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ESG in Action

ROLE OF ESG

AS PART OF DIRECTORS' DUTIES IN THE DECISION MAKING PROCESS

In recent years the topic of environmental, social and governance ("**ESG**") has been trending. The COVID-19 pandemic further accelerated ESG, especially in the light of issues surrounding forced labour and modern slavery. Organisations are now not only subject to scrutiny from regulators, but also other stakeholders such as investors, activists and society at large. Given the increased interest from stakeholders, there are calls for organisations to consider ESG in its business undertakings.

In this article, our Partner Muhammad Zukhairi bin Muhammed Salehudin of the Corporate Finance and Securities practice group of Zaid Ibrahim & Co. (a member of ZICO Law) provides an overview on the duty of Malaysian directors to consider ESG in the decision making process, focusing on duties under the Companies Act 2016.

Environmental, social and governance ("ESG") issues have been substantively discussed in recent years. The ongoing global situation with COVID-19 has further accelerated the discussion on ESG, particularly concerning issues surrounding forced labour and modern slavery. Business organisations have been the subject of scrutiny, not only from the regulators, but also other stakeholders such as, investors, activists and society at large.

Malaysia and Forced Labour

Given the increase in demand of medical gloves supplies due to COVID-19 pandemic and considering that Malaysia is the world largest glove manufacturer,[1] Malaysian manufacturers have been the subject of the scrutiny related to forced labour and modern slavery. The US Customs and Border Protection has been issuing "withhold release order" to multiple Malaysian glove manufacturers prohibiting imports from these manufacturers into the US. The main reason cited is that there exists forced labour and modern slavery in production facilities of these manufacturers. The issue was further intensified by a study on "*Forced labour in the Malaysian medical gloves supply chain during the Covid-19 pandemic*" conducted by the UK-based Modern Slavery & Human Rights Policy & Evidence Centre in 2021.[2] The study found that all 11 ILO Forced Labour Indicators were present in these manufacturers even prior to the COVID-19 pandemic, with four out of them worsened during the COVID-19 pandemic.

Call for Change

Given the heightened interests from various stakeholders, there have been calls for business organisations to take into account ESG factors in its business undertakings. The aim of this article is to provide an overview on the duty of Malaysian corporate directors to consider ESG in the decision making process with focus on directors' duties under the Malaysian Companies Act 2016 ("**CA 2016**").

Why Directors?

"***Quality*** *starts in the boardroom.*"

A company, being an artificial person, cannot act on its own but rather through the agency of natural persons. These natural persons are its directors, who are empowered to make all decisions in the running of the company. This is reflected in section 211(1) of the CA 2016 which stipulates that the business and affairs of the company shall be managed by, or under the direction of the Board of directors ("**Board**"). Any decision taken by the Board is a decision taken by the company. It follows that, any possible ESG impact from business undertakings of a company is dependent upon the Board's stance over ESG factors in its deliberation on any decision to be made for the company.

Are Directors Required to Consider ESG?

It goes without saying, to the extent that there are specific legislations on any of the ESG factors that are applicable to the business undertakings of the company, the directors must ensure that the company abides with such legislations. Therefore, all decisions to be made by the directors should take into consideration on the implication of such decisions in respect of the company's compliance with the specific legislations. These include legislations such as the Environmental Act 1974, Wildlife Conservation Act 2010, Employment Act 1955, Employees' Minimum Standards of Housing, Accommodations and Amenities Act 1990, etc. to the extent applicable. Under these legislations, the directors may be personally liable for the company's failure to comply with these legislations.

However, in a situation where the legislations related to any of the ESG factors are not directly applicable to the business undertakings of a company or that there are no legislations concerning the relevant ESG factors, the question remains, should the directors consider ESG factors in the decision making? In particular, whether the CA 2016 imposes any requirement on the directors to do so? An immediate answer to this is that the CA 2016 does not have specific provisions requiring the directors to consider ESG in their decision making process. In contrast, and as a matter of comparison, the UK Companies Act 2006 has a specific provision requiring the directors to consider, among others, the interest of the employees, the need to foster the business relationship with suppliers, customers and the implication of the company's operation on the community and environment. Thus, in the absence of such clear provision in the CA 2016, would that mean the directors have no duty to consider the ESG factors at all?

To answer the above, the ensuing paragraphs will broadly discuss the key duties imposed by the CA 2016 on the directors before analysing whether these duties require the directors to take ESG factors into consideration in the decision making process.

Section 213 of the Companies Act 2016

Section 213(1) of the CA 2016 is the key provision relating to the duties of the directors in Malaysia. It requires a director at all times to exercise his powers for proper purpose and in good faith in the best interest of the company. Often, when any decision is challenged at the court, the court will consider whether the directors have complied with this key provision in making any decision, failing which such decision may be held to be irregular or deficient, and the directors may be held to have breached his/her duties. It is important to note that, each director owes this duty to the company separately and independent of the other directors. A director may be subject to any action for breach of duty notwithstanding participating in a collective decision-making process.

SECTION 213(1) HAS TWO LIMBS

Firstly, the director must exercise the power conferred to him/her for a proper purpose.

Secondly, the directors should ensure that the decision was made in good faith in the best interest of the company.

Notwithstanding this, each of them is not to be considered exclusively over the others. This can be seen through many decisions of the courts which held that if a decision of the directors was made for an improper purpose, the decision may be challenged and the directors may be considered to have failed to act in the best interest of the company as required by section 213(1).

Proper purpose?

What is considered as proper purpose? Or, should the precise question be, what is considered as improper purpose? Loosely, it refers to the underlying objective of the decision made. In cases where improper purpose is pleaded, the improper purpose typically relates to any ulterior motive of the directors such as the directors' pursuing their own benefit or to preserve their control over the company. However, it is often in practice that there could be multiple purposes influencing the deliberation and decision made by the directors, either from the company's perspective or the individual director's own perspective. Take for example, a scenario where the directors decide to acquire certain assets and agree that the seller is to be issued with new shares in the company. This is perfectly legal and within the power of the directors under the CA 2016. The purpose of the acquisition could be to facilitate a long term growth of the company, increase revenue to the company and consequently increase the potential dividend payable to the shareholders. However, it is also possible that the actual main purpose of the acquisition and issuance of the consideration shares to the seller is to dilute the voting power of the existing shareholder(s) of the company, which may risk of being held to be improper.

In the scenario where there are multiple purposes, the court will ascertain the individual states of mind of the directors at the time when the decision was made to examine what was the substantial or dominant purpose for which the directors made such a decision and whether the directors were pursuing a proper purpose or otherwise. Given that the court is an independent third party not involved in the decision making, the court will definitely rely on all written documentation relevant to the issue in hand as well as oral statement made by witnesses brought to the court.

This was perfectly illustrated at length by the High Court judge in the case of Petra Perdana Bhd vs Tengku Dato' Ibrahim Petra bin Tengku Indra Pertra & Ors.[3] In this case, the court was called upon to ascertain whether the primary or dominant purpose of the decision of the directors to divest the company's investment in an investee company was to meet genuine cash flow problem of the company or a conspiracy to deplete the company's majority shareholding in such investee company hence injuring the company. In doing so, the court had to look at the minutes of several board meetings, audio recordings and oral evidence from key witnesses to picture the circumstances surrounding the decision.

Best interest of the company?

In addition to the foregoing, it is important for the directors to ensure that the decision made is in the best interests of the company. The phrase "best interest of the company" has no single meaning applicable to all cases. Depending on the circumstances, it may be pegged to the interest of the company as a separate entity, or to the shareholders of the company collectively, and in some cases the interests of the company may not be directly involved at all. Therefore, it is upon the directors to make a judgment call of what is considered to be the best interest of the company.

If a decision of the directors is challenged, the court will apply subjective and objective tests. The test is subjective because the court will consider whether the director had exercise his/her discretion bona fide in what he considered (and not what the court considers) is in the best interests of the company. In other word, the court will not use the benefit of hindsight that it has to substitute its own decision for that of the directors. The test is objective too because the court will objectively assess whether an intelligent and honest man in the position of a director of a company could have reasonably believed that such decision was for the best interest of the company.

ESG Factors and Directors' Duties

As noted above the CA 2016 does not have specific provision requiring the directors to consider ESG factors. Consequently, under the CA 2016, it is not mandatory for the directors to take into consideration the ESG factors in decision making. However, considering that the directors have an overriding duty to exercise their duty for proper purpose and act in the best interest of the company, arguably, giving consideration to ESG factors in decision making process may very well fall within this duty. This is especially the case where the relevant ESG factors materially affect the interests of the company, be it from the perspective of risk or opportunity, and that it is not considered as improper to take into account the ESG factors.

For example, in deciding whether the company should merge with another company, the directors should consider the implication of the merger to the employees of the company in addition to the typical commercial consideration of the merger. The employees are among the main stakeholders of the company. Failure to consider and address any concern regarding the implication of the merger on the employees may upset the employees. It follows that, if majority of the employees decide to leave the company, it may likely pose material risk to the operation of the company, hence impacting the interest of the company. Therefore, it is important for the directors to consider this in the decision making process regarding the merger, failing which, could potentially be viewed as a breach of duty by the directors.

As analysed above, the court will not rely on the subjective test alone in determining whether the decision of the directors is in the best interest of the company, but will also apply the objective test. If, by applying the objective test, the court is satisfied that an intelligent and honest man in the position of a director of a company could have reasonably believed that considering the ESG factors is in the best interest of the company, but the directors failed to do that, the directors would likely be held to have breached their duty under the CA 2016.

As a practical guide, it is prudent for the directors to consider documenting all deliberations and discussions on ESG factors implication properly. This can be documented in the minutes of the Board meeting or any recording device. As noted above, if there is a dispute, the court will rely on written and oral evidence in ascertaining whether the directors have breach the statutory duty. Therefore, having proper record on the ESG factors discussion will assist the court to decide.

Other Reasons

In addition to the legal consideration above, the directors may also wish to consider whether there could be any reputational risk to the company if the decision taken by the directors falls short of the expectation from various stakeholders of the company on the ESG factors. These stakeholders are those interested or affected by the operations of the company such as the investors, activist shareholders, employees, suppliers, customers, as well the public at large.

The push by these stakeholders on ESG factors has become increasingly evident. For instance, back in January 2021, BlackRock made it public that it will vote, and in fact voted, against the re-election of six independent directors of Top Glove Corporation Berhad in its annual general meeting. BlackRock decided to do this because it held the view that "the Board had failed in its oversight responsibility relating to its migrant workers' health and safety". Earlier than this, the shareholders of FGV Holdings Berhad, including an institutional investor, voted against several resolutions relating to the remunerations of the directors of the company to show their displeasure towards the proposed remunerations for directors albeit FGV's financial standing at the time. Similarly, in December 2021, the Employees Provident Fund disposed its interests in VS Industry Bhd and ceased to be its substantial shareholder following the news on potential labour problem at the company. The disposal was followed by another disposal of interest in the company by Kumpulan Wang Persaraan (Diperbadankan) on the same day.

For companies listed on the Main Market of Bursa Malaysia Securities Berhad, there is an expectation that it adheres to the Malaysian Code of Corporate Governance ("**MCCG**") issued by the Securities Commission Malaysia which is further elaborated by the Corporate Governance Guide ("**CGC**") issued by Bursa Malaysia Berhad. Included in the MCCG is a principle relating to meaningful relationship with stakeholders. The "stakeholders" is explained in the CGC to include, among others, shareholders, employees, customers, local communities, business partners etc. Although the MCCG and the CGC are soft law in nature, the listed companies are required under the Listing Rule to disclose on the application of the principles set out in the MCCG in its annual report. If a listed company decides not to adhere to the MCCG, it may possibility ruin its reputation and be disciplined by the market and investors at large.

Conclusion

Based on the foregoing, the CA 2016 does not directly require the directors to consider ESG factors in their decision making process. Nevertheless, to the extent that the ESG factors have sufficient nexus to the interests of the company, the directors should consider them in the decision making process. In addition, as scrutiny on business organisations related to ESG factors heightened, it is prudent for directors to bear in mind ESG factors even if they are not legally required to do so.

[1] 'Malaysian rubber glove group says demand to oustrip supply until 2023' Reuters (15 March 2021) <https://www.reuters.com/article/us-malaysia-gloves-idUSKBN2B709W>.

[2] Mahmood Bhutta, Ben Bostock et at, 'Forced labour in the Malaysian medical gloves supply chain during the Covid-19 pandemic, Research Summary' (Modern Slavery & Human Rights Policy & Evidence Centre, July 2021) <https://modernslaverypec.org/assets/downloads/Malaysia-research-summary.pdf>.

[3] [2014] 11 MLJ 1.

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Zukhairi is experienced in advising corporate clients in various sectors such as banking, manufacturing, telecommunications, property development, energy, shipping, logistic & warehousing, food chain, retail, venture capital & private equity. Zukhairi has been heavily involved in a wide range of corporate exercises including:

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- Mergers & acquisitions involving publicly listed corporations and private corporations, either acting for the seller or the buyer, including advising on foreign direct investment;
- Reorganisation and restructuring of publicly listed corporations and private corporations involving scheme of arrangement, capital reduction and repayment;
- Establishment of Shariah funds, management of the funds, investments, exits and closure of the funds;
- Corporate advisory on other areas of corporate exercise such as management buy-out, take-over, rights issue, restricted offer for sale, derivatives, business trust, employee share scheme and foreign equity offering into Malaysia.

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