

Delaware Court of Chancery holds for the first time that duty of oversight applies to officers

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The Delaware Court of Chancery's recent decision expands potential *Caremark* liability to officers for oversight failures, and we can expect to see an increase in books and records demands and claims targeting executives as a result.

In *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. No. 2021-0324-JTL (Del. Ch. Jan. 26, 2023), the Delaware Court of Chancery held for the first time that the *Caremark* duty of oversight applies to officers. Here are some key questions and takeaways for officers and companies to consider:

Is this a new duty for officers of a Delaware corporation? The decision characterizes its holding as a clarification of Delaware law, but the case reflects the first time that a Delaware court has expanded the duty of oversight first articulated nearly 30 years ago in *Caremark* to apply to corporate officers.

What is an officer's general duty of oversight? The decision explains that officers of Delaware corporations owe the same fiduciary duties as directors. As applied to the duty of oversight, officers must (1) make a good faith effort to establish information systems to monitor and oversee risks to the company and (2) monitor those systems for red (or even yellow) flags implicating those risks. The decision does not discuss whether the case presented the types of existential or "mission critical" risks that have prominently featured in recent Delaware decisions addressing the *Caremark* duty of oversight. As a result, it is not clear whether the decision seeks to reframe the types of risk that officers must take into account when exercising their duty of oversight.

Which "officers" owe a duty of oversight? Senior executives such as the CEO, CFO, and CCO clearly are subject to the duty of oversight. Other "officers" or "executives" also owe a duty of oversight, but the decision does not provide guidance on where to draw the line. At a minimum, officers who hold titles that are set forth in a company's bylaws or in a board resolution should be considered subject to the duty of oversight. Beyond that, officers who have meaningful supervisory responsibilities will likely be considered subject to the duty of oversight.

Does the scope of the duty change depending on the officer? Yes. The decision makes clear that the scope of the duty of oversight is context-specific. Senior executives such as CEOs have a company-wide remit and therefore a more expansive duty of oversight. Lower-level officers may only have oversight obligations within their area of responsibility, such as a corporate division or specific geography. But officers cannot ignore clear red flags that they come across even if those flags relate to areas outside the officer's remit. Importantly, given the egregious nature of the alleged misconduct summarized in the decision, the Chancery Court's decision may not be all that controversial in this case. What is perhaps more significant, however, is the implication of the decision on situations where one or more officers are not personally implicated in the misconduct, but who may be subject to meaningful personal liability resulting from the misconduct of others in the company.

What are the implications of the decision?

- **More expansive books and records demands.** Shareholders are increasingly using Section 220 of Delaware’s General Corporation Law to seek a company’s books and records to investigate potential wrongdoing and mismanagement. Companies may receive more books and records demands to investigate officer-level breaches of the duty of oversight. Those demands may seek the production of categories of documents beyond the board-level materials that have been the traditional focus of Section 220 demands. Companies may decide to evaluate their practices of documenting management oversight programs in formal reports (or other materials) provided by management to the board.
- **More litigation demands in response to allegations of officer-level misconduct.** The decision makes clear that the board should be capable in most instances of considering whether to pursue claims against officers accused of misconduct. For that reason, we do not expect that this will lead to more lawsuits filed by shareholders in the first instance, but it could prompt shareholders to make additional litigation demands in the wake of allegations of officer-level failures of oversight. Boards should expect that their decisions concerning how to respond to those demands will be closely scrutinized to see whether those decisions themselves give rise to a breach of fiduciary duty claim.
- **Shareholders will closely scrutinize board oversight of officers.** Boards should expect to continue to have their conduct closely scrutinized following allegations of officer-level misconduct. This includes shareholder investigations of a board’s compliance with its duty of oversight through books and records demands. The decision suggests that a robust board response that addresses identified misconduct can mitigate liability, and it underscores the importance of addressing officer misconduct promptly. Boards should also carefully assess payments made to executives departing under a cloud of potential misconduct and any deviation from company policies in addressing misconduct.
- **Shareholders may increasingly file duty of loyalty claims in connection with employment-related misconduct.** In the decision, the Chancery Court permitted a breach of the duty of loyalty claim to proceed against the executive based on his own alleged misconduct. The holding that the officer’s sexual harassment of employees constituted an independent breach of the duty of loyalty expands the duty of loyalty to encompass “reprehensible” and “selfish” employment-related misconduct that harms the company. Shareholders are likely to use this aspect of the decision to make litigation demands or assert breach of the duty of loyalty claims against officers in other employment-related contexts.
- **Expect senior executives to take notice of this decision.** Companies will need to assess the implications of this decision in the context of protections available to officers. We expect these issues to factor into decision-making around exculpatory provisions for officers, employment agreements, and D&O insurance coverage.

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