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Taking the Green Transition Seriously: A Proposal for a 'Transition Reserve'

Enabling Transition of Large Emitters in the Netherlands

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By prof. dr. Marija Bartl and mr. drs. Nena van der Horst[1]

1 The Problem

Large emitters, more so than any other company, are exposed to the risk of transition. If they do not transition, they will end up with **unsustainable business models and stranded assets** in the not-so-distant future, eventually going bankrupt as a result. One would hope that large emitters would take this risk seriously and invest into their own transition - but this is not necessarily the case. The incentives inherent in the contemporary model of financial markets and corporate governance,[2] alongside the possibility of public 'bail out', motivate companies to distribute their funds to shareholders or managers instead of investing into the green transition.[3]

As an example, over the financial year 2021-2022, the profits of one of the greatest emitters in the Netherlands, Tata Steel, have sharply increased due to high steel prices. As a result, Tata Steel now pays out four times as many dividends as it did in April 2019 (the year before the coronacrisis) at a dividend yield of 4.78% which is considered high.[4] Moreover, Dutch newspapers recently reported that the Dutch Tata Steel subsidiary paid out, in its own words, 'unprecedentedly high profit distribution' to its employees.[5] While compensating underpaid employees is welcome, especially in the times of high inflation, large distributions

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[2] European Commission Staff, 'Working Document Impact Assessment Report Accompanying the document Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937', SWD/2022/42 final, <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52022SC0042>.

[3] In this short note we do not address management bonuses, but we do flag that this is certainly an issue as well, next to the payouts to shareholders. A side effect of our proposal may be that the funds available for the payout of excessive management bonuses are more limited. An easier solution would be to directly regulate management compensations.

[4] Tata Steel, 'Tata Steel reports highest ever consolidated EBITDA at Rs 63,830 crores; Net debt to EBITDA improves to 0.8x' (*TataSteelEurope.com, 03 May 2022)* <https://www.tatasteeleurope.com/corporate/news/tata-steel-reports-highest-ever-consolidated-ebitda-at-rs63830-crores> Accessed 24 June 2022.

[5] RTL Nieuws, 'Bonus van 25 procent voor personeel Tata Steel na topjaar' (*Rtlnieuws.nl*, 20 May 2022) <https://www.rtlnieuws.nl/economie/life/artikel/5310020/tata-steel-bonus-25-procent-hoge-gestegen-staalprijs-staal> Accessed 23 June 2022.

to shareholders and managers make far less 'common sense' given the transition risks and costs Tata Steel is facing.

This decision of Tata Steel appears more rational, however, if we consider that the Dutch government has reserved 22 billion euros for investing in **greening the Dutch industry,** including Tata Steel.[6] Hence, public funds may be used for greening Tata Steel, while the company itself can pay out large amounts of its earnings to shareholders and managers. Tata Steel is just one example of a large emitter who makes significant profits due to the ongoing energy crisis, while citizens are getting poorer. And yet, it is those same citizens who are expected to pay for the transition of those same companies. Such payouts represent the crudest version of **socializing the costs of pollution, while privatizing the benefits**.[7]

Announced in the governmental accord, the ministry of environment and economic matters is currently negotiating with large emitters to develop tailored **transition plans**.[8] The government, however, will have to induce this commitment to the transition with the promise of investing additional public funds, since at present short-term dividend pressures still remain more urgent for these companies, as the Tata Steel example shows. What is more, in these ongoing negotiations with large emitters, the Parliament, stakeholders and public have little say and thus little oversight on how the public money will be eventually spent.[9]

In this short note we want to argue that **the help of Dutch company law** is needed to streamline the efforts of the government and help companies transition. This proposal is directed at large emitters, who seem to be in the greatest need of urgent help, now. We also believe, however, that the proposals outlined below should be applied to all bigger companies in the longer run, for instance in line with the criteria set out in the proposal for the 'Corporate Sustainability Due Diligence Directive'.[10]

We propose to introduce two new legal obligations for large emitters, both aimed at ensuring that these companies do their part in the transition. First, we argue that large emitters should be required *to keep enough money on their accounts* to actually be able to pay for the costs of the transition. In order to achieve that, we propose to introduce a legal

[6] Kabinetsformatie, 'Coalition agreement: Looking after each other, looking ahead to the future' (*Kabinetsformatie2021.nl*, 15 December 2021) <https://www.kabinetsformatie2021.nl/documenten/publicaties/2021/12/15/coalitieakkoord-omzien-naar-elkaar-vooruitkijken-naar-de-toekomst> Accessed 24 June 2022.

[7] Recall that the public support in the form of salary support in the covid pandemic were accompanied by a prohibition on dividend payouts and management bonuses. See art. 17 of the Tweede tijdelijke noodmaatregel overbrugging voor behoud van werkgelegenheid, in which this measure was introduced. Available at: Rijksoverheid, 'Tweede tijdelijke noodmaatregel overbrugging voor behoud van werkgelegenheid' (*Rijksoverheid.nl*, 22 June 2020) <https://www.rijksoverheid.nl/documenten/regelingen/2020/06/22/now-2.0> Accessed 24 June 2022.

[8] See the statement of minister Jetten in Nieuwsuur, at Nos, 'Jetten: 'Door gascrisis meer kolen, dan ook meer klimaatmaatregelen' (*Nos.nl*, 3 June 2022) <https://nos.nl/nieuwsuur/artikel/2431364-jetten-door-gascrisis-meer-kolen-dan-ook-meer-klimaatmaatregelen.> Accessed 24 June 2022.

[9] An aspect that does not fare well in the context of the efforts for a more inclusive and transparent governmental culture.

[10] <European Commission, 'Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937', COM/2022/71 final, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>.

requirement to establish a new mandatory reserve: **a transition reserve.**[11] Second, we argue that the best way to establish the height of such reserves, as well as outline necessary steps toward such transition, would be the **transition investment plans**. We make some suggestions as to how to formalize these transition investment plans in law, building on the current developments at national and EU level around such plans.[12]

2 The tension between transition investments and distributions to shareholders in the current legal framework

Currently, the legal system neither incentivizes nor obliges companies, however polluting, to invest their earnings in financing the transition. The pressures of contemporary financial markets and institutional investors are such, that payouts to shareholders seem difficult to resist.[13] There are strong incentives for boards to maximize distributions to shareholders, not least because they may be dismissed by shareholders in the case the latter find the payouts insufficient.[14] To complicate issues further, companies can pay out dividends whether they make profit or not. In fact, companies may even borrow money to pay out dividends or to buy back their own shares.[15]

Importantly, the transition is also not taken into account in the existing limitations on distributions to shareholders. Only when there is a clear causal link between concrete distributions to shareholders and illiquidity in the sense that the company cannot pay its creditors, can the board and/or shareholders be sanctioned by the judge for the distributions.[16] Circumstances demonstrating the necessity for a green transition are too distanced to be relevant in such a specific test. Moreover, judges may regard the disapproval

[11] Another comprehensive solution to the issues that we address in this proposal, which integrates sustainability transition directly in the financial accounts of the company, has been proposed recently by Prof. Murphy (Sheffield University Management School). The proposal is available at: <https://www.taxresearch.org.uk/Blog/wp-content/uploads/2022/03/FRS-on-Accounting-for-Environmental-Change-3-22.pdf.> For this proposal, the International Financial Reporting Standards (IFRS) need to be changed. These standards are applicable to European public companies on the basis of EU law. This is a larger project that extends beyond the authority of the Dutch legislator. Instead, our proposal does fall within the scope of the authority of the Dutch legislator.

[12] See section 4 of this paper.

[13] European Commission Staff (n 2).

[14] Art. 132/242 and 134/244 of Book 2 of the Dutch Civil Code. An example of this in France is the case of Danone, in which the board was dismissed because a few large institutional investors demanded higher dividends. Financieele Dagblad, 'Gevallen Danone-ceo: 'Ik wilde het system van binnenuit veranderen' (*fd.nl*, 9 July 2021) <https://fd.nl/weekend/1389998/gevallen-danone-ceo-ik-wilde-het-systeem-van-binnenuit-veranderen#:~:text=In%20het%20kort,enkele%20aandeelhouders%20tevreden%20te%20stellen.> Accessed 24 June 2022.

[15] De Weijs, R. and Aart, J., 2020. Speed limitations for the Financial Sector: Three Ways to Take Leveraged Finance and its Risks Seriously. In: A. Boot, P. Hoffman, L. Laeven and L. Ratnovski, ed., Perspectives on Leveraged Finance and Fintech (Topics in Corporate Finance, no. 28). Amsterdam: Amsterdam Centre for Corporate Finance.

[16] Van Olffen, M. & Rensen, G.J.C., 2019. Mr. C. Assers Handleiding tot de beoefening van het Nederlands burgerlijk recht. 2. Rechtspersonenrecht. Deel IIa. NV en BV. Oprichting, vermogen en aandelen, Deventer: Wolters Kluwer, no. 208.

of the distribution by the directors even as a case of mismanagement - if there are no sufficiently 'concrete' reasons for such disapproval.[17]

In Dutch company law, however, there is one instrument that is capable of legally requiring companies to keep money in their accounts for important purposes: the **legal and statutory reserves.** The so-called 'balance test' states that dividend pay-outs and share buybacks may not encroach on the reserves that the company is required to create by law or statute.[18] There are different types of reserves. The currently existing *legal reserves* have the character of accounting counterparts, with the purpose of preventing companies from distributing money that flows from results that they have not yet actually achieved. Organizations themselves can also create *earmarked reserves* that are intended to be spent on a certain purpose, either based upon their statutes or voluntarily. The law can also require companies to create such an earmarked reserve in their statutes, which then needs to be taken into account in the balance test.[19]

3 The transition reserve

In order to facilitate the green transition, we propose the introduction of a new mandatory reserve: the **transition reserve.** A new legal provision should require large emitters to introduce the transition reserve as an 'earmarked reserve' in their statutes.[20] In accounting terms, this transition reserve would be charged to the free reserves.[21] Such reserve would enable large emitters to live up to their substantive commitments to green transition, [22] as it ensures that large emitters have sufficient funds to transition in the short and long term.

[17] Van Olffen, M. & Rensen, G.J.C. (n 16)

[18] Art. 105/216 of Book 2 of the Dutch Civil Code. The balance test states that profits can only be distributed to the extent that the company's equity capital (consisting of paid and called-upon capital, agio, legal and statutory reserves, and profits or losses) is larger than the tied-up capital, namely the sum of the paid and called-up part of the capital plus the legal reserves (e.g. revaluation reserve or reserve for costs of developing new products) and statutory reserves.

[19] An example is the earmarked reserve that is created on the basis of art. 18 under 6 of Book 2 of the Dutch Civil Code, in the statutes of a former foundation that is converted into a different legal form. This earmarked reserve ensures that the foundation's equity can only be used for transactions that are in line with the former foundation's purpose.

[20] Earmarked reserves are not directly created by this legal provision, but have to be created by companies themselves in their statutes. Hence, the large emitters would be legally required to create the transition reserve in their statutes, within the framework of the legal provision and referring to the companies' individual transition plans. The transition reserve is based on law and thus mandatory. This means that it cannot be removed from the statutes or converted into capital. This is similar to how the earmarked reserve for a former foundation's equity works (see n 19).

[21] The details of this proposal in terms of accounting need to be worked out further. An alternative to this layered structure would be that all funds for green investments would be allocated to a mandatory provision. This would make the transition investments an integral part of the company's financial statements. We are aware that a twist to the accounting standards may be necessary in order to implement such a provision. It is for accountants to experiment with this. Inspiration may be taken from Prof. Murphy's (Sheffield University Management School) recent proposal for 'Accounting for environmental change' (n 11).

[22] The transition reserve can be seen as a publicly mandated 'Green Pill' (Armour, J., Enriques, L., & Wetzer, T., 'Corporate Carbon Reduction Pledges: Beyond Greenwashing'. (*Oxford Business Law Blog*, 2 July 2021) <https://www.law.ox.ac.uk/business-law-blog/blog/2021/07/corporate-carbon-reduction-pledges-beyond-greenwashing> Accessed 21 June 2022)..

There are different ways in which **the height of the reserve** could be determined. It could be set as a percentage of a company's profits, or it could be a percentage of any planned distributions to shareholders.[23] Inspired by the ongoing negotiations between the government and the large emitters in the Netherlands, as well as the Corporate Sustainability Due Diligence Directive proposal,[24] we believe that the most effective way to determine the height of the reserve is in relation to the **actual costs of the transition**. Such reserve should be replenished yearly. Importantly, only once the company has accumulated sufficient transition reserves for investments into the sustainability transition for at least the following 5 years, should it be allowed to pay out dividends. As this reserve is mandated by law and statutes, distributions to shareholders cannot be charged to this transition reserve.

This proposal will change investment incentives and introduce a longer-term perspective in the company's operation. The transition reserve works to **increase the investment of large emitters overall,** addressing the lack of investment which is identified as one of the major problems related to the contemporary 'shareholder value' economic model.[25] The transition reserve will make sure that company's profits are actually invested in the necessary steps of the transition – limiting the risks posed by the transition to the company and society – rather than paid out to shareholders and managers.

4 The transition investment plan

In order to ensure that all large emitters will do their part in funding their transition, we argue that the **transition investment plans**, as currently negotiated by the government, should be legally formalized for at least the large emitters. Formalizing the obligation to make such plans will not only improve the government's 'negotiation position', but it would also create more transparency toward shareholders and investors on the one hand,[26] and enable the oversight by the parliament on the other.[27]

An obligation to create 'transition plans' will also become part of the duties of the board of directors, if the European Commission's proposal for the **Corporate Sustainability Due Diligence Directive** (CSDD) comes to pass.[28] The implementation of the CSDD in Dutch law could also provide a legal basis also for the introduction of transition investment plans, inasmuch the proposal is a minimum harmonisation directive.

However, there is an important difference between the transition investment plans proposed here and the ones proposed by the CSDD directive. We propose **an *investment plan*** rather than a plan that is a list of (science based) targets. Thus, rather than just setting, for instance, climate targets, the investment transition plan sets out *the particular investments necessary for the climate impacts mitigation and the costs associated with them, on a yearly basis*. For this reason, we see no need for the Dutch government to await the implementation

[23] All of which would pose some implementation challenges.
[24] See n 10.
[25] European Commission Staff (n 2)
[26] In line with the efforts to ensure 'green finance' at the European level.
[27] Currently, the plans seem to be negotiated between the large emitters and the ministry: leaving thus the parliamentarians out of the picture.
[28] See n 10.

of the CSDD, and instead it should continue leading the way and put the transition investment plans into law, at least in relation to large emitters.

The transition investment plans need to estimate the **costs of the sustainability transition overall** and attribute those costs on a **yearly basis** to the steps necessary for achieving set environmental objectives.[29] Such 'investment plans' are not unknown in the Dutch legal order, as every apartment owner knows: each association of owners has a multi-year investment plan for the planned investments in the shared property.[30] The transition investment plans would serve both as an indicator for the height of the reserve that needs to be created every year to cover the real costs of transition, as well as be an actual investment plan for the sustainability investment.

The transition investment plan has to be based on the **realistic estimations of costs of transition**, over the periods of 5, 10, 15, and 20 years. Such plans should be updated in case a new technology or new knowledge appears. The transition investment plans should set the height of the reserve that is to be created, the years in which the money should be reserved, and the concrete investments to be made.[31]

5 Implementation of the proposal

There are several possible places to formalize the transition investment plans and the transition reserve in law, also depending on how the Corporate Sustainability Due Diligence Directive will be implemented in Dutch law. For the purpose of specifically regulating the transition plans of large emitters, one option would be to add **a new part to Book 2 of the Dutch Civil Code** called 'Provisions for legal entities identified as large emitters', in which these companies are required to create transition investment plans and a transition reserve.[32] The details of implementation should then be worked out in a government decree (AMvB). The transition investment plan and transition reserve can also be introduced in a **specific legal act.**

Large emitters should **report yearly,** showing the creation of the transition reserve, how they invest the reserve in accordance with their transition investment plan and what are the environmental impacts of these investments. These reports should be audited.[33] In case the funds were not invested in line with the investment plan, the companies would be

[29] The six environmental objectives, as set out in the EU taxonomy regulation are environmental objectives: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; the protection and restoration of biodiversity and ecosystems.

[30] As required in art. 126 of Book 5 of the Dutch Civil Code.

[31] Of course, the steps towards the transition that are already completed do not have to be reserved for. Moreover, if a 'provision' is made for particular sustainability investments that are planned in detail and that will happen in the short-term, the yearly 'reserve refill' may be lowered for the same sum.

[32] In case the transition reserve would be implemented, it would be important to make sure that this legal reserve cannot be converted to capital and distributed in the form of bonus shares.

[33] Under the Corporate Sustainability Reporting Directive, a new type of 'sustainability auditors' will be created. These sustainability auditors could potentially audit these transition plans. Alternatively, if such plans are developed in cooperation with the ministry of environmental affairs, they could also be audited by the same ministry.

required to take remedial actions. The reports and the conclusions of the auditors of large emitters should be made public.

This proposal would be applicable to Dutch large emitters. For those companies that are subsidiaries of an international concern, the transition reserve should be made either on the level of the Dutch subsidiary, or, where that would lead to group financing issues, at the level of the holding company.

6 Connections to other legal interventions

Importantly, this proposal for a transition reserve is **not a tax measure.** Instead, the transition reserve remains the company's own fund that should serve as its investment into its own future resilience and sustainability. This proposal makes the company future-proof, introducing a degree of 'common sense' in the appreciation of the risks and costs of transition, as well as mitigating the moral hazard of banking on public bail out. Such fund is in the long–term interest of investors, shareholders, stakeholders, taxpayers and society.

The proposal is also in line with current developments in EU company law that require companies to take more responsibility for environmental and societal issues and **mitigate the pressures of short-termism** that undermine fundamental public and private interests.[34] By introducing this proposal into its legal order, the Netherlands could lead the way in Europe.

7 Conclusion

With this short note, we want to start a discussion about the feasibility and possible ways to implement a transition reserve and transition investment plan. The government – and society – have paramount reasons to require large emitters to employ their own earnings to finance green transition ('polluter pays principle'). Equally, there should be no public 'bail out' to companies which have paid out dividends while not ensuring the realistic prospect of self-financed transition.

Importantly, we believe that this proposal will do more than just force large emitters to invest in their own green transition. By making sure that the money stays in the company, this proposal also fosters a new way of thinking about the use of company funds, foremost within the company itself. Instead of being pressured to maximize payouts for shareholders, it creates space to consider new pathways for investing in more innovative and sustainable ways.

We realize that this proposal may not appear in the (short-term) interest of investors. But who really are the investors in the end? Aren't they also grandparents who wish a future for their grandchildren? 'Millennials' who may still like to have a family and offspring? Or taxpayers who want their tax to be invested in a way that ensures a safe future for them and

[34] European Commission, Directorate-General for Justice and Consumers, 'Study on directors' duties and sustainable corporate governance: final report', Publications Office, 2020, <https://data.europa.eu/doi/10.2838/472901>.

their children? In the long run, all people, as well as future generations and our ecosystems, will benefit from healthy, future-proof companies and a more resilient and sustainable economy.