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Increased Risks, D&O Insurance Considerations, Following Delaware’s Extended Oversight Duties

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The Delaware Chancery Court recently held that the duty of oversight extended to corporate officers. The important decision came after McDonald’s shareholders sued the company’s former head of human resources, alleging that the officer breached his duty of oversight by “allowing a corporate culture to develop that condoned sexual harassment and misconduct.” In that same decision, Vice Chancellor Laster also determined that acts of sexual harassment can constitute a breach of fiduciary duty. Officers are rightly focused on the potential ramifications on their personal liability following the ruling. But that potential increased exposure also raises several insurance implications for companies to consider while procuring and renewing directors and officers insurance coverage.

McDonald’s is an expansion of Delaware law. That is, the decision is the first to recognize that officers, as well as directors, owe a duty of oversight. Traditionally, that obligation was with directors, who monitor the officers. Now the decision opens the door for breach of oversight claims to be brought against both directors and officers.

From an insurance perspective, including officers among the individuals subject to a duty of oversight means more potential claims, more putative defendants in derivative lawsuits, and more claims for defense and indemnity under D&O insurance policies.

The *McDonald’s* litigation involved claims against the former HR head brought derivatively on behalf of the company. In “derivative” suits, shareholders allege that directors and officers harmed the corporation by breaching their fiduciary duties. Coverage for derivative suits raises a number of D&O insurance issues.

First, because plaintiffs in derivative actions sue directors and officers on behalf of the company, many states prohibit the company to indemnify directors and officers for derivative suit losses. Since the company is effectively prosecuting derivative suits through its shareholders, any settlement or judgment paid by the defendant officers or directors would go back into the company rather than to the shareholder plaintiffs. To avoid these kinds of circular payments, many states, including Delaware, prevent company indemnification for derivative claims.

Those statutes, however, permit companies to buy insurance to protect directors and officers from derivative settlements or judgments. Delaware's statute states that a "corporation shall have power to purchase and maintain insurance on behalf of" a director or officer who was serving as a director or officer at the time such liability was incurred "whether or not the corporation would have the power to indemnify such person against such liability under this section." Because company indemnification is prohibited, derivative claims implicate D&O policies' "Side A" coverage (or Side-A-only policies), which are designed specifically to cover individual insureds for non-indemnifiable losses.

Thus, a rise in duty-of-oversight claims brought derivatively as a result of the *McDonald's* ruling underscores the importance of having sufficient coverage for non-indemnifiable Side A losses in the event of an adverse judgment or settlement. Ideally, companies would provide dedicated Side A only limits—either as part of the company's D&O policy or through a standalone Side A-only policy—to protect its officers and directors. This is particularly true in derivative suits since they can be brought in tandem with other direct claims against the company that could erode D&O limits that otherwise could be available to protect individual officers and directors. Having dedicated Side-A coverage in place provides an additional layer of protection in a derivative suit where the company is prohibited from indemnifying for settlement costs.

Second, while a company cannot indemnify for settlements or judgments in derivative suits, it is usually able to pay for the officers' or directors' legal fees in defending against the claims. This implicates a D&O policy's "Side B" coverage, which reimburses the company for defense costs paid as indemnification. Thus, as part of any due diligence on the scope and availability of D&O coverage for post-*McDonalds'* fiduciary claims, policyholders should pay close attention to potential process-related issues in policy provisions governing defense cost reimbursement.

For example, how quickly must the insurer reimburse covered costs? Are defense cost payments subject to a right to recoupment and, if so, under what circumstances? Do insurer reimbursement obligations continue until there has been a final adjudication in the underlying proceeding adverse to the insured, such that exclusions like those for willful or intentional acts do not apply at the time suit is filed? D&O policies vary widely with respect to these important provisions. These and similar insurance considerations could materially impact the company's ability to obtain repayment of indemnified legal fees or, in a worse case situation, negate Side A protections for individual directors or officers if the company is unable to pay for the defense.

A second part of the *McDonald's* ruling—that is, the court's statement that acts of sexual harassment can constitute a breach of fiduciary duty—is perhaps less heralded but still significant in its own right. The ruling highlights yet another example of environmental, social, and corporate governance exposures that can reach the board room. We have previously described how companies can assess these risks and protect themselves and their officers and directors from ESG-related investigations, enforcement actions, and litigation. The McDonald's decision may add another tool in the putative plaintiff's toolkit to develop "red flags" to survive a dismissal motion based on an individual's alleged acts of sexual harassment.

Not only that, but claims involving sexual harassment implicate not only D&O policies but also other coverages like employment practices liability insurance. Circumstances potentially implicating multiple policies require careful analysis to ensure that those policies operate in harmony to avoid gaps in coverage and maximize recovery across all insurance assets. From breach of fiduciary duty and derivative claims to allegations of sexual harassment and similar ESG risks, taking a proactive approach to analyze potential coverage at the time of procurement or renewal will help mitigate risk in the event a claim arises.

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