Chapter 1
Introduction

1.1 Negative Externalities, ESG & Group Undertakings

The societal impact of businesses has been the subject of fundamental discussion for many years. The ways in which this impact can be viewed are manyfold. In itself, economic activity may have a positive impact on broader society (i.e. in addition to the positive impact for the parties directly involved). This can, for instance, be measured in terms of the jobs that companies help create, the supply of goods that support food security, the development of medical innovations that can help to make people's lives better and the general sense of purpose and cohesion that is nurtured by people and groups that work together.[1] There are also many ways in which economic activity can have (and, in practice, has) an adverse impact on society. Such adverse impacts may include climate change, pollution, biodiversity loss, human rights violations and inadequate workplace health and safety.

From an economic perspective, the unintended effects of business activities on third parties or society as a whole are often referred to as external effects or 'externalities'.[2] In economic theory, externalities are considered a form of market failure. This failure is not necessarily problematic, however, as from a social welfare perspective there are no reasons to object against *positive* externalities. The debate typically focuses on *negative* externalities, and the various strategies which may be applied to mitigate or eliminate those.

One potential strategy is disclosure. For instance, in his 1981 doctoral thesis – written when most of the thinking on the corporation was still driven by shareholder value maximization-oriented agency theorists[3] – Hein Schreuder presented the concept of 'social reporting' to address potential workforce-related negative externalities.[4] Schreuder, a former student of Erasmus University and an academic by trade, would later join the newly listed and privatized Dutch chemicals business DSM and become an important figure in the continuous strategic transformation

1 For the various standards on making a positive contribution to society, *see* the UN Sustainable Development Goals, available at http://sdgs.un.org/goals/.

2 On this concept, *see* C. Mayer, *Firm Commitment. Why the Corporation is Failing to us and how to Restore Trust in it* 36 (Oxford University Press, 2013); *see also* J.E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* 17 (Norton, 2010). Also note that in some instances, externalities may be intentional (e.g. as a consequences of R&D processes).

3 *See* M. Friedman, *Capitalism and Freedom* 133 (Chicago University Press, 1962), famously arguing that 'there is one and only one social responsibility of business – to use it resources and engage in activities designed to increase its profits so long as it […] engages in open and free competition without deception or fraud'.

4 H. Schreuder, *Maatschappelijke verantwoordelijkheid en maatschappelijke berichtgeving van Ondernemingen* (H.E. Stenfert Kroese, 1981). Note that the concept of welfare economics was initially developed in A.C. Pigou, *Economics of Welfare* (Macmillan, 1920).

of that organization, which recently transformed into the Swiss-Dutch nutrition company DSM-Firmenich.

Another possible strategy consists of 'internalizing' negative externalities. Regulators have, for example, sought to impose taxes for pollution or by creating a market for carbon credits.[5] The upside of this approach is that any negative impact becomes part of the decision-making process for businesses, and as such public resources are no longer seen as without cost. The downside of internalizing externalities is that it reduces complex problems to a cost-benefit analysis, thus potentially crowding out any moral considerations. In addition, whilst the negative impact of business on society may be reduced, it will likely not be addressed in full.

However, as the world faces major challenges, which to some extent have been aggravated by economic activity, society increasingly demands to not only mitigate negative externalities, but rather to eliminate them as much as possible. For that reason, recent regulatory initiatives, of which the EU Corporate Sustainability Due Diligence Directive (CSDDD) is perhaps the most ambitious, have transcended the 'license to pollute'-principle and aim to introduce a mandatory due diligence obligation. In short, this means that companies are obliged to identify actual or potential negative consequences arising from their business operations and have to prevent and limit them where possible.[6] The CSDDD proposes to cover a company's own operations, those of its subsidiaries, and the value chain operations carried out by their business relationships.[7]

There are, of course, other ESG policy initiatives as well, some of which show an interesting resemblance with Schreuder's earlier thinking. The EU, for example, has introduced far-reaching non-financial (or sustainability) reporting obligations. This started in 2014 with the Non-Financial Reporting Directive (the NFRD).[8] The scope and obligations of sustainability reporting under the NFRD have expanded significantly as a result of the Corporate Sustainability Reporting Directive (the CSRD).[9] Other legislative instruments that (amongst others) impact corporate sustainability reporting are the Sustainable Finance Disclosure Regulation (the SFDR)[10] and the Taxonomy Regulation.[11] The common denominator of such ESG-related initiatives is that all seek to promote a more inclusive form of welfare.

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5 On the latter, *see* e.g. J.A. Mathews, 'How carbon credits could drive the emergence of renewable energies', 36 *Energy Policy* 3633 (2008).

6 *See* S.B. Garcia Nelen, 'The Proposal for a Corporate Sustainability Due Diligence Directive: Background and Latest Developments', 25 *Ondernemingsrecht* 222 (2023).

7 *See* Garcia Nelen 2023.

8 Directive 2014/95/EU of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

9 Directive (EU) 2022/2464 of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

10 Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector.

11 Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088. Other jurisdictions to adopt ambitious climate disclosure obligations include notably California. *See* e.g. L. Cheng &

Moreover, parallels can be drawn between the public initiatives mentioned above and the actions of certain private organizations. For instance, NGOs such as Friends of the Earth (*Milieudefensie*) may (threaten to) initiate litigation with a view to targeting the adverse impacts resulting from a company's activities in its entire value chain, including those outside the organization's direct span of control ('scope 3').[12] In 2021, the District Court of The Hague held that (then) Royal Dutch Shell was obliged to reduce its absolute carbon dioxide emissions by 45% by the end of 2030, relative to 2019.[13] In addition, one could point to the ESG ratings published by ratings agencies, including MSCI, LSEG and S&P, which score companies based on the sustainability of their operations, using elaborate sets of data. Shareholders can then use these ESG scores to better understand an investee company's sustainability profile.[14] Some activist investors, in fact, launch campaigns seeking to convince firms to become more sustainable.[15]

The above-mentioned public and private initiatives all seem to be based on an important assumption however, namely that a company's business activities, which are typically organized through international group structures, can be fully controlled by unified group policies that are determined and implemented at the level of the holding entity. This, in turn, presupposes that the parent company has the legal and organizational instruments at its disposal to oversee its subsidiaries so that it can effectively guide and, if necessary, change their operations. This assumption is an important focus point in our research.

As the Netherlands are usually considered an open economy, home to many internationally oriented businesses, there are two sides to this issue. First, there is the perspective of Dutch parent companies with foreign subsidiaries. Second, one can consider the situation of Dutch subsidiaries of foreign parent companies. Depending on the jurisdiction of incorporation of the parent and the subsidiary – and the applicability of Dutch corporate law to either of these entities – the parent

D.A. Zilberberg, 'The California climate disclosure laws, SEC's proposed climate-related disclosure rule and the CSRD: What U.S. companies need to do now to comply' (22 February 2024), available at http://www.corpgov.law.harvard.edu/.

12 Note that it is debatable to what extent the concept of the 'value chain' is similar to what is commonly understood to encompass 'scope 3'.

13 The Hague District Court, 26 May 2021, ECLI:NL:RBDHA:2021:5339 (*Milieudefensie/Shell*), no. 4.4.55. This ruling is currently being appealed. The verdict of this appeal is due shortly after this report is published. In the meantime, Friends of the Earth also announced its intention of filing a claim against ING. *See* A. Mooney, K. Bryan & O. Walker, 'ING faces threat of legal action from climate group behind Shell case' (19 January 2024), available at http://www.ft.com/.

14 Meanwhile, ESG scores are widely diverging across rating agencies, impairing their usefulness. *See* F. Berg, J.F. Kölbel & R. Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings', 26 *Review of Finance* 1315 (2022).

15 *See* e.g. S. Sciorilli Borelli & A. Mooney, 'The factory by a Tuscan beach and the future of ESG investing' (22 December 2020), available at http://www.ft.com/, discussing the campaign of Bluebell Capital Partners to improve waste management at an Italian chemical plant. Curiously, Bluebell would later target BP for its (perceived) overly ambitious ESG strategies. *See* T. Wilson, 'BP faces activist investor pressure to ditch clean energy pledges' (29 January 2024), available at http://www.ft.com/.

may possess either less or more legal and organizational instruments to ensure that policies are effectively implemented throughout the corporate group as a whole.

In practice, the interests of parent and subsidiary entities will often run in parallel, but the relationship can also lead to tensions. In the context of our research, this means that, on the one hand, the parent entity may feel the need to make the group entities comply with its societal obligations. On the other, the (board of a) subsidiary can be legally required to determine its own policies, including in relation to ESG matters. In addition, both the parent and the subsidiary have a duty to respect the governance rules that apply to their organizational relationship, which can also hinder fully aligning group wide policies.

1.2 Aim, Focus & Purpose of the Study

With support from the *Stichting Tot Organisatie van Effectenhandelaren Rotterdam* (STOER) and the Erasmus Trustfonds, which is gratefully acknowledged, the International Center for Financial law & Governance (ICFG) of Erasmus University Rotterdam conducted a study pertaining to the following research question:

> How should a Dutch parent or subsidiary entity, as part of an international and economically active organization, address (potential) negative externalities via its ESG policies?

Of course, the actual ESG challenges that each company encounters may very well differ depending on, for instance, the industry or the country in which the business is operating. Certain businesses may, for example, be focused more on the responsible use of natural resources, whereas others pay more attention to ensuring sustainable working conditions. As such, this study does not purport to argue that certain ESG issues may be more pressing than others, but rather aims to identify the various potential procedures and ways of thinking across companies in handling these respective challenges.

Indeed, existing (doctrinal) research has paid comparatively little attention to the ways in which ESG is addressed in intra-group situations. Typically, the analysis focuses on decision-making within a single legal entity. The perspective of the group, i.e. the entirety of economic and operational organizations held within a multitude of entities in different jurisdictions, is, however, much more relevant with a view to reducing or eliminating negative externalities.

The purpose of this study is threefold and relates to (i) mapping the duties and responsibilities of directors of Dutch entities, being either (a) a parent company listed in the Netherlands with foreign subsidiaries[16] or (b) a Dutch subsidiary of

16 As noted, the legal regime applicable to the subsidiary may differ based on its country of incorporation. On this issue, *see* Section 2.2.1.

a company listed abroad, and (ii) collecting good practices and lessons learned. These practices will then be used to (iii) explore guidelines for effective handling of intra-group relationships, specifically aimed at General Counsels, Chief Legal Officers, Chief Sustainability Offers, as well as in general, those that are in charge of the implementation of ESG policies. The research thus seeks to combine solid theoretical analysis with real life experiences. The recommendations in Chapter 5 may serve as a starting point for discussions between (legal) corporate professionals interested in or responsible for ESG policies with a view to bringing their own role and interactions to a higher level, both in current and future practice.

1.3 Methodology & Scope

1.3.1 Methodology

To holistically analyze the relevant issues at hand, this study adopts an interdisciplinary approach, combining insights from legal and economic disciplines as well as building on the knowledge gained during in-depth discussions with selected corporate representatives (see Section 1.3.2).

First, there is the legal aspect. This part of the study focuses on corporate law but also, to the relevant extent, takes securities and financial reporting laws into account. For the avoidance of doubt, we abstain from discussing specific environmental laws that, for example, prohibit certain types of pollution. Instead, we focus on provisions that apply to all sorts of companies, regardless of their specific activities. The (broad) legal perspective involves studying statutes, principles, precedents and scholarly works. The purpose of this part of the analysis is to draft a coherent framework in relation to the legal position of the Dutch entity, be it as a parent or as a subsidiary, as well as to identify potential regulatory inconsistencies or areas of improvement.[17]

Second, the economic and management angles of the study seek to promote welfare maximization[18] and analyze the extent to which the various approaches to ESG contribute thereto. The concept of welfare can be interpreted more narrowly, focusing solely on monetary factors (e.g. the shareholder value-centric approach), or more broadly, including factors such as environmental and social well-being.[19] In light of the project's ESG-orientation and the societal objective of mitigating or eliminating negative externalities, this study expressly subscribes to the broader notion of welfare.

17 *See* W. Twining, *Law in Context: Enlarging A Discipline* 33 (Oxford University Press, 1997): 'The study of law is equated with the study of legal rules […] a high premium is placed on conceptual precision, on logical consistency within the system, and on technical excellence.'

18 *See* R.A. Posner, 'Utilitarianism, Economics, and Legal Theory', 8 *Journal of Legal Studies* 103 (1979).

19 *See* L. Kaplow & S. Shavell, *Fairness versus Welfare* (Harvard University Press, 2002).