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THE ROLE OF ESG IN CORPORATE GOVERANCE: LEGAL PERSPECTIVES

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ABSTRACT

The term ESG i.e. Environmental, social and governance is actually similar in context to the connotation CSR i.e. corporate social responsibility however ESG is more concrete; it possesses the information and measurements required to guide corporate and investor decision-making."ESG, at its core, is a means by which companies can be evaluated with respect to a broad range of socially desirable ends. ESG describes a set of factors used to measure the non-financial impacts of particular investments and companies."[2]

The main purpose of ESG is to push the companies to strike a balance between sustainability and development. Organisations have to deal with both product management as well as environment safety and consumer satisfaction , a direct nexus has to be drawn between these areas so to enable the organisations to grow. The E in ESG stands for environmental aspects covering the effect of company's activities on environment , the S stands for social relationship of company with outsiders i.e the consumers and G stand for the governance i.e. the rules followed by the organisation.

Thus, the present article attempts to understand how ESG factors influence corporate decision making from legal perspective, focusing on the G aspect of ESG making the companies accountable for their activities and understanding its impact on the corporate governance. This article focuses on understanding ESG in corporate governance by examining the international and national standards in India with help of relevant judgements.

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[2] Ariel Deckelbaum, Brad Karp, David Curran, Jeh Charles Johnson, Loretta Lynch, Mark Bergman, Paul Weiss, *Introduction to ESG*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERANCE(Aug. 1, 2020) , https://corpgov.law.harvard.edu/2020/08/01/introduction-to-esg/.

INTRODUCTION

A company's capacity to ensure the environment, overseepartnerintuitive, and maintaininner control over administration, authority, decision-making, and shareholder rights is measured by a set of measures known as ESG.

The present period of sustainable development makes it more essential to study the ESG as a tool for sustainable business activities and consumer concerns. Since individuals have become more cautious about the impact of their purchasing decisions , companies are facing a high pressure of keeping itself environmental friendly. For example , the recent makeup brands like letshyphen, rare beauty are being injected into the society with the main agenda to attract the eco-friendly niche of consumers and thus showcasing how consumers are ready to pay high for products with ESG claims rather than those without these claims, as also shown by a study conducted by McKinsey & Company and NeilsenIQ that in many categories of products there was a direct link between ESG related claims and consumer spending[3].

ESG as an idea have been existing since centuries back to 1950 Howard Bowen's book "Social Responsibilities of the Businessman" which started the concept of corporate accountability and which with time developed into corporate social responsibility popularly known as CSR but sine it could not live up to the moment and due to the dissatisfaction attached with this concept it lead to the emergence of ESG.

The integration of ESG in corporate governance is not only to get consumer loyalty to your brand and high return on investment, but also to ensure that the business does not violate environmental regulations and thus lowering its value and stake in the market. Investors are also interested in investing in companies that are more inclined towards ESG initiatives ensuring future benefits. It tries to put the organisation in a setting where it is guided to follow the basic principles or standards of sustainable development.

UNDERSTANDING ESG THROUGHLEGAL FRAMEWORKSAND REGULATIONS

International standards- Broad guidelines for ESG integration are provided by international standards like the OECD Guidelines for Multinational Enterprises and the UN Global

[3]Consumers care about sustainability—and back it up with their wallets, https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/consumers-care-about-sustainability-and-back-it-up-with-their-wallets#/ (last visited July 2024)

Compact. There are ten fundamental UN global impact principles that help businesses protect the environment. The following are pertinent when discussing ESG in corporate governance:

Principle 1: Companies shall uphold and respect the defense of internationally recognized human rights.
Principle 2: Verify that they are not involved in violations of human rights.
Principle 7: Companies ought to encourage taking preventative measures when dealing with environmental issues.

Principle 8 : Take action to encourage more environmental responsibility.

Principle 9: Promote the advancement and adoption of eco-friendly technologies.[4]

By adhering to these principles, the corporations can ensure that they fulfil global sustainable development goals. The goal of the companies should be to make profit and increase their customer base and market segmentation which is only possible in today's environmental sensitive world, by abiding by the ESG principles. In *Milieudefensie et al. v. Royal Dutch Shell plc* , in this case the court gave the decision ordering Royal Dutch Shell to lower the emission of carbon thereby it can be held that this decisionhighlighted the need to include climate-related ESG concerns into corporate governance by emphasizing the legal responsibilities of firms for their environmental impact.[5] In *ClientEarth v. EIB*[6]the point that was highlighted which is to be noted in respect of this article is that financial institutions face higher legal risks if their practices do not align with ESG principles , ensuring a direct nexus between corporate governance and sustainability.

National standards -

If we talk about India ESG is in its infancy ,starting to progress with the help of various already existing laws and regulations. Though there is no one single or comprehensive piece of legislation but its inference can be drawn from various Acts which deal with various aspects one of the being corporate governance, some of which are-

Companies Act, 2013:

[4]The Ten Principles of the UN Global Compact,https://unglobalcompact.org/what-is-gc/mission/principles, (July 2024)
[5]Milieudefensie et al. v. Royal Dutch Shell plc, (2021) C/09/571932 / HA ZA 19-379
[6]*ClientEarth v. EIB, (2020)* T-9/19

Sec 134(3)m- duty to the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed;[7]

Sec 135. itself provides for Corporate Social Responsibility which can be said to be precursor of ESG concept.[8]

Environment protection act 1986 along with its subsidiariesWater Act 1974 and Air Act*1981*provide for a framework to preserve the environment in short putting pressure on the companies to abide by these rules as in *Vellore Citizens Welfare Forum v. UOI* the court held that despite leather industry being a major source of foreign exchange for India but this does not grant the liberty/privilegeto have the right to destroy the environment.[9]

Securities and Exchange Board of Inida (SEBI) Regulations:

Listing Obligations and Disclosure Requirements (LODR) Regulations, 2015: which makes it mandatory for the listed companies to make ESG disclosures and moreover the recent SEBI amended regulation 34 (2) of the LODR regulations to enhance disclosures of ESG by top 1000 listed companies.

As corporate world id developing at a fast rate so is the scope and requirement of ESG principles.Its for the company's betterment to adopt these principles for its growth and development in today's era of eco friendly customer base which will as a result help it expand its market segmentation and target each and every section of market. Out of all these regulation SEBI plays a pivotal role in implementing international standards in India.

CORPORATE GOVERANCE MODELSAND ESG INTEGRATION

Traditionally the companies or organisations used to follow the shareholder model of governance that basically revolves around the idea of increasing the overall profitability of the company ,and the main goal of the company was to be profit -oriented. Indeed, the increased awareness of sustainability and the mandatory nature of corporate social responsibility have led to a significant shift from the shareholder model to the stakeholder model of corporate governance. Now as per the stakeholder model the company is not only concerned with money making i.e. the interest of the shareholders but all the conflicting demand/goals of all the stakeholders be it the customer, employees, supplier, government or

[7] The Companies Act, 2013, No. 18 , Act of Parliament , 2013 (India)
[8]Ibid.
[9]Vellore Citizens Welfare Forum v. UOI , (1996) SSC 647

most importantly the society ,forcing the organisation to incorporate sustainable goals in their governance process and thereby reducing environmental degradation. This is short means incorporation or integration of ESG in corporate governance that i.e. introduction of environmental and social concerns in governance by the companies which is in fact beneficial for the companies as it provides them an edge above their competitors.

"This perspective shift from a shareholder approach to a stakeholder approach promotes a broader view of success that goes beyond financial gain. It allows businesses to incorporate sustainability and social responsibility into their strategies, resulting in a positive impact on the society and environment in which they operate.While the shareholder approach has its merits in driving economic growth, it can limit a company's long-term viability by focusing narrowly on financial outcomes. Conversely, the stakeholder approach, by taking into account the broader spectrum of influences and impacts, can potentially foster a more sustainable and inclusive business environment."[10]

CHALLENGES AND CITICISM ININCORPORATING ESG IN CORPORATE GOVERNANCE

One of the key challenges in incorporating ESG in corporate governance is the lack of metrics which are drafted as per standard methods and reporting frameworks. Thus making it difficult for companies to consistently measure and report their ESG performance, leading to inconsistencies and incomparability of ESG data across different organizations.

Another challenge is the act of greenwashing, in which companies engage themselves in misleading or superficial ESG methods to create in the eyes of public a positiveimage without making drastic changes to their actual practices. This can be a concern for investors and stakeholders who rely on ESG information to make decisions.Additionally, there are criticisms that incorporating ESG factors into corporate governance may prioritize non-financial goals over the economic interests of shareholders. Critics argue that this could lead to a lack of focus on maximizing shareholder value and ultimately harm the company's financial performance.

[10] Yaser Mutaher, *Shareholder Vs. Stakeholders: A Shift in Organizational Focus,* Linkedln*(July 23, 2024, 9:29 PM) , https://www.linkedin.com/pulse/shareholders-vs-stakeholders-shift-organizational-focus-yaser-mutaher/*

Greenwashing by companies about their ESG claims has unpleasant repercussions both for the consumers and company itself , because it has to face with legal implications for the conduct. As per the 2022 the European commission (EC) laid down certain proposals that will protect the consumers against greenwashing.Highlighting the key aspect of the proposal- “Two other EU-level initiatives would complement this proposal: the Green Claims initiative and the Sustainable Products initiative. The objective of the Green Claims initiative will be to introduce further requirements in relation to environmental claims made about products and organisations, both when made by businesses towards consumers and by businesses towards other businesses.”[11] In short this would make the companies have a clear plan of action for ESG and make public statements according to avoid any legal or financial crisis.

“Organisations also face difficulties in adapting existing business models to align with ESG principles, often encountering internal resistance when making complex strategic decisions, such as determining the timing and approach for discontinuing business with high-emission sectors. Additionally, the compartmentalised nature of ESG initiatives across departments can lead to inefficiencies and a fragmented strategy.”[12]

Moreover, there is a lack of regulatory clarity and enforcement mechanisms around ESG requirements, making it challenging for companies to navigate the evolving landscape of ESG regulations and guidelines.

Lastly, some stakeholders express concerns about the cost and resource implications of integrating ESG considerations into corporate governance, particularly for smaller companies with limited capabilities to implement and monitor ESG practices effectively.

UNDERSTANDING THE IMPACT OF IMPLEMENTATION OF ESG INCORPORATE GOVERANCE: CASE STUDIES

The implementation of ESG has been beneficial for some companies while detrimental for others depending their method of adoption of ESG model. Lets try to delve deeper into this concept by understanding some real world examples of how ESG activities have influence the corporate management and its growth and popularity.

[11]EU LAW- EUR-LEX, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0143&qid=1649327162410, (last visited July 24, 2024).
[12]Maarten Rijssenbeek, *Stefanie Citroen, The Critical Point of ESG Integrity Governance: Addressing Challenges Today for a Sustainable Tomorrow*,1, 2, 2024, https://www2.deloitte.com/content/dam/Deloitte/nl/Documents/finance/deloitte-fa-critical-juncture-of-esg-integrity-governance.pdf

An interesting case study can be of makeup brand launched by Selena Gomez that is Rare Beauty. The main aim of the brand as advocated by the owner herself was to endorse a brand which supports mental health awareness and social impact by starting the Rare impact fund alongside its beautification products. The impact fund raises money with corporate partners and its community to support organisations that are inclined towards the same goal i.e to reduce the taboo associated with mental health issues.Rare Beauty has integrated ESG principles into its brand identity, focusing on social relations with consumers and environmental aspects. By studying the implementation of ESG principles by rare beauty we can understand how its practice has influences its customer relationship thereby increasing the customer reach. It helps us to understand how it positively impacted its product development for say the hand creams are designed in such manner that it can be easily operated by a person having shaky hands as a result of lupus. It ultimately helps the brand to earn a higher profit by resonating with group of people who are ready to pay high for products having ESG values.So,it sheds light on the potential synergies between ESG values and business success, serving as a compelling example of how companies can align their core mission with broader societal and environmental goals.

Comparing it to the well known example of Unilever company which also had a positive implication of implementation of ESG principles in its corporate management. Some of the initiated to be noted were launch plant based foaming materials etc .It acts a great examples how by introducing innovation and social responsible practices can help businesses make an important mark on the well being of the society and at the same time prove financial beneficial for them that is aligning of short term gaols with long term success.

Both these case studies act as example of positive effects of implementation of ESG in corporate governance as studies prove that consumers of both these companies were ready to pay a high cost for best quality sustainable products , there by striking a perfect balance between the needs and demand of the modern environmental friendly society and growth of profit market for the companies.

This being one side of a coin, the other side being the negative impact of ESG principles on company's financial component even though it promotes sustainability. False reporting of ESG statics can have a huge negative impact on the company's growth and position in the market."For example, in 2014, the market value of Volkswagen lost approximately 15 billion euros due to its emission manipulation scandal. The Volkswagen scandal began in early 2014 with the release of results from an investigation by the International Council on Clean Transportation Report (ICCT). Volkswagen installed defeat device software in their diesel engine (EA 189) to manipulate emission control. This software could identify when the vehicle was being tested and adjust the emission control system accordingly .By disabling the nitrogen oxide storage catalytic converter, the nitrogen oxide emissions would exceed the official limit by up to forty times.The scandal led to a significant drop in Volkswagen's share value, losing over 20% within days. Additionally, a global recall of 11 million vehicles incurred a total cost of 6.7 billion euros."[13]

Another important case study showcasing the negative impact of false ESG reporting is of Johnson &Johnson company which errored in proper disclosure of the contents (cancer causing chemicals) of its product that is sunscreen. Due to its fault had to suffer a huge loss both financially and reputation wise as it had to remove the said product from the market after the disclosures.

These two case studies well explain how false ESG claims can decrease its efficiency and lead to financial stress. This case study of positive as well as negative impact basically highlights the issue of burden on companies to incorporate ESG practices due to its benefit for the environment and more consumer attraction, in lieu of this companies end up in practices such as greenwashing leading to a long run negative impact on its reputation. So though it is true that companies with ESG initiates are more preferred by consumers but it should be kept in mind that no matter what at the end the company that strikes a balance between honesty and profit is the one which wins the race in long run. Hence companies should go for transparency rather than malafide practices and maintain a much-needed balance between their business and need of the hour that is sustainability.

CONCLUSION

Environmental and social governance as popularly called as ESG is no doubt the leading topic of concern and discussion in this era. With the increase in alignment towards sustainability and sustainable products , ESG has become the need of the hour. ESG has become the part and parcel of the aspect of growth of organisations, in today's time no

[13]Rui Xue a,* , Hongqi Wang b , Yuhao Yang b , Martina K. Linnenluecke c , Kaifang Jin d , Cynthia Weiyi Cai, *The adverse impact of corporate ESG controversies on sustainable investment*, 427 JCLEPRO 1, 1-2 (2023).

company can get maximize market without indulging in ESG practices. As discussed prior to ESG the area dealing with same concept was CSR that imposed mandatory obligation on the companies to give a certain amount of their turnover towards societal concerns, "however CSR activities are scatters as different companies do CSR in different directions,in different States and in different sizes. In the absence of an integrated approach, CSR will work like an unorganised sector. Therefore, achieving Sustainable Development Goals (herein after referred to as SDG) through CSR Activities enforced through section 135 of the Companies Act, 2013 will be very difficult."[14]

With the increase of degradation of environment be it in from of dump disposing , cutting of greenery and vehicular and industrial pollution , people have become conscious about the effect and repercussions of these uncontrolled human activities on the planet."In simple words, in common man's language, it could be said that the ecological balance is deteriorating due to indiscriminate cutting of trees and removal of forest cover for urban living, as a result of which there are not enough trees and plants to observe the CO2. Released by these constructs. Therefore, the underlying theme of ESG is to introduce ways and means for sustainable living."[15]

Thus, to conclude its high time that companies take steps for ESG that is environment concerns which will be beneficial for both parties that is the environment and companies as well, but all this should be done keeping in mind the effects of false ESG reporting of metrics by the companies. So, its for the companies to maintain an equilibrium between fair reporting of ESG metrics and maintaining their financial levels. It's not only companies to act actively to reduce the environmental degradation but we all that is the companies, consumers and government as a single unit should take the required steps, because its not about me and you its about us that is the planet as a whole.

FUTURE DIRECTIONS/ SUGGESTIONS

a) ESG as a concept is continuously expanding but needs to match the pace of growth in technology. The legal sphere of ESG is also evolving with shift of focus on transparency and accountability.

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[14]DR.K S RAVICHANDRAN, CSR,ESG & CHARITABLE INSTITUTIONS 185 (LexisNexis 2024)
[15]DR.K S RAVICHANDRAN, CSR,ESG & CHARITABLE INSTITUTIONS 184 (LexisNexis 2024)

b) Companies need to adopt the best possible management methods to ensure sustainability which will in fact help them attract new customers and thereby increasing their profit market.

c) As per Forbes report companies require stewardship that is focusing on a wide range of issues rather than limiting the goals.

d) For effective ESG implementation companies should focus on long term goals and adopt the latest technological changes like adopting new tools for data collection and ESG metrics reporting.

e) Business should act keeping in mind this quote as rightly stated by "Sarah Gillard, CEO, (a Blueprint for Better Business),*Businesses designed to create value for society are also good businesses that manage to sustain themselves during crises*"