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McDonald's fast food restaurant in New Jersey. Photo: Diego M. Radzinschi/ALM

COMMENTARY

Why Fla. Lawyers Should be Mindful of Chancery Court's Decision in 'McDonald's'

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By Heather Woods | May 08, 2023 at 05:00 PM

The exact contours of liability for executives and officers who fail to comply with oversight duties have been a long unresolved issue. Those seeking to determine whether and to what extent executives and officers are liable for employee misconduct, were sent down a winding and murky path in the wake of *In re Caremark International Derivative*

Litigation, 698 A.2d 959, 961 (Del. Ch. 1996) (*Caremark*), and its progeny.

While *Caremark* unquestionably established directors and officers owe a duty of oversight, exactly what that means and how executives and officers should be expected to comply with such a duty were questions left unanswered—that is, until the Delaware Court of Chancery recently issued its ruling in *In re McDonald's Stockholder Derivative Litigation*, 289 A.3d 343, 354 (Del. Ch. 2023) (*McDonald's*).

All lawyers should be mindful of this recent shift, especially those whose practice involves advising on corporate conduct and misconduct, including those admitted to practice in Florida—given the significant number of Florida companies registered in Delaware and Florida's legal history of following Delaware precedent.

In January, Vice Chancellor Travis J. Laster unequivocally ruled directors and officers who are aware of corporate misconduct are, for the first time, culpable when there is a conscious failure to act and respond to instances of systemic bad faith, even if such conduct was outside of the core competencies or an employee's role.

Specifically, in *McDonald's* the shareholders alleged the chief people officer and the human resources department that he oversaw allegedly "turned a blind eye" to sexual harassment at McDonald's and the chief people officer himself had personally contributed to the toxic environment.

Laster, in the landmark decision, broadened risk oversight particularly when it comes to sexual harassment, but certainly the application of the *McDonald's* case can be applied beyond sexual harassment cases. He penned "when engaging in sexual harassment, the harasser engages in reprehensible conduct for selfish reasons. By doing so, the fiduciary acts in bad faith and breaches the duty of loyalty." Further, corporate officers must "make a good faith effort to establish an information system" for detecting and reporting irresponsible behavior, and that "a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain."

Failure to act in accordance with oversight duties creates exposure for claims of corporate misconduct and bad faith. Each individual leader at a company owes a duty of loyalty to the company. Misuse of company funds violates that responsibility, but so to does misuse of employees. In the case of sexual harassment, that misappropriation are actions that are not in the best interests of the company, which can constitute bad faith. While oversight cases are typically evaluated pursuant to the heightened standard of bad faith, shareholder class action lawsuits are costly whether won or lost. Moreover, in certain circumstances, companies can be stripped of certain rights or put even end up in receivership for not meeting their duties.

Here, in Florida, executives, directors, officers, employees making their way up the ranks, and counsel—whether in-house or outside—must rethink how they conduct themselves as individuals and fiduciaries, because they too may one day be held accountable not only for their own actions but also for the actions of others that they chose to tolerate and failed to report. Those who ignore all systemic problems—not just sexual harassment—can and should expected to be held to task.

As my colleague, Jeffrey A. Tew, a Miami lawyer with over 40 years of experience in corporate securities litigation, noted the "*McDonald's* case is a wake-up call for companies to put in place the systems to prevent officer's liability for workplace misconduct." In exercising a higher standard of care, companies should:

- **Immediately address existing problems.** As issues present themselves, immediate efforts should be made to address the same. As the *McDonald's* case makes clear, those in authority must take swift and strong actions, that may include dismissing executives and officers. It is better to get rid of a problem than let it fester.
- **Assess the reporting system.** Is there a system? An internal or external review should make an honest determination. If none exists, creating a reporting system should be a top priority. If there is a system, how effective is it? Are people using it? What is the company doing with information once it is received?
- **Create reporting channels for employees.** As issues arise, there must be a safe space where people feel they can speak up to avoid a culture of silence. Employees should not fear retribution or sense that their reports will be ignored. They should feel comfortable reporting on someone even if the individual works in another department.
- **Establish a proper reporting system.** There needs to be a uniform manner in which improper behavior or actions are reported and to whom, so that a proper channel and chain of command is established, and appropriate records are kept.
- **Communicate the reports.** It is no longer sufficient to make a report, shove it in a file, and close it. Officers and executives, including those in human resources, must take steps when a

systemic problem exists. Courts and plaintiffs will examine how executives have addressed—or failed to address—recurring problems in their departments and how those problems were managed and reported.

- **Establish and enforce rules for action against a violator.** Clear consequences for bad behavior, such as administrative leave or termination, must be diligently implemented against violators. A lower level of tolerance could result in creating exposure that should make the directors, officers, human resource department members and in-house counsel uncomfortable.
- **Train employees to recognize improper behavior.** Employees must be taught what constitutes improper behavior. Programs should educate not just people in the C-suite, but those lower in the ranks. Otherwise, it can be argued in court that there is no culture of compliance within a department or the entire company.
- **Develop a culture where failures are recognized.** That is the first step to making institutional change. Once mistakes are acknowledged, meaningful steps to promote proper behavior can be taken.
- **Give legal counsel a role.** In-house or outside attorneys can examine governing documents and applicable law to determine the best procedures for the removal of directors and officers exhibiting bad behavior. As new people are hired, employee agreements can include an off-ramp for those who operate outside the bounds of decency or fail to act in good faith.
- **Exercise caution when making hiring decisions.** Hiring decisions should be made with the new standards in mind and

those responsible for making hiring decisions should carefully consider candidates and their background to mitigate risk.

Additionally, some trends to brace for following the issuance of the McDonald's opinion, include:

- An uptick in removals of corporate officers, with or without cause, by shareholder vote, arbitration, or internal actions;
- Higher directors-and-officers insurance premiums;
- An increased number of lawsuits alleged the failure to comply with oversight duties and additional judicial gloss on what the duty of oversight means;
- Increased litigation expenses as claims that may have been easily disposed of pre-*McDonald's* are able to withstand motion practice and requiring discovery, which can not only be costly but also result in reputational damage; and
- Increased corporate and personal financial liability for those committing misconduct

Delaware courts will no doubt continue to weigh in on the *McDonald's* decision. Lawsuits are certain to be filed here because our courts look to Chancery Court rulings for guidance. No one wants to be the first case in Florida following that ruling. Thus, corporate leaders have much work to do in terms of staying above board. Those that do not do so at their own peril.

Heather Woods *is an attorney at Miami-based Rennert Vogel Mandler & Rodriguez. She practices commercial litigation, with an emphasis on business litigation, real estate, and construction disputes. She is admitted to practice law in Delaware, Florida and Massachusetts.*