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Evolving Risks for Officers and Directors of Public Companies

J. Gregory Deis, Glenn K. Vanzura, Richard M. Rosenfeld, and Andrew J. Spadafora*

In this article, the authors examine a recent Securities and Exchange Commission order and a Delaware Chancery case that highlight expanding liability exposure that public companies and their officers and directors may face when they fail to adequately monitor, investigate, and communicate key risk areas or allegations of workplace misconduct.

The recent order (Order) by the Securities and Exchange Commission (SEC) in *Activision* and the Delaware Chancery Court's recent decision in *In re McDonald's Corp. Stockholder Derivative Litigation* highlight expanding liability exposure that public companies and their officers and directors may face when they fail to adequately monitor, investigate, and communicate key risk areas or allegations of workplace misconduct. These risks exist even when such issues fall outside the scope of conduct generally understood to implicate the federal securities laws.

This article discusses the *Activision* and *McDonald's* cases in turn.

Activision

The SEC's Order

The *Activision* Order reflects the SEC's expanded view regarding the scope of potential liability for failure to monitor employee misconduct and other compliance risks.[1] On February 3, 2023, video game developer and publisher Activision Blizzard, Inc. (Activision) agreed to pay a $35 million civil penalty to settle an SEC enforcement action. The action principally targeted Activision's policies, procedures, and controls designed to address employee complaints of workplace misconduct.[2]

More specifically, according to the Order, between 2018 and 2021, Activision's Forms 10-K and 10-Q identified as risk factors

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the company's ability to attract, retain, and motivate employees.[3] The SEC alleged that, despite these disclosures, Activision lacked controls and procedures among its separate business units to collect and analyze employee complaints or other information regarding incidents of alleged employee misconduct.[4]

In the SEC's view, absent such controls and procedures, the company's management and disclosure personnel did not have sufficient information regarding the volume or substance of employee complaints to assess their materiality.[5] That failure left the company "without the means to determine whether larger issues existed that needed to be disclosed to investors," according to the SEC's Director of the Denver Regional Office.[6] The Order does not clearly articulate the underlying misconduct or information that, in the SEC's view, should have or could have been captured by properly designed controls and procedures. That said, Activision had recently faced investigations by the Equal Employment Opportunity Commission (EEOC) and a California regulator, along with related shareholder class action litigation, concerning allegations of pervasive sexual harassment and pregnancy discrimination at Activision.[7]

Significantly, the Order does not allege that Activision's disclosures actually contained material misstatements or omissions. Instead, the SEC found only that the company violated Securities Exchange Act Rule 13a-15(a). That rule requires most issuers of securities registered under Section 12 of the Exchange Act to maintain disclosure controls and procedures to channel information that must be disclosed to the issuer's management.[8] Thus, the SEC predicated liability on insufficient controls to determine whether additional disclosures were required, rather than disclosures that were, in fact, false or misleading. By extension, the SEC's liability theory was predicated on potential harm to shareholders, but with no allegation of any actual harm given the absence of any false or misleading disclosure.

Activision therefore suggests companies may face an increased risk of liability on two fronts—assuming courts agree with the SEC's expansive view of Rule 13a-15(a).

First, *Activision* reflects the SEC's view that Rule 13a-15(a) violations do not require a materially misleading disclosure. In the SEC's view, an absence of controls around certain risk factors—which may prevent companies from assessing whether a material risk exists—is sufficient to violate the rule.

Second, the SEC's interpretation of Rule 13a-15(a) suggests that the required disclosure controls and procedures must not only accumulate and communicate "information required to be disclosed"[9] but also "information that is *relevant* to an assessment of the need to disclose developments and risks that pertain to the issuer's business."[10]

Commissioner Hester Peirce dissented from the Order, citing its failure to allege a misleading disclosure or omission. She also noted the broad implications of the SEC's interpretation of Rule 13a-15(a). Peirce further observed the tension between the allegation that management was denied access to relevant information and the absence of any claim that Activision's risk disclosure was misleading. "If the information that management did not receive were relevant, one would expect that not having it would affect the quality or accuracy of the related disclosure," she wrote.[11] But the SEC Order made no such allegation.

Peirce's dissent highlights the challenge that the SEC's broad interpretation of Rule 13a-15(a) presents for issuers who must draw a line between relevant and irrelevant information for purposes of designing and implementing a company's disclosure controls. "If workplace misconduct must be reported to the disclosure committee, so too must changes in any number of workplace amenities and workplace requirements, *and so too must any multitude of factors relevant to other risk factors*," Peirce wrote.[12] As a result, she argued, it is "difficult to see where the logic of this Order stops."

Activision Lessons

The SEC's *Activision* Order suggests that disclosures intended to identify corporate risks—which could serve as a prophylactic to certain types of securities claims based on a failure to disclose—could actually heighten an issuer's obligation to monitor or investigate potentially relevant misconduct. *Activision* could portend a substantial increase in the scale of companies' internal audit and compliance functions. After all, risk disclosures relating to the ability to attract, retain, and motivate employees, like Activision's, are commonplace, and the Order's logic could be applied to other types of standard disclosures. On the other hand, unless its expansive implications are cabined, the Order could have an unintended chilling effect on corporate risk disclosures, incentivizing companies

to reduce their number in order to limit the corresponding obligation to investigate and collect information potentially related to the identified risks. In that way, the SEC's Order could have the presumably unintended (and perverse) effect of incentivizing companies to provide less fulsome disclosures concerning risk factors.

In re McDonald's Corp. Stockholder Derivative Litigation

Officers Owe a Duty of Oversight

In *McDonald's*, the Delaware Chancery Court held for the first time that corporate officers—not just directors—"owe a duty of oversight" as part of their duty of loyalty.[13] The court principally relied on the same principles that led to its recognition in the 1996 *Caremark* case[14] that directors owe a duty of oversight. Noting that those principles apply equally to officers, the court further pointed out that the Delaware Supreme Court has likewise held that "corporate officers owe the same fiduciary duties as corporate directors, which logically include a duty of oversight."[15]

The court held that the scope of an officer's duty depends on that officer's particular area of responsibility, and includes a "duty to make a good faith effort to establish an information system" and a "duty to address and report upward about red flags … within the officer's area."[16] The court further held that a "particularly egregious red flag might require an officer to say something *even if it fell outside the officer's domain*."[17] Such reasoning suggests that chief executive officers and chief financial officers, in particular, may bear responsibility for implementing controls and overseeing broad areas within the corporate organization, including areas outside their primary responsibilities.

Background

In *McDonald's*, the plaintiffs alleged that the company's global chief people officer, David Fairhurst, engaged in sexual harassment on at least three occasions.[18] The plaintiffs further alleged that the human resources function Fairhurst oversaw "turned a blind eye to complaints about sexual harassment," despite coordinated

complaints from employees and two multi-city employee strikes protesting sexual harassment and the company's response.[19]

More specifically, the plaintiffs alleged that Fairhurst and the company's chief executive officer, Stephen Easterbrook, promoted a "party atmosphere" at the company's headquarters. The headquarters allegedly hosted an open bar, with weekly happy hours and frequent drinking "excursions."[20] Both men allegedly gained reputations for "flirting" with female employees.[21] Further, in 2018, Fairhurst was disciplined for grabbing a female employee at a company event and pulling her onto his lap. Fairhurst had allegedly previously harassed the same employee in 2016, although she (and several other witnesses) reported only the latter occurrence.[22]

Also in 2016, employees across the company filed EEOC complaints alleging sexual harassment and retaliation.[23] Employees later organized a strike in more than 30 cities to draw attention to the EEOC complaints.[24] In 2018, another round of EEOC complaints was filed, followed by a second strike to protest sexual harassment and the company's failure to address it.[25] Following these events, and a letter from U.S. Senator Tammy Duckworth inquiring about the company's efforts to address sexual harassment, the company conducted a review of its training programs, hired consultants to provide additional training, established a new third-party managed hotline, issued a new franchisee guide, conducted a cultural assessment, and ended its prior policy requiring mandatory arbitration for harassment and discrimination claims.[26]

In 2019, Easterbrook was terminated after the Board learned that he was engaged in a prohibited relationship with an employee. Fairhurst was terminated for cause shortly thereafter. Although the Board materials and press release did not disclose the basis for his termination, the court concluded that it was "reasonable to infer at the pleading stage that Fairhurst engaged in an additional act of sexual harassment."[27] Less than two weeks later, employees filed a class action alleging systemic sexual harassment, routine abuse, a lack of sexual harassment training, and a lack of human resources support.[28] A second class action claim filed in 2020 made similar allegations, including that the company's human resources department was completely ineffective at preventing sexual harassment and discouraged employees from lodging complaints.[29]

Expanding the Scope of Liability

A public company's chief executive officer and chief financial officer are subject to particular certification requirements, and are therefore the officers most frequently targeted by breach of fiduciary duty claims. As *McDonald's* warns, though, the duty of oversight extends to other executive officers, particularly within their respective areas of functional responsibility.

Moreover, *McDonald's* could be construed to extend the duty of oversight to areas that do not necessarily directly impact financial reporting or core operational functions, despite earlier cases limiting the duty of oversight to "mission-critical" areas.[30] But it may be more accurate to say that *McDonald's* expands the scope of the areas of a company's business that are considered "mission critical." Indeed, the court's subsequent opinion dismissing claims against McDonald's directors explicitly found that it could easily be inferred that "maintaining employee safety is both essential and mission critical."[31] As with *Activision*, the application of these principles creates challenges for companies, as they must make determinations *ex ante* about which company functions are (or may be later deemed to have been) mission critical and thus subject to a duty of oversight.

Finally, as noted above, *McDonald's* theorizes an expansion of liability for the duty of oversight beyond an officer's area of responsibility for a "particularly egregious red flag." Such a fact pattern was not presented in the case, though, and the circumstances in which the court's theory may be applied remains uncertain.[32]

Pleading and Proving Oversight Liability Remains a High Bar

An officer's liability exposure for an oversight failure remains limited by the relatively high standard to establish a breach of the duty of loyalty, which requires a showing that the officer acted in bad faith. Specifically, to establish that an officer breached his or her duty of oversight, a plaintiff must plead and prove "disloyal conduct that takes the form of bad faith," meaning either that the officer "consciously fail[ed] to make a good faith effort to establish information systems" or that the officer "consciously ignore[d] red flags."[33] A failure to take action must be "sufficiently sustained, systematic, or striking to constitute action in bad faith."[34]

The alleged facts in *McDonald's* pled the relatively rare circumstances in which the alleged red flags were so pervasive as to suggest that the officers consciously disregarded them: human resources allegedly ignored complaints and discouraged reporting; employees feared retaliation for making complaints; dozens of employees filed coordinated EEOC claims alleging sexual harassment and misconduct; employees organized two nationwide strikes to protest sexual harassment and the company's response; employees filed two class action claims alleging pervasive sexual harassment and the company's failure to remedy it; and Fairhurst, the company's top human resources officer, was himself alleged to be a repeat sexual harasser.

Notably, at least at the pleading stage, the *McDonald's* court concluded that these red flags stated a claim for breach of the duty of oversight regardless of the company's purported attempts to address sexual harassment problems. In particular, the court found that there was an "absence of evidence from the Section 220 [books and records] production indicating that the Company was taking meaningful action to address problems with sexual harassment and misconduct until January 2019," and given Fairhurst's repeated sexual harassment, it was possible that he "went through the motions of assisting his colleagues while continuing to turn a blind eye to instances of harassment."[35]

As to the company's directors, the court subsequently dismissed the claims against them. In dismissing those individuals from the suit, the court found that "[t]hroughout 2019, the Director Defendants engaged with the problem of sexual harassment and misconduct at the Company."[36] It was therefore "not possible to draw a pleading-stage inference that the Director Defendants acted in bad faith."[37]

While the directors in *McDonald's* ultimately avoided liability, officers and directors should nevertheless consider *McDonald's* and the duty of oversight when misconduct allegations arise, particularly where officers or directors themselves are allegedly engaged in misconduct or where red flags are pervasive. While the *McDonald's* court ultimately found that the directors had sufficiently "engaged with the problem" to preclude an inference of bad faith, it remains to be seen how courts will credit the level of engagement in this context.[38] In considering the appropriate level of engagement, a board should consider certain factors, including:

- Substantiated misconduct involving the risk area(s) in question;
- The company's risk assessments, including any periodic certifications required of employees that would require disclosure of the alleged misconduct in question;
- Repeated complaints or hotline reports on the same topic, including varied allegations that might collectively call into question tone at the top or other systemic issues;
- Alleged misconduct by executive officers, particularly in the areas they oversee;
- Whether internal audit appears to be functioning properly, and the extent of internal audit focus on the area in question; and
- Training provided regarding the risk(s) in question.

Parallels

The *Activision* Order and *McDonald's* opinion share certain commonalities. Both focus on and suggest an expansion of liability for failure to monitor employment-related misconduct, rather than financial or accounting-related misconduct or other conduct generally thought to implicate the federal securities laws. Both the Order and opinion implicate potential slippery slopes: the Chancery Court's definition of a "mission critical" corporate function subject to the duty of oversight, the Chancery Court's view on board engagement necessary to preclude an inference of bad faith, and the SEC's categorization of information relevant to a disclosure under Rule 13a-15(a). Each equally bring employment misconduct within the bounds of an obligation to investigate, but each of the Chancery Court's and SEC's views give rise to potentially difficult line-drawing challenges.

Whether defined as "mission critical" or "central" compliance risks, or as relevant to ubiquitous disclosures relating to the company's general risk factors (e.g., the ability to hire and retain key personnel), it is clear that employment and discrimination issues—and potentially many others—may now be the subject of oversight obligations under corporate and securities law. Even if the limiting consideration requiring that officers or directors acted (or failed to act) in bad faith offers some protection in private civil litigation premised on a breach of *Caremark* oversight duties, companies may

still find themselves subject to SEC scrutiny on an *Activision* theory if they have not established sufficiently comprehensive monitoring and information systems.

Conclusion

Until greater clarity develops as case law and regulatory actions address alleged officer misconduct, companies can expect private plaintiffs to seize on *McDonald's* and *Activision* to expand the scope of their allegations and to test the boundaries of liability. Issuers and their officers and directors will be well-advised to ensure adequate information systems to filter complaints of potential misconduct, and adequate compliance procedures, internal controls, and investigation procedures to identify and address misconduct. Companies should also consider whether the controls and procedures in place to direct information to their disclosure committees are sufficiently robust to capture information potentially relevant to determining the existence of a material issue that requires public disclosure.

Notes

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1. In the Matter of Activision Blizzard, Inc., Securities Exchange Act Release No. 96796, Administrative Proceeding File No. 3-21294 (Feb. 3, 2023), https://www.sec.gov/litigation/admin/2023/34-96796.pdf.

2. The Order also alleged that Activision entered into separation agreements with employees that violated whistleblower protections under SEC Rule 21F-17. *Id.* ¶¶ 14-18, 20.

3. *Id.* ¶¶ 2, 7.

4. *Id.* ¶¶ 8-9.

5. *Id.* ¶ 10.

6. Activision Blizzard to Pay $35 Million for Failing to Maintain Disclosure Controls Related to Complaints of Workplace Misconduct and Violating Whistleblower Protection Rule, https://www.sec.gov/news/press-release/2023-22.

7. *See* Cheng v. Activision Blizzard, Inc., 2023 WL 2136787, at *1 (C.D. Cal. Jan. 22, 2023); What You Should Know About: EEOC's Settlement with Activision Blizzard | U.S. Equal Employment Opportunity Commission, https://www.eeoc.gov/what-you-should-know-about-eeocs-settlement-activision-blizzard.

8. 17 C.F.R. § 240.13a-15(a), (e).
9. Activision, ¶ 5 (quoting Rule 13a-15(e)).
10. Activision, ¶ 5 (quoting Certification of Disclosure in Companies' Quarterly & Annual Reports Final Rule Adopting Release, Release No. 33-8124 (Aug. 29, 2002)) (emphasis added).
11. The SEC Levels Up: Statement on In re Activision Blizzard, https://www.sec.gov/news/statement/peirce-statement-activision-blizzard-020323#_ftn2.
12. *Id.* (emphasis added).
13. In re McDonald's Corp. S'holder Deriv. Litig., 289 A.3d 343 (Del. Ch. Ct. Jan. 26, 2023).
14. In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).
15. In re McDonald's, 289 A.3d 343.
16. *Id.* at 350.
17. *Id.* (emphasis added).
18. *Id.*
19. *Id.*
20. *Id.* at 352.
21. *Id.* at 352.
22. *Id.* at 353.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.* at 355.
27. *Id.* at 356.
28. *Id.* at 357.
29. *Id.*
30. *See e.g.*, Marchand v. Barnhill, 212 A.3d 805, (Del. 2019) ("Although Caremark may not require as much as some commentators wish, it does require that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks. In Blue Bell's case, food safety was essential and mission critical."); In re Boeing Co. Derivative Litig., 2021 WL 4059934, at *26 (Del. Ch. Ct. Sept. 7, 2021) (finding plaintiffs stated a claim for Boeing directors' breach of their oversight duty by failing to implement reporting or information systems with respect to airplane safety, which was "essential and mission critical to Boeing's business"); *see also* February 7, 2023, SEC Order in In re Gentex Corporation & Kevin C. Nash (finding that Gentex's Chief Accounting Officer made adjustments to bonus compensation accruals without the required accounting analysis or supporting documentation, and adjusted accrual to meet consensus earnings per share), https://www.sec.gov/files/litigation/admin/2023/34-96819.pdf.
31. In re McDonald's Corp. S'holder Deriv. Litig., 291 A.3d 652, 680 (Del. Ch. Ct. Mar. 1, 2023).
32. In re McDonald's, 289 A.3d at 350.
33. *Id.* at 350, 375.

34. *Id.* at 376.

35. *Id.* at 379.

36. In re McDonald's Corp. Stockholder Derivative Litig., 291 A.3d at 662.

37. *Id.*

38. The response included, but was not limited to, the following: "(i) hiring outside consultants, (ii) revising the Company's policies, (iii) implementing new training programs [following a holistic review of training programs], (iv) providing new levels of support to franchisees [including a hotline], and (v) taking other steps to establish a renewed commitment to a safe and respectful workplace." In re McDonald's Corp. Stockholder Derivative Litig., 291 A.3d at 662.