McGriff
Executive Risk Advisors
Client Advisory

April 2023

McDonald's Fallout – Expanded Liability for Corporate Officers

Background:

On Nov. 1, 2019, the McDonald's Corporation Board of Directors voted to terminate the employment of then-CEO Stephen Easterbrook. The vote was taken following an investigation into allegations that he had violated company policy by having an inappropriate relationship with an employee and exercising poor judgment, actions which disqualified him from employment.

After the board initially exercised its discretion in terminating Easterbrook "without cause," he negotiated a lucrative severance package of cash and stock awards worth approximately $125 million. In July 2020, after Easterbrook had been terminated, McDonald's conducted a more extensive investigation into his tenure as CEO after the board learned from a whistleblower that Easterbrook had relationships with three additional subordinates and that he had lied about the nature of the relationships. On Aug. 10, 2020, McDonald's filed a complaint in the Delaware Chancery Court alleging that Easterbrook breached his fiduciary duties and committed fraud in the inducement. McDonald's sought to clawback the previously awarded severance package.

Easterbrook filed a motion to dismiss arguing that McDonald's lacked jurisdiction and that the complaint failed to state a claim upon which relief might be granted. As to the latter argument, he argued that the claims were barred by the Separation Agreement's anti-reliance clause and that McDonald's knew or should have known of his indiscretions since the information was in their possession. The defense team's motion to dismiss was denied and the case subsequently settled with Easterbrook agreeing to return approximately $105 million of the severance package.

Verified Derivative Complaint:

The termination of Easterbrook led to additional litigation against McDonald's, its board, certain officers of the company and Easterbrook. In May 2021, two institutional investors challenged the reelection of two McDonalds's board members. On July 28, 2021, a Verified Derivative Complaint (DC) was filed (*Phyllis Gianotti, Derivatively on behalf of the Nominal Defendant, McDonald's Corporation v. Lloyd H. Dean et al* C.A. 2021-0642-JTL) against nine board members, Easterbrook, current McDonald's CEO Christopher Kempczinski, David Fairhurst (the former EVP and Chief People Officer), Charles Strong (West Coast Zonal President of McDonald's U.S.) and a law firm that was alleged to have advised the board.

The Consolidated Amended Derivative Complaint asserted allegations of sexual misconduct, racial discrimination, and a failure of oversight. More specifically, the DC alleged the **directors** breached their duty of loyalty. **Against the named officers, the DC alleged breaches of the duties of care and loyalty**. Finally, the DC asserted allegations of aiding and abetting against the law firm. There were also numerous Book & Record Demands served pursuant to Delaware statute *8 Del. C. § 220.*

Securities and Exchange Commission (SEC) Charges Easterbrook and McDonald's:

On Jan. 9, 2023, the SEC charged Easterbrook with making false and misleading statements to investors related to events leading up to his termination. The SEC also charged McDonald's with making false and misleading statements in public filings relating to Easterbrook's separation agreement. Contemporaneously, the SEC issued an Order Instituting Cease and Desist Proceedings Pursuant to § 8A of the Securities Exchange Act of 1933 and §21C of the Securities Exchange Act of 1934 against Easterbrook and McDonald's Corporation. (A 3-2 vote of the five SEC Commissioners.)

Specifically, the SEC determined that Easterbrook's conduct violated § 10(b) of the Exchange Act, Rule 10b-5, § 17 of the Securities Act and caused violations of § 13(a) of the Exchange Act and Rules 12b-20 and 13a-11. Easterbrook agreed to resolve the SEC charges without admitting or denying its findings by agreeing to a five-year bar order precluding him from serving as an officer or director and agreeing to pay a $400,000 civil penalty. While the SEC also sought to impose a disgorgement penalty of over $50 million, it deemed this part of the agreement satisfied considering the settlement in the McDonald's Corporation action against Easterbrook.

As to McDonald's, the SEC determined that its Definitive Proxy Statement disclosing that it had terminated Easterbrook "without cause" and describing the terms of his separation agreement, which included his right to unvested equity-based compensation, was false and misleading. McDonald's was charged with violation of Item 402(b) of Regulation S-K, a provision governing executive compensation. Item 402(b) requires the registrant explain all material elements of the registrant's compensation of executive officers. In charging McDonald's, the SEC found McDonald's was in violation of Item 402(b) and, as such, violated § 14(a) of the Exchange Act and Rule 14a-3.

Specifically, McDonald's failed to disclose that it exercised discretion in terminating Easterbrook "without cause" under the relevant compensation plan documents after finding that he violated corporate policy, allowing Easterbrook to retain equity-based compensation that would have been forfeited if the company had terminated him for cause. McDonald's agreed to resolve the SEC charges, without admitting or denying its findings, by consenting to the entry of a cease-and-desist order. The SEC did not levy a financial penalty on McDonald's "in light of the substantial cooperation it provided to SEC staff during the course of its investigation, including voluntarily providing information not otherwise required to be produced in response to the staff's requests, as well as remedial measures undertaken by McDonald's, including seeking and ultimately recovering the compensation Easterbrook received pursuant to the separation agreement."

Each of the foregoing matters has been significant not only to the individuals involved but on a larger scale to public and private companies and D&O Insurers. **Significantly, a decision emanating out of the Delaware Chancery Court has expanded the potential culpability of defendants in favor of plaintiffs**.

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Court Denies Defendant Fairhurst's Motion to Dismiss:

On Jan. 26, 2023, the court overseeing the McDonald's Derivative matter entered a 64-page decision denying a Motion to Dismiss filed on behalf of Defendant David Fairhurst, Executive Vice President and Global Chief People Officer of McDonald's Corporation. (*In re McDonald's Corporation Stockholder Derivative Litigation* C.A. No. 2021-0324-JTL) (Del. Ch. 2023). The plaintiff alleged that Fairhurst breached his fiduciary duties by allowing a corporate culture to develop that condoned sexual harassment and misconduct, that these fiduciary duties included a duty of oversight, and that he consciously ignored "red flags." The plaintiff also alleged that Fairhurst personally engaged in acts of sexual harassment and, in so doing, breached his duty of loyalty to the company.

The basis for the defendant's Motion to Dismiss was a failure to state a claim upon which relief can be granted. Specifically, Fairhurst argued that Delaware law does not impose any obligation on officers comparable to the duty of oversight articulated in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). *Id.* He further argued that even if he owed a duty of oversight, the plaintiff had failed to allege sufficient facts supporting such a claim.

In denying the motion to dismiss, **the Court ruled that its decision "clarifies that corporate officers owe a duty of oversight" in the same way that the duty was recognized in *Caremark* as being applicable to directors**. The decision went even further, stating that **"the duty of oversight applied equally, if not to a greater degree, to officers."** (*Id* at p.2). Additionally, the Court held that the plaintiff had pled sufficient "red flags" at the pleading stage to support the inference that the officer knew of the misconduct and consciously failed to act requiring that the defendant's motion be denied.

Despite having decided the issue based on *Caremark* and *Graham v. Allis-Chalmers Manufacturing Co., 188 A.2d 125 (Del. 1963)*, the court continued in its effort to justify its ruling by **noting that an officer that reports to the board is both an "agent" of the board and a fiduciary**. [citing *Lebanon Cnty. Empls.' Ret. Fund v. AmerisourceBergen Corp.*, 2020 WL 132752, at *21 (Del. Ch. Jan. 13, 2020).] The court continued to find that, as an agent, that person has a specific duty to provide relevant information to its principal. This duty extends beyond what the agent actually knows to what the agent has reason to know or should know and to disclose to a superior officer or the board "material information relevant to the affairs of the agency entrusted to them." The failure to share material information must be "the product of gross negligence or disloyalty."

Duty of Oversight Claims Against Corporate Officers:

Anticipating the concerns of defendants in this landmark case that **explicitly recognizes a duty of oversight claim against officers**, the court tried to calm fears noting "[t]he bulwark against stockholders liberally asserting oversight claims against officers is not the invalidity of the legal theory. Rather, it is the fact that oversight claims are derivative, so the board controls the claim unless a stockholder can plead demand futility or show wrongful refusal. It is those doctrines, applied at the pleading stage under Rule 23.1, that minimize the risk of oversight claims against officers, not the absence of any duty of oversight." (p.36)

We believe that claims within the province of the company will not be the bulwark as the court states, but rather will be yet another inflection point for plaintiffs to allege demand futility or wrongful refusal. **The practical effect of this expansion of liability will be the existence of potential conflicts of interest and finger-pointing among defendants leading to the potential need for separate counsel, higher legal fees and, perhaps most notably, a continuing trend of increased *Caremark* filings and the survival of those actions in the Delaware Chancery Court.**

Scope of the Duty Owed by Corporate Officers:

Having found there to be a duty of oversight for corporate officers, the court next addressed the scope of duty owed. **The court determined that officers will be responsible for addressing or reporting "red flags" only within their area of responsibility while simultaneously stating there could be exceptions where the duty might be much broader.** It also held that oversight liability for officers requires a showing of bad faith. The officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore "red flags."

Fairhurst's motion also sought to dismiss that portion of the plaintiff's case that alleged that the actions of sexual harassment by Fairhurst constituted a breach of fiduciary duties, i.e., acts normally considered to be the basis for an employment suit should now also rise to create a breach of fiduciary duty case. The court again denied the motion to dismiss by stating, "It is not reasonable to infer that Fairhurst acted in good faith and remained loyal to the company while committing acts of sexual harassment, violating company policy, violating positive law, and subjecting the company to liability. It is reasonable to infer that Fairhurst acted disloyally and for improper purpose, unrelated to the best interests of the company."

This logic conflates acts of sexual harassment with the duties of an officer of a company and his fiduciary duties owed to the company. The court again tries to minimize the import of its decision by holding that any such claim remains derivative and subject to all the usual defenses associated with a derivative case. Yet this decision would seem to suggest that it is within the court's province to look at the acts of an individual at the pleading stage and determine whether such allegations are egregious enough to rise to the level of satisfying a *Caremark* claim. More importantly perhaps is whether correlating an employment practice liability claim with a breach of fiduciary duty claim marks the beginning of other ESG claims finding a foothold in derivative filings.

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Practical Guidance and Takeaways for Companies and their Boards:

Let us turn now to the takeaways for companies and their boards from the SEC action. The SEC did not impose any monetary penalty against the company due to a variety of factors:

1. substantial cooperation during the investigation
2. voluntarily providing information not otherwise required be produced in response to staff requests
3. recoupment of substantially all the compensation Easterbrook had received as severance
4. the implementation of new and enhanced measures to establish a more ethical and professional work environment that includes all levels of employees beginning with senior management

These measures also included updating the company's Standards of Business Conduct that dealt with the need to cooperate fully with any audit or investigation. It is worthwhile to repeat that the SEC's action against McDonald's was premised upon a § 14(a) and Rule 14a-3 violation of the Securities Exchange Act of 1934. It held the company accountable for its failure to provide the necessary disclosures required by Item 402(b) and (j)(5) of Reg. S-K. The 402 provisions pertain to compensation reporting requirements for executives and required disclosures.

It is notable that two dissenting commissioners wrote that they viewed McDonald's as "the victim of Mr. Easterbrook's deception" and that the majority of the commissioners were using a "novel interpretation" of Item 402 to hold the company as a securities law violator. Nevertheless, we see the SEC choosing to utilize compensation as a means of prosecution.

It is also noteworthy that the company's pursuit of Easterbrook to clawback the severance package was a significant consideration. The SEC imposed a disgorgement of over $50 million against Easterbrook but allowed it to be satisfied as part of the recovery made by McDonald's. This suggests **we might see more affirmative action by companies to clawback funds from terminated executives where circumstances warrant it.**

We strongly urge all companies – public, private, and not-for-profit – to review with their McGriff broker their D&O limits in light of the expanded liabilities, the inclusion of clawback coverage so as to include at a minimum defense cost coverage, and to track ongoing developments in the Delaware Chancery Court and in the growing number of business courts in other jurisdictions.

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