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COMMENTARY

India's New Corporate Social Responsibility Requirements – Beware of the Pitfalls

In August 2013, the Indian parliament passed the Indian Companies Act, 2013 (the "New Act"), which has replaced the Companies Act of 1956. The New Act has made far-reaching changes affecting company formation, administration and governance, and it has increased shareholder control over board decisions. The New Act is being implemented in stages, and we have been monitoring its progression.

Corporate Social Responsibility

One of the New Act's most startling changes—which came into effect on April 1, 2014—has been to impose compulsory corporate social responsibility obligations ("CSR") upon Indian companies and foreign companies operating in India. These obligations mainly come in the form of mandatory amounts companies must contribute to remediating social problems. This is a wholly new requirement; although companies were permitted, within certain limits, to make charitable contributions in the past, the New Act is essentially a self-administered tax. The Indian Ministry of Corporate Affairs recently has published, or "notified," detailed rules implementing the CSR requirements .

Entities Covered by the CSR Obligations

The threshold coverage levels for CSR are low. Companies are subject to the CSR requirements if they have, for any financial year:

- a net worth of at least Rs. 5 billion (approximately U.S.$80 million);
- a turnover of at least Rs. 10 billion (approximately U.S.$160 million); or
- net profits of at least Rs. 50 million (approximately U.S. [$800,000).

Companies meeting these thresholds are required to develop a CSR policy, spend a minimum amount on CSR activities and report on these activities, or prepare to explain why they didn't.

Required Amount of CSR Spending

An entity or business that meets these specified thresholds must spend on CSR activities no less than two percent of its average net profit for its preceding three financial years. *Net profit* means a company's profits as per its profit and loss account prepared in accordance with the New Act, but excludes profits from a company's operations outside India or dividends received from an Indian company that has itself met its CSR requirements.

Permitted CSR Activities

There is a long list of permissible areas for CSR funding. They include such purposes as ending hunger and poverty; promoting public health; supporting education; addressing gender inequality; protecting the environment; and funding cultural initiatives and the arts.

All CSR funds must be spent in India. The New Act encourages companies to spend their CSR funds in the areas where they operate, but money cannot be spent on activities undertaken that are part of the normal course of the company's business or on projects for the exclusive benefit of employees or their family members.

Contributions of any amount to a political party are not a permitted CSR activity. However, the New Act has an exception allowing companies to use their CSR funds to support development projects initiated by the prime minister or central government. It is important to note, as discussed further below, that such projects in India have had a troubling tendency to become vehicles for political patronage, and they can raise legal issues in other jurisdictions if they come to be seen as political payoffs.

CSR Committee and CSR Policy

The New Act requires companies to appoint a Corporate Social Responsibility Committee consisting of at least three directors. If a company is one that is required by the New Act to appoint independent directors to its board, then the CSR committee must include at least one independent director. The CSR committee is required to recommend a formal CSR Policy. This document, which is to be submitted to the company's board, should recommend particular CSR activities, set forth a budget, describe how the company will implement the project, and establish a transparent means to monitor progress.

Administration of CSR Projects

A company can meet its CSR obligations by funneling its activities through a third party, such as a society, trust, foundation or Section 8 company (i.e., a company with charitable purposes) that has an established record of at least three years in CSR-like activities. Companies may also collaborate and pool their resources, which could be especially useful for small and medium-sized enterprises.

Reporting Requirements

Unfortunately, the New Act imposes significant bureaucratic requirements. It requires companies to prepare a detailed report, in a particular format, about the company's CSR policy, the composition of the CSR committee, the amount CSR expenditures, and the specifics of individual CSR projects. A company's board must include this report in its annual report to shareholders and publish it on the company's website.

The report must also include a statement from the CSR committee that the implementation and monitoring of the board's CSR activities is, in letter and spirit, in compliance with its CSR objectives and CSR Policy of the company.

Failure to Comply

If the minimum CSR amount is not spent, the board is required to disclose this fact, with reasons therefore, in its annual Director's Report to the shareholders.

It is still not clear whether failure to comply is an legal offense of any sort. Thus, the new Act may be the advent of a new regime in Indian corporation law of the concept of "comply or explain." What is clear, however, is that failure to explain non-compliance is a punishable offence under the New Act. It is therefore likely that any company that fails to comply with its CSR obligations will be subject to investigation by the Indian authorities.

Implications for Indian Subsidiaries of Foreign Corporations

If the Indian company undertaking CSR is a subsidiary of a United States entity, or if its business activities "touch" the U.K., then the U.S. Foreign Corrupt Practices Act ("FCPA") or the U.K. Bribery Act ("UKBA"), respectively, as well as other regulatory laws of these jurisdictions, may apply to the Indian company's CSR payments. This may raise serious issues of compliance and liability.

It is typical in India for social welfare projects to be administered through private non-governmental organizations ("NGOs"). This has led to a proliferation of such groups; by one estimate, there are two million NGOs in India, or one for every 600 people. Although most NGOs are reputable and well-meaning, there have been many instances of fraud and abuse. Indian NGOs often are informally organized, unaudited, and operate with little governance. Thus, it is difficult to know their ownership structure or to monitor or audit their use of CSR funds. Moreover, it is common for politicians and political groups in India to form NGOs as a means of collecting political donations, dispensing patronage, or circumventing Indian election laws.

Because creating a CSR department may entail significant costs, such as increased headcount, overhead, and administrative expense, many companies may choose to implement their CSR activities through NGOs, such as the existing societies, trusts, or foundations that the New Act contemplates. While this decision may make financial sense, it will raise a number of concerns for the compliance functions of any company subject to the FCPA or the UKBA. In particular:

- If the ultimate or beneficial owner of the NGO is a government official, a company's CSR payments may violate the FCPA if they are seen to have been made to influence the actions of the government official or to secure an improper business advantage.
- Under the UKBA, the offense of bribery is committed when payment is made with the intention of inducing the person bribed to improperly perform a relevant function. Thus, regardless of whether the ultimate or beneficial owner of the NGO is or is not a government official, any payments made under a CSR program that can be said to have been made to induce an improper act may be a crime under the UKBA.
- If the NGO's beneficial or controlling owner is a Politically Exposed Person, this fact could trigger enhanced due diligence requirements under U.S. or U.K. anti-money laundering ("AML") regulations. Generally speaking, these AML regulations require a company to implement "know your client" due diligence procedures before engaging in monetary transactions, and failure to do so can expose an organization to penalties regardless of whether or not the company was found to have been involved in a suspicious transaction.

As corporate counsel know all too well, the FCPA, UKBA and the AML laws of the U.S. and U.K. impose serious criminal and civil penalties upon companies and corporate officers that make improper payments, are involved in suspicious transactions, or fail to undertake reasonable measures to protect against or prevent the same. Thus, even though the New Act is directed at Indian companies, its effects will be felt in any multinational company with significant operations in India. Companies will need to police how they implement their CSR Policy and add CSR compliance oversight to their compliance and internal controls program to ensure that these functions remain robust, and that any CSR activities conducted under the New Act are made and monitored for appropriate purposes.

Conclusion

The New Act's CSR requirements will increase the costs of doing business in India and add to existing administrative and reporting burdens.

Unfortunately, the sheer amounts of money that must now be spent on CSR in India have increased substantially the dangers of violating U.S. and U.K. law, and we expect that there will be close scrutiny of companies' CSR payments by United States and U.K. authorities. Because of these risks, foreign companies with operations in India should seek the advice of counsel in structuring the CSR programs and establishing internal controls.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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