

The CSDD, Oversight Liability and Risk Management Systems

1. INTRODUCTION

Paragraph 2 of this Editorial discusses briefly the content and current status of the proposal for an (EU) Directive on corporate sustainability due diligence. This Directive will require affected companies to set up a risk management system to be able to comply with the directive. This raises the question of directors' liability in case such a system is inadequate or in case directors fail to react on the signals that the system may generate. Paragraph 3 discusses a recent and interesting decision by the Court of Chancery of the (US) State of Delaware on the matter of risk management and directors' liability. Paragraph 4 is a short conclusion.

2. THE PROPOSAL FOR A DIRECTIVE ON CORPORATE SUSTAINABILITY DUE DILIGENCE

On 23 February 2022 the European Commission published a proposal for a Directive on corporate sustainability due diligence (CSDD, CSDDD, CS-triple-D or CS-3D).¹ The purpose of the directive is to introduce for certain companies the obligation to carry out due diligence measures, not only for their own operations and the operations of their subsidiary companies,² but also for the operations of their established business relationships.³ These due diligence measures must address environmental issues and human rights issues. Affected companies must design a due diligence policy (Article 5), identify actual and potential risk in the two fields mentioned (Article 6), prevent adverse impacts (Article 7), bring these

adverse impacts to an end (Article 8), and have in place a complaints procedure (Article 9). Also, affected companies must adopt a plan to combat climate change (Article 15). Under Article 25, section 1 of the proposal, company directors shall 'take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences'.⁴ Under Article 26, section 1 company directors are responsible in particular for putting in place and overseeing the design of the company's due diligence policy.

The Council of the European Union formulated (via the Permanent Representatives Committee) its 'General Approach' on the proposal on 30 November 2022.⁵ In this document both Article 25 and Article 26 were deleted. As concerns Article 25, this was 'Due to the strong concerns expressed by Member States that considered Article 25 to be an inappropriate interference with national provisions regarding directors' duty of care, and potentially undermining directors' duty to act in the best interest of the company'. As concerns Article 26, its content was integrated into the provision that companies must design a due diligence policy (Article 5), because of 'the variety of corporate governance systems and the freedom of companies to regulate their internal matters'. The most significant amendments to Article 5 are the following:

- the original text of section 1 reads: 'Member States shall ensure that companies integrate due diligence into all their corporate policies and have in place a due diligence policy'. The amended

1 Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 (text with EEA relevance), COM(2022) 71 final. Compare, the special issue of the law journal *Ondernemingsrecht*: Steven Hijink & Matthijs de Jongh, *From Company Law to 'Value Chain Law': Observations and Dilemmas on the CSDDD Proposal*, *Ondernemingsrecht* 2023/29; Tineke Lambooy, *Sketching the Wider Context for Introducing the EU Corporate Sustainability Due Diligence Directive (CSDDD)*, *Ondernemingsrecht* 2023/30; Jean-Philippe Robé, *Steering Towards Sustainability*, *Ondernemingsrecht* 2023/31; Samuel Garcia Nelen, *The Proposal for a Corporate Sustainability Due Diligence Directive: Background and Latest Developments*, *Ondernemingsrecht* 2023/32; Anne Lafarre, *Mandatory Corporate Sustainability Due Diligence in Global Value Chains: The Long-Awaited European Solution Compared to Existing International Standards*, *Ondernemingsrecht* 2023/33; Menno Baks & Kitty Lieverse, *Supervision and Enforcement under the CSDDD*, *Ondernemingsrecht* 2023/34; Tomas Arons & Manuel Lokin, *The Corporate Climate Transition Plan: How to Ensure Companies are Paris-Proof*, *Ondernemingsrecht* 2023/35; Loes Lennarts, *Civil Liability of Companies for Failure to Conduct Corporate Sustainability Due Diligence Throughout Their Value Chains – Is Art. 22 CSDDD Fit for Purpose?*, *Ondernemingsrecht* 2023/36; Alessio M. Paccès, *Civil Liability in the EU Corporate Sustainability Due Diligence Directive Proposal: A Law and Economics Analysis*, *Ondernemingsrecht* 2023/37; Mieke Olaerts, *Corporate Sustainability and the Duty of Care of Directors*, *Ondernemingsrecht* 2023/38; Davine Roessingh, Hylke ten Bruggencate, Lisanne Baks & Sven Dumoulin, *Practical Implications of the CSDDD: A Threat to its Effectiveness*, *Ondernemingsrecht* 2023/39; cf. also Harold Koster, Editorial: *Mandatory Corporate Due Diligence regarding Human Rights, the Environment and Good Governance?*, (6) *Eur. Co. L.J.* 214–215 (2020), doi: 10.54648/EUCL2020030.

2 Compare, Karsten Engsig Sørensen, *Corporate Sustainability Due Diligence in Groups of Companies*, (5) *Eur. Co. L.J.* 119–130 (2022).

3 Preamble, consideration 15; Art. 1, s. 1, under a.

4 Compare, Federica Agostini & Michele Corgatelli, *Article 25 of the Proposal for a Directive on Corporate Sustainability Due Diligence: Enlightened Shareholder Value or Pluralist Approach?*, (4) *Eur. Co. L.J.* 92–99 (2022), doi: 10.54648/EUCL2022016.

5 Council of the European Union, Permanent Representatives Committee, document 15024/1/22 REV 1.

text reads: ‘Member States shall ensure that companies integrate due diligence into all their policies and risk management systems and have in place a due diligence policy’, stressing the importance of *risk management systems*;

- the amended text adds a new section 3 that reads: ‘Member States shall ensure that companies [...] put in place and oversee the actions listed in Article 4(1)’. The actions listed in Article 4, section 1 are primarily the obligations that affected companies have in accordance with Articles 5 through 9. When read in combination with the amended section 1, this new section 3 would also serve to stress the importance of *risk management systems*.

The proposal was adopted by the European Parliament on 1 June 2023.⁶ The European Parliament did not make any changes to Article 25, but deleted Article 26. Because the original proposal has been amended (by both the Council and the Parliament), the proposal is now subject to interinstitutional negotiations between the European Parliament, the European Council (and the European Commission). Regardless of the outcome of the interinstitutional negotiations, the CSDD will require affected companies to set up risk management systems to be able to comply with the CSDD. And: in the end responsibility for setting up these systems lies with corporate boards.⁷ This opens the question of liability of board members for either failing to set up risk management systems or for failing to act upon the signals these risk management systems generate that something is going wrong.⁸ Interestingly, a recent decision by the Court of Chancery of the State of Delaware addresses exactly that issue.

3. IN RE MCDONALD’S CORPORATION (26 JANUARY 2013)

D. Fairhurst had been an executive officer of McDonald’s Corporation from 2015 until 2019. In that position, he had served as head of human resources. He was the company’s ‘Global Chief People Officer’, and in that capacity he was not a member of the board of directors. S.J. Easterbrook, the company’s chief executive officer, and Fairhurst together led the company under the direction of the board of directors.⁹

A number of shareholders of McDonald’s Corporation brought a (derivative) suit against Fairhurst before the Court of Chancery of the State of Delaware.¹⁰ These shareholders claimed that Fairhurst

had breached the fiduciary duties he owed to the company. The shareholders alleged that Fairhurst had allowed a corporate culture to develop in which misconduct and sexual harassment could occur. More specifically, the shareholders argued that Fairhurst (as part of the fiduciary duties) owed a duty of oversight to McDonald’s Corporation. They were of the opinion, that although Fairhurst had put in place a management information system that addressed the company’s culture, he had ignored ‘red flags’ that the system had generated. On his part, Fairhurst asked the Court of Chancery to dismiss the suit against him (a so-called motion to dismiss). The Court of Chancery (in an opinion by Laster V.C.) considered that its decision depended on the following: ‘The analysis comes down to whether Fairhurst acted in bad faith by consciously ignoring the red flags’.

The Court of Chancery considered that the duty of oversight not only applies to persons who are members of the board of directors, but also to persons (like Fairhurst) who are officers of the company but are not members of the board of directors. Then, in general terms, the Court of Chancery made a distinction between two kinds of oversight claims: an ‘Information-Systems Claim’,¹¹ where there are no information systems and controls in place, and a ‘Red-Flags Claim’,¹² where information systems and controls are in place but the follow-up by the company’s directors and officers fails.

As a further point, the Court of Chancery noted: ‘officers owe duties of oversight comparable to those of directors. But that does not mean that the situational application of those duties will be the same’. Elaborating on this, the Court of Chancery considered that ‘Although the CEO and Chief Compliance Officer likely will have company-wide oversight portfolios, other officers generally have a more constrained area of authority’, for instance ‘The executive officer in charge of sales and marketing is not responsible for the financial or legal reporting systems’. And, as for the standard that the Court of Chancery would have to apply the Court considered: ‘As with directors, officers only will be liable for violations of the duty of oversight if a plaintiff can prove that they acted in bad faith and hence disloyally’. In connection with this standard, the Court also recognized ‘a concern that the threat of liability will cause good people to decline to serve’.

In this case, the suit against Fairhurst was a ‘Red-Flags Claim’. On the basis of a number of facts that the Court of Chancery identified,¹³ the Court concluded that ‘it is reasonable to infer that

6 Amendments adopted by the European Parliament on 1 Jun. 2023 on the proposal for a directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 (COM(2022)0071 – C9-0050/2022 – 2022/0051(COD))(2); adopted text P9_TA(2023)0209.

7 Compare Chris van Oostrum & Jessie Pool, *Maatschappelijke due diligence en bestuurdersaansprakelijkheid: leuker kunnen we het niet maken, wel duidelijker*, *Ars Aequi* 766–770 (AA20230766) (2023).

8 Compare, M. Olaerts, Editorial: *Sustainable Decision Making and Directors Duties*, (5) *Eur. Co. L.J.* 94–96 (2023), doi: 10.54648/EUCL2023017.

9 This would imply that at that time Easterbrook was the only executive director serving on the board of directors of McDonald’s Corporation.

10 Court of Chancery of the State Of Delaware, *In re McDonald’s Corporation*, stockholder derivative litigation, opinion delivered by Laster, V.C., C.A. No. 2021-0324-JTL, 26 Januari 2013.

11 Also called an ‘Information-Systems Theory’ claim.

12 Also called a ‘Red-Flags Theory’ claim.

13 Some of these facts are: Easterbrook and Fairhurst promoted a party atmosphere at the Company that emphasized drinking; employees feared retaliation for reporting complaints to the human resources department; employees in over thirty cities across the United States had staged a one-day walkout to protest problems with sexual

there were problems with sexual harassment and misconduct at the Company. It is also reasonable to infer that Fairhurst knew about them'. Under the standard that the Court had to apply, it concluded that Fairhurst 'was acting in bad faith. The allegations against Fairhurst accordingly support a claim for breach of the duty of loyalty'. Therefore the Court of Chancery did not award Fairhurst's motion to dismiss the derivative suit against him.

4. CONCLUDING REMARKS

The decision by the Court of Chancery in the case '*In re McDonald's Corporation*' concerned an officer of the company (Fairhurst) who was not a member of the board of directors. In the opinion of the Court, the oversight duties that an officer who is not a member of the board owes to the company are comparable to the oversight duties that board members owe to the company. The CSDD expresses a similar opinion. Article 3, under o of the proposal defines 'director' as follows: (1) any member of the administrative body of a company that has a one-tier board structure, any member of the management body or the supervisory body of a company that

has a two-tier board structure, (2) the chief executive officer (and the deputy chief executive officer) if these officers are not board members, and also (3) other persons who perform similar functions to those performed by the persons in the first and second categories. This approach, like the approach by the Court of Chancery, widens the group of persons that may be held liable for violations of their oversight duties. It will be noteworthy to follow to what extent national courts in the EU/EEA will follow the approach adopted by the Court of Chancery that the duty of oversight is 'situational' in the sense that it is coupled to the responsibilities that a board member or an officer holds. At the same time the Court also considered (making things a bit more intricate): 'If a red flag is sufficiently prominent [...] then any officer might have a duty to report upward about it. An officer who receives credible information indicating that the corporation is violating the law cannot turn a blind eye and dismiss the issue as "not in my area"'.
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harassment and misconduct at the company; Fairhurst engaged in an act of sexual harassment at a party for the human resources staff; eight US senators wrote to the company asking questions about sexual harassment and workplace safety; in Nov. 2019, the board directors dismissed Fairhurst because he had engaged in another act of sexual harassment; in Apr. 2020, workers filed a law suit against the company, seeking damages for sexual harassment, retaliation, and related misconduct.