



NEWSLETTER

Legal, Compliance and ESG

09 August 2021

Dear Readers,

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A. LEGAL AND REGULATORY UPDATES:

~ Anand Asawa and Saurav Agarwal

I. Amendment to Companies (Meetings of Board and its Powers) Rules, 2014¹

Rule 4 of the Companies (Meetings of Board and its Powers) Rules, 2014, restricted companies from dealing with certain matters (such as approval of annual financial statements, board's report, prospectus or matters relating to mergers/ acquisitions/ demergers/ takeovers, etc.) in board meetings held through video conferencing ("VC") or other audio-visual means ("OAVM"). The MCA had, through various circulars, provided relaxation on applicability of Rule 4 to companies till June 30, 2021. However, the MCA has now omitted this rule 2021, thereby allowing board of companies to deal with all such matters even by way of VC/ OAVM meetings.

II. Further clarifications on COVID-19 related spending which qualify as eligible CSR activities²

In continuation of the various circulars issued by the MCA since March 23, 2020, in relation to eligibility of COVID-19 related spending as eligible Corporate Social Responsibility ("CSR") activities, the MCA has further clarified that spending of CSR funds for COVID-19 vaccination for persons other than employees and their families, is an eligible CSR activity under item No. (i) of Schedule VII of the Companies Act, 2013 relating to the promotion of health care (including preventive healthcare) and item No. (xii) relating to disaster management disaster management.

¹<https://egazette.nic.in/WriteReadData/2021/227614.pdf>

²<https://mca.gov.in/bin/ebook/dms/getdocument?doc=MzEwMTU=&docCategory=Circulars&type=open>

III. Housing financial companies to be considered as financial institutions under National Housing Bank Act, 1987³

The Ministry of Finance has notified housing financial companies registered under the National Housing Bank Act, 1987, and having assets worth INR 100 crore and above to be 'financial institutions' under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

IV. RBI releases consultation paper on regulation of Microfinance⁴

The RBI has issued a consultation paper on regulation of microfinance institutions, or financial services, which provide small loans and other financial services to poor and low-income households.

The following customer protection concerns were noted in the existing framework:

- i. Microfinance lenders (other than Non-banking Financial Companies - Micro Finance Institutions ("NBFC-MFI") are unregulated. This results in small borrowers availing loans from multiple such lenders and are eventually faced with over-indebtedness.
- ii. Customers are unable to benefit from better rates of interest from market competition amongst microfinance lenders as the regulatory ceiling fixed on the rate of interest for NBFC-MFIs is being used as a benchmark rate by all microfinance lenders, regardless of lower costs of fund/ greater economies of scale.

³<https://financialservices.gov.in/sites/default/files/HFC%20GENERIC%20NOTIFICATION.pdf>

⁴<https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/MICROFINANCE21A930650DE644A2B6DEB55BF03315D6.PDF>

In light of the above, the RBI has proposed the following:

- i. Uniform Definition of Microfinance Loans – collateral free loans to households with annual household income of INR 1,25,000 (rural areas) and INR 2,00,000 (urban/semi urban areas).
- ii. Board policies – each regulated entity will be required to have board approved policies in relation to: (a) household income assessment; (b) capping the interest payments and principal repayments of outstanding loans of a household as a percentage of the household income (subject to a regulatory ceiling of 50% of the income); (c) determining periodicity of repayments; (d) all-inclusive interest rates charged to the borrowers.
- iii. Non-Profit Companies – Companies incorporated under Section 8 of the Companies Act, having assets above a certain threshold (for e.g., INR 100 crore or more) and extending microfinance will no longer be exempt from regulation by the RBI.
- iv. Other Instructions:
 - a. Microfinance loans should not have prepayment penalties

- b. Microfinance lenders should disclose the pricing of loans and rates of interest in a simple one-page disclosure format (for customers to compare with the pricing of loans of other lenders).
- c. Microfinance lending of all regulated entities should be collateral-free.

V. New Definition of Micro, Small and Medium Enterprises - Addition of Retail and Wholesale Trade⁵

As per RBI notification RBI/2021-2022/67 FIDD.MSME & NFS.BC.No.13/06.02.31/2021-22 dated 07.07.2021, Ministry of Micro, Small and Medium Enterprises vide Office Memorandum (OM) No. 5/2(2)/2021-E/P & G/Policy dated July 2, 2021, has decided to include Retail and Wholesale trade as MSMEs for the limited purpose of Priority Sector Lending and they would be allowed to be registered on Udyam Registration Portal.

⁵<https://rbidocs.rbi.org.in/rdocs/notification/PDFs/MSME25199EAA23EF4A409B11F776148EB0E4.PDF>

B. CASE STUDY: State Bank of India & Anr vs Mula Sahakari Sakhar Karkhana Ltd., [2006 (6) SCC 293]
(Distinction between Contract of Indemnity & The Contract of Guarantee)

~ Yogesh Babar

FACTS: Mula Sahakari Sakhar Karkhana Ltd., a cooperative society, engaged in the business of running a sugar factory ("Respondent"), entered into a contract with M/s. Pentagon Engineering Pvt. Ltd. ("Pentagon") for installation of a paper plant at village Sonai on turnkey basis so as to enable it to utilize the left over material called "bagasse" of the sugarcane. The total value of the contract was Rs. 3,40,00,000/-. Pentagon furnished a performance guarantee in regard to the machinery supplied by it. The said contract contained a clause for retention of 10% of the contract price by the Respondent, but Pentagon insisted the Respondent to waive the right of retention instead proposed to have a letter of credit so that they can furnish appropriate bank guarantee. Differences arose between the Pentagon and the Respondent, and the latter invoked the bank guarantee. The demand of the bank guarantee met resistance from the appellant stating that it had executed an agreement of indemnity and not of bank guarantee.

ISSUE: Whether the statements in the document constitute a bank guarantee or a contract of indemnity?

ORDER OF THE HIGH COURT: The matter relating to passing of an interim order went upto the High Court. The High Court by an order dated 23rd February 1988 directed that the said amount be retained by the Appellant subject to the condition that in the event, the suit is decreed the said amount would be paid with interest @ 12% per annum. The suit was dismissed. An appeal was preferred thereagainst by the Respondent before the High Court. The High Court construing the said agreement dated 25.9.1983 to be a Bank Guarantee decreed the suit directing Appellant to pay the said sum of Rs.34,00,000/- with interest @ 14% per annum.

JUDGMENT: The Hon'ble Supreme Court has observed that a document must primarily be construed on the basis of the terms and conditions contained therein. While construing a document the court shall not supply those words which have not been used by the author. The document in question is a commercial document and does not contain any ambiguity. The High Court itself has said that prima facie the document appears to be a contract of indemnity. Surrounding circumstances are considered to be relevant for the construction of the document only when there any ambiguity exists in the document and not otherwise. The said document in question, as per the Court, is considered to be a contract of indemnity and not a bank guarantee as it is clear from the facts that the appellant was to indemnify the cooperative society against all losses, claims, damages, actions and costs which may be suffered by it. The document does not contain such expressions which a bank guarantee contains like "unequivocal condition" or "the cooperative society would be entitled to claim the damages without any delay or demur" or the guarantee is "absolute and unconditional" as has been held by the High court. The High Court has misread and misinterpreted the document and opined that the document is in the nature of bank guarantee and not a contract of indemnity.

It was clearly stated that the bank guarantee consists of a separate, distinct and an independent contract between the bank and the defendants. The document, in the case before the Court, does not specifically refer to any particular clause of the contract. In fact, the contract does not contain any clause requiring Pentagon to furnish any bank guarantee. It is to say that the nature of transaction would be judged together with the surrounding circumstances in a case where a document suffers from any ambiguity, but it is also to say that the courts will take recourse if no such ambiguity exists. It is beyond any quibble that a bank guarantee must be construed on its own terms. It is considered to be a separate transaction.

HELD: The Court held that the said document in question constitutes a contract of indemnity and not a document of guarantee as it was clear from the facts that the appellant was to indemnify the respondent against all loses, claims, damages, actions and costs which may be suffered by it which consists the nature of document as a contract of indemnity. The Court set aside the impugned judgment of the High court and restored the decree passed by the Trial court. Appeal is allowed with costs.

C. YOUR LEGAL QUERIES ANSWERED

(Answers by K. Selvaraj, Group General Counsel and Head Compliance, Corporate Office, Mumbai)

Q) Whether a Hindu Undivided Family (HUF) can become a partner in a partnership firm?

A) HUF is not a juristic person for all purposes and as such it cannot become a partner with another HUF or individual. But Karta of the HUF can enter into a partnership as a representative of the family. When the Karta of the HUF enter into partnership with the strangers, the members of the family do not become members of the partnership. However, courts have held that creditors of such partnership firm would be entitled to proceed against the assets of HUF. The courts further held that the liability of the non-partner co-parceners arises by reason their status as co-parceners and not by reason of any contract of partnership by them

Q) In the event of death of a borrower or co-obligant/co-borrower to a loan whether his heirs can be impleaded in the court of law for recovery of debts even though there is no covenant in the loan document to bind his legal heirs?

A) In case of death borrower/ co-borrower, his estate is liable. In the event of his death, his legal heirs can be impleaded in the recovery suit. However, the liability of the legal heirs is limited to the extent of assets inherited by them from the borrower/co-borrower.

Note: The above shows importance of having details of (a) all assets owned by the borrowers and co-borrowers and (b) details of their legal heirs, in our credit file which will help us in the event of death of the borrower/co-borrower.

D. ESG: THE INTERPLAY BETWEEN CSR AND ESG NORMS⁶

Across the world, there is a growing demand on corporations to focus on sustainable development goals and strengthen the social responsibility of business. Working in sync with each other, while Governments are taking initiatives to bring legislative changes, investors also have started to value and consider such factors as key parameters for making an impact with their investment.

The investors (such as private equity funds, venture capital funds, social venture funds, banks, financial institutions) are looking towards going a step further to not just focus on monetary returns but also achieve positive social and environmental impact. The impact of COVID-19 has already created ripples in society to switch focus on various social goals.

Against this backdrop, the framework in India has progressed significantly with increased accountability for directors, key personnel and more disclosures relating to businesses. A series of efforts have been taken by the Indian Government, one of which requires spend of 2% of average net profits by India Inc. (certain eligible companies) towards corporate social responsibility (CSR) activities in eligible areas.

The move to introduce a CSR regime went beyond philanthropic activities to create a systematic model to create impact in society. The CSR objective of the Government works in sync with the Government's focus on expansion of disclosures on environment, social and governance (ESG) reporting by Indian listed companies. In fact, a company's reporting of performance on sustainability-related factors has become as vital as reporting on financial and operational performance.

Given the above context, this article analyses the interplay between the CSR and ESG regimes in India and how the corporations and investors would be impacted by these measures.

Development of social responsibility of businesses

The first milestone in the evolution of identifying social responsibility of businesses was the release of the Corporate Governance Voluntary Guidelines in 2009 by the Indian Ministry of Corporate Affairs (MCA), to encourage corporates to voluntarily achieve high standards of corporate governance. This was followed by the release of the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business (NVGs) in 2011, which were subsequently used by the securities markets regulator in India, Securities and Exchange Board of India (SEBI) to frame the Business Responsibility Reports in 2012 and top 100 listed companies by market capitalization were mandated to file such reports. Later, in 2015 the mandatory reporting was extended by SEBI to top 500 listed companies by market capitalization.

With the enactment of the Indian Companies Act, 2013 (the "Act"), the concept of CSR spending achieved legal recognition and apart from Section 135 of the Act which deals with the requirement, conditions and compliances for CSR spending, Section 166 of the Act also emphasized on the obligation of each director to 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 not only the company, its employees, shareholders but also the community and for the protection of environment. In 2019, MCA revised the NVGs and

⁶ An article by Manendra Singh, Associate Partner and Tanvi Goyal, Principal Associate at Economic Law Practices published in CSR Journal (July 2021 edition).

<https://thecsrjournal.in/interplay-csr-and-esg-norms-india-investors-elp/>

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formulated the National Guidelines on Responsible Business Conduct, which lays down nine principles of business responsibility.

Section 135 of the Act and its rules were recently amended on January 22, 2021, to provide that spending CSR amount will be mandatory and mere statement of a reason for not spending the required amount on CSR activities will not suffice. However, keeping in view that not all CSR activities are likely to be completed in the same year of its commencement, any unspent CSR amount for the financial year has been classified into two buckets, one relating to ongoing projects and another relating to non-ongoing projects. In either case, there is a sunset period within which the unspent CSR amount for each financial year is to be transferred to the specified Government fund or unspent CSR account opened by the company.

To further encourage CSR spending, the amount spent in excess of the CSR obligation of 2% of the average net profits of the company can now be utilized to set off against the CSR obligation of 3 subsequent financial years. To further ensure that CSR amounts are spent in the manner intended under the Act and the rules framed thereunder, the new revised rules require the Chief Financial Officer of the company to certify that the CSR funds have been disbursed and utilized in the manner as approved by the board. Even the annual disclosure report has undergone changes and now more detailed information about the CSR projects, allocation of CSR funds, unspent amount, excess spending, carry forward, etc, is required to be reported.

ESG reporting: Impact investing

A varied set of investors are looking to invest in assets that have ESG integrated or sustainable investing models. Their intent is not to just make profits but make impact in the social and environmental fields. The increased focus of stakeholders seeking corporations to be responsible and sustainable towards ESG goals has witnessed Governments actioning various legislative changes.

In the Indian context, SEBI on May 5, 2021, replaced BRR (Business Responsibility Report) with the Business Responsibility and Sustainability Report (BRSR) which imbibes the ESG principles. To begin with, BRSR has been made applicable to the top 1,000 listed entities (by market capitalization calculated as on 31st day of March of every financial year), for reporting on a voluntary basis for financial year 2021-22 and thereafter on a mandatory basis from financial year 2022–23.

SEBI has prescribed a detailed format and guidance note for BRSR and requires listed entities to disclose on their performance against the following nine principles of the 'National Guidelines on Responsible Business Conduct' (NGBRCs). The reporting under each principle is divided into essential and leadership indicators. The essential indicators are required to be reported on a mandatory basis while the reporting of leadership indicators is on a voluntary basis.

Principles of ESG Reporting

1. Businesses should conduct and govern themselves with integrity in a manner that is Ethical, Transparent and Accountable.
2. Businesses should provide goods and services in a manner that is sustainable and safe
3. Businesses should respect and promote the well-being of all employees, including those in their value chains.
4. Businesses should respect the interests of and be responsive to all their stakeholders.
5. Businesses should respect and promote human rights.

6. Businesses should respect and make efforts to protect and restore the environment.
7. Businesses, when engaging in influencing public and regulatory policy, should do so in a manner that is responsible and transparent.
8. Businesses should promote inclusive growth and equitable development.
9. Businesses should engage with and provide value to their consumers in a responsible manner.

Some of the key disclosures under the new BRSR include disclosures relating to environment, waste generation and management, employees/ workers employed including benefits given to them, occupational and health safety management systems implemented, safety related incidents, process used to identify work-related hazards, measures taken to ensure safe and healthy work place, consumer complaints, product labelling and recall, CSR, details of fines/ penalties paid in proceedings with regulators, etc.

Systematic disclosure on BRSR will help the stakeholders assess and mitigate the ESG risks, and at the same time, also require the companies to put system in place to ensure that ESG reporting is true and correct as many investors will base their investment considering ESG as a key factor.

Way forward for corporate India and investors

The revised CSR norms and ESG reporting are likely to help stakeholders in understanding the compliance by companies of the laws relating to ESG. While the benefits of CSR and ESG reporting are immense, at the same time, corporates need to be careful of what they disclose and ensure that the disclosures are in line with the current legal requirements relating to labour, environmental law, consumer law, etc. ESG and CSR will also act as potential tools to engage into meaningful conversations with the stakeholders and create value. While in the beginning, ESG and CSR have been made applicable to certain limited corporations, however, with the results and impact, their reach may well be expanded to other entities as well.

ESG may be in its nascent stage at the moment, however, with the global economies' focus shifting to sustainable development, reducing carbon footprint, fulfilling beneficial social and environmental goals, it will make investors closely assess ESG and CSR factors in identifying their potential investments to have an impact. The diligence exercises carried out by investors will indeed have dedicated focus on ESG norms. It is important therefore, for corporations and stakeholders to carefully assess the disclosures and compliances with ESG and CSR norms, in consultation with their advisors, both legal and financial.

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