Directors' Duties and ESG Considerations in India

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Directors' Duties to Incorporate ESG in Decision-Making

The concept of environmental, social and governance (ESG) factors in corporate governance is generally considered to be market-driven in that investors (particularly of the institutional variety) demonstrate their expectations that portfolio companies are managed in sustainable manner. However, in many countries, including India, corporate and securities regulators have begun issue legal or regulatory instruments that mandate, or at least regulate, the manner in which companies discharge their ESG responsibilities. Here, it is necessary to explore how the Indian legal system deals with the roles and responsibilities of corporate boards in accounting for ESG factors in their decision-making process and how those duties are enforced, a task that this article briefly embarks upon.

At the outset, ESG considerations are an integral part of directors' duties as codified in India's companies' legislation. One finds the best reflection of this approach in the codification of directors' duties in the 2013 legislation. Section 166(2) of the Companies Act 2013 provides:

> A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, community and for the protection of environment.

Best Interests of the Company

This statutory provision treats the interests of the company as separate and distinct from that of the shareholders, or any of the other specified stakeholders. Although the text of the legislation does not offer any obvious interpretation, there is sufficient authority to indicate that, from a temporal standpoint, directors must favour the long-term sustainable interests of the company over any short-term interests that largely encapsulate shareholder considerations. Directors must discharge their duty to act for the company's wellbeing and interest. It is clear that the best interests test is not synonymous with the short-term interests of the current shareholders. Rather, the long-term vision for the company that directors are statutorily required to employ has to align with the interests of shareholders as well as other stakeholders, and is entirely consistent with the stakeholder-oriented approach to corporate law.

The above analysis suggests that directors of Indian companies would be required to identify and address ESG risks, such as climate change, and implement strategies to address them. This aligns itself with the financial model of ESG because risks such as climate change could bring about direct financial impact on companies, especially those in industries that are particularly vulnerable to climate effects. Moreover, a company's indifferent attitude towards ESG risks could also invite adverse reputational repercussions, with the shareholders ultimately facing the financial consequences. For example, directors could be exposed to liability if they display conscious disregard or willful neglect towards the ESG risks emanating from the operations of a company, such as environmental impact. This could also arise when the directors measure the success of the company (and their own) by deploying short-term yardsticks rather than alternative strategies that would have accounted for long-term sustainable value.

Related to this is the question of how directors on boards of Indian companies deal with risk management on ESG issues. A broader framework for risk-management is contained in the Companies Act 2013, which applies to all companies, and in the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 (hereinafter the 'SEBI LODR Regulations') issued by India's securities regulator, the Securities and Exchange Board of India (hereinafter 'SEBI'), which apply only to publicly listed companies. The Companies Act requires the board of directors to include in its annual report a statement indicating the development and implementation of a risk management policy. Given that ESG risks on matters such as climate change could be significant, boards would need to incorporate them in their risk analysis. Moreover, independent directors are called upon to bring to bear their 'independent judgment' on matters relating to risk management, as set out in the Companies Act 2013, Schedule IV, clause II(1). Similarly, under the LODR Regulations, board responsibilities include reviewing and guiding the company's risk policy, and ensuring that appropriate mitigating mechanisms for addressing risks are in place. Moreover, large companies are also required to establish risk committees comprising directors.

Given the increasing importance of ESG factors in corporate law, directors of Indian companies would bear the responsibility to keep up with developments in the field and address possible ESG risks through appropriate mitigating mechanisms. Similarly, where there are risk committees, their members would bear specific (and arguably greater) responsibility in this regard, particularly for companies operating in sectors that are more vulnerable to ESG risks.

Best Interest of Various Stakeholders

Apart from acting in the interests of the company, under section 166(2) of the Companies Act 2013, directors are also required to specifically consider the interests of various constituencies identified therein. The statutory enactment process as well as the express language of the provision in India indicate that there is a positive duty (and not merely an option) on the part of the directors requiring them to consider various stakeholder interests. In that sense, it is an obligatory provision rather than merely a permissive one. It is also noteworthy that the Companies Act in Schedule IV also imposes obligations specifically on independent directors to 'safeguard the interests of all stakeholders' and to 'balance the conflicting interest of the stakeholders', apart from the requirement to 'assist in protecting the legitimate interests of the company, shareholders and its employees'. Clearly, the legislation requires independent directors on Indian corporate boards to consider the interests of non-shareholder constituencies.

Section 166(2) and its stakeholder orientation have been receiving attention from the Indian Supreme Court. In *M.K. Ranjitsinh v. Union of India* 2021 SCC OnLine SC 326, the Court was concerned with the specific duty of the directors to consider 'the protection of the environment' and treated it to be on par with duties to other stakeholders, including shareholders. Since the expression 'environment' does not find a definition in the Companies Act, the Court readily imported the meaning ascribed to the term under section 2(a) of the Environment (Protection) Act 1986, which defines the word to include the 'inter-relationship which exists among and between water, air and land, and human beings, other living creatures, plants, micro-organisms and property.' The width of this definition is adequately capable of accommodating several ESG risks. Hence, ESG considerations are not merely optional for directors to consider on a voluntary basis, but they carry more onerous legal obligations.

Separately, in *Tata Consultancy Services v. Cyrus Investments Private Limited* (2021) 9 SCC 449, in the context of section 166(2) the Supreme Court observed that 'the history of evolution of the corporate world shows that it has moved from the (i) familial to (ii) contractual and managerial to (iii) a regime of social accountability and responsibility.' It then went on to note that '[w]hat is ordained under Section 166(2) is a combination of private interest and public interest.'

While the duty to act in the interests of the company, and more specifically the long-term interests, retains within itself the idea of ESG as financial risk, the additional elements in section 166(2) that impose duties to consider the interests of specific constituencies such as those affected by the environment has the effect of extending beyond merely treating ESG from a financial risk perspective. This requires directors to consider ESG matters regardless of their associated financial implications.

At the same time, it is clear that such a stakeholder-oriented duty may complicate board decision-making, in particular, due to the pluralistic approach adopted in section 166(2). In case of conflicts between various groups of stakeholders, directors may have to consider what is fair among them inter se. Moreover, the somewhat extensive discretion conferred upon directors to consider varying interests may have the effect of limiting any restraints on the exercise of that discretion. This is particularly challenging given the intangibility and immeasurability surrounding the varied stakeholder interests.

Enforcement of ESG-Related Duties

While the Indian legislature has taken steps to incorporate stakeholder- and ESG-related considerations into board decision-making, several questions have been raised on whether this amounts to mere rhetoric or whether the relevant duties of directors envisaged in section 166(2) of the Companies Act 2013 are enforceable. At the outset, the Indian corporate statute does not specifically clarify whether directors owe their duties to the company or directly to the shareholders or other stakeholders. Nevertheless, it is generally understood under Indian corporate jurisprudence that the duties of directors are owed only to the company, which is also the accepted position in common law. Hence, it is generally only the company that can initiate legal action for breach of directors' duties. However, if the board fails to bring an action, shareholders can initiate a derivative action, with the benefit of such action flowing to the company and not directly to the shareholders.

Derivative actions pose a number of challenges under Indian law. First, there is no statutory derivative action provided under the Companies Act, and parties must rely on common law to bring them. Second, derivative actions in India are extremely rare given the costs and delays involved in instituting them successfully, thereby depriving such actions of their efficacy. Third, and most importantly, the law recognises that only shareholders can initiate derivative actions. Indian corporate law has not, at least as yet, recognised the ability of non-shareholder constituencies to bring derivative actions for breach of directors' duties to account for stakeholder interests.

Breaches of directors' duties could potentially attract two other types of claims under Indian law. The first relates to actions for oppression, prejudice and mismanagement ('OPM') under section 241 of the Companies Act, 2013. However, this remedy can be invoked only by shareholders who hold a prescribed minimum number of shares in the company, and is not available to other stakeholders. The second claim relates to class actions. Under section 245 of the Companies Act 2013, if shareholders are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its shareholders, they can initiate a class action. Here too, only shareholders holding a minimum number of shares are allowed to bring class action. It is clear that the class action mechanism is oriented towards shareholders and does not explicitly recognise the interests of other stakeholders.

In the context of ESG matters, the scenario relating to enforcement of directors' duties bears considerable uncertainty. Viewing ESG from a financial risk perspective, it is clear that shareholders can seek to bring any of the actions discussed above under Indian corporate law. Presumably, such actions may be brought on the ground that, by not considering ESG factors and acting with a view towards long-term sustainable value, shareholders may suffer a loss. In these circumstances, ESG-oriented shareholders could potentially initiate legal action in their capacity as shareholders and to preserve and enhance the value of their shareholding in the company. However, viewing ESG beyond mere financial risk, matters become compounded. ESG-oriented shareholders may have a daunting task in initiating legal action for breach of directors' duties by applying the entity model of ESG, to which the enforcement mechanisms in India appeal ill-suited, at least as yet.

Given the tenuousness of the various actions in the context of ESG (except when it shareholder-risk based), the directors' duties to incorporate ESG considerations in their decision-making may lack sufficient legal bite. Hence, unless the enforcement measures receive more targeted support through legislative amendments or judicial innovation, the now well-commented verbiage of section 166(2) will remain 'law in the books' as compared to 'law in action'.

Conclusion

In all, despite certain doctrinal holdups in ensuring an effective enforcement regime, directors' duties in India in the context of ESG has taken on greater prominence given the debates surrounding section 166(2), which one can ill-afford to ignore. This must be viewed in the context of other efforts by Indian regulators to expand on ESG disclosure-related obligations of companies and on ESG stewardship-related obligations of institutional investors.