also noted that the company obtained meaningful corporate benefits from the agreement — ending the tenure of a CEO who had engaged in an improper relationship, securing his swift exit and releasing potential claims by him — without giving him a release; securing his cooperation on post-termination matters; obtaining his agreement to noncompetition, nonsolicitation and nondisclosure provisions; and the likelihood of avoiding litigation with him that would have highlighted the sexual harassment problem the company was trying to put behind it.

Caremark Duties Extend Beyond Mission-Critical Risks

The court stated that — contrary to a commonly held view — Caremark duties do not apply only to mission-critical risks.

The phrase "mission critical risks" has acquired "talismanic importance in the aftermath of [the Delaware Supreme Court's 2019 reversal of the Court of Chancery's dismissal of Caremark claims in] Marchand v. Barnhill," the court wrote.

However, the court emphasized that in Marchand, the state Supreme Court held that while the Caremark doctrine "may require more, … [it] at least requires attention to the corporation's central compliance risks." The Supreme Court found in that case that food safety was a central compliance risk for the ice cream manufacturer involved because it was mission-critical to producing ice cream.

Vice Chancellor Laster wrote in McDonald's that, although, based on Marchand, it is fair to infer that "all 'essential and mission critical risks' qualify as 'central compliance risks,' it is also possible that some 'central compliance risks' may not reach the level of 'essential and mission critical.'"

The extent to which a Caremark claim that a board failed to put into place a reporting and monitoring system "might extend to other risks depends on the facts," the court wrote. It further noted that McDonald's, unlike Marchand, involved a Caremark claim relating to ignoring red flags about potential harm to the corporation — a "Red-Flags Claim" — rather than a Caremark claim relating to the failure to put an oversight system in place — an "Information Systems Claim."

In the red flags claim context, the court said the concept of central compliance risks plays a different role because the issue is whether the defendant directors or officers consciously ignored corporate misconduct that they knew about.

"[A]ll else equal, if a red flag concerns a central compliance risk, then it is easier to draw an inference that a failure to respond meaningfully resulted from bad faith" — but that does not mean that directors and officers "can ignore red flags about other risks," the court stated.

Sexual Harassment Is a Mission-Critical Risk

The court found that, in any event, it was "easy to draw a pleading-stage inference that maintaining employee safety" is mission-critical for companies, as employees "perform the work that affects the value of the corporation," and thus "corporate fiduciaries must take care of the corporation's workers."

Specifically, "[s]exual harassment and misconduct render the workplace unsafe … [and] can result in serious injury to the corporation."

In addition, the court noted that the company's internal documents, discovered in the plaintiffs' Section 220 investigation, reflected that the company itself, once it began to address the sexual harassment issue, presented it in various corporate materials as a mission-critical risk for the company.

Practice Points

Address red flags.

A board and management should not ignore red flags of corporate misconduct and should act to address the misconduct, whether it relates to a mission-critical risk or not.

The clearer the red flag, the more it relates to a mission critical-type of risk, and the less the board or the officers do to address the problem, the greater the potential for liability under Caremark.

Address corporate misconduct that jeopardizes employees' welfare.

It is unclear what the implications will be of the court's statement that "taking care of the corporation's workers" is a mission-critical risk for companies.

Clearly, companies should review, update and monitor their policies, processes and training relating to sexual harassment — and similar risks, such as discrimination — to ensure that

current best practices are in effect and being enforced.

Address risks associated with departing from an existing zero-tolerance policy.

Generally, a board should consider carefully and document its reasons for making an exception to a zero-tolerance policy with respect to sexual harassment or similar policies.

In addition, when entering into a separation agreement with an officer who is being terminated for misconduct under any such policy, the company should consider whether the agreement provides meaningful corporate benefits.

Maintain Caremark-related best practices.

Risk management considerations should be a corporate priority and integrated into the company's corporate strategies and decision making.

Generally, a board should:

- Be active in establishing the effective management of key risks as a corporate priority;

- Identify the key risks facing the company and delegate responsibility for oversight of these risks to specific board committees;

- Consider setting a regular schedule for reporting from management on key risks and be proactive in seeking out additional reports when appropriate;

- Not simply delegate to senior officers of the company the management of key risks, but become informed about and consider how those risks are managed;

- Proactively address red, and possibly yellow, flags, about corporate misconduct, particularly — but not exclusively — relating to key risks;

- Create a record, such as in board minutes, of its risk monitoring and oversight efforts; and

- When recruiting new directors, take into consideration the board's expertise in addressing regulatory and other key risks, such as cybersecurity and human resources management.

Generally, management should:

- Establish regular processes and protocols requiring management to keep the board apprised of key regulatory compliance and other practices, risks or reports;

- Inform the board when it learns of red, or possibly yellow, flags, about corporate misconduct, including, for example, complaints or reports from regulators or whistleblowers, particularly when the misconduct involves key risks;

- Include the board in the company's whistleblower process;

- Tailor risk management strategies to the company's specific circumstances and risk profile;

- And inform the board of the practices of other companies in its industry or peer companies with respect to oversight of mission-critical risks.

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