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“Dharma is to protect the Needy”

Article on**REGULATION OF THE SHELL COMPANIES AND MONEY
LAUNDERING: A CRITICAL ANALYSIS WITH REFERENCE TO
INDIA****By Sravani Kurra**

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ABSTRACT

As per section 3 and Section 7 of the Companies Act, 2013 the incorporation of a shell company is not illegal if it fulfills the requirements. But these shell companies are mostly indulged in illegal activities such as money laundering, Tax evasions, Ponzi Schemes etc. Such Shell companies pose serious threat to the people who invest. There is no proper definition as to what constitutes Shell Companies. The author in the project concentrates on how these shell companies are used to launder money by rich people. Further the author discusses law relating to anti-money laundering in India. The author also analyses how this law prevents shell companies for doing money laundering. The author also discusses the regulatory mechanisms in India. At the end before concluding the author discusses some landmark cases relating to shell companies and money laundering. Finally, the author concludes with suggestions.

INTRODUCTION

A “shell company” refers to an entity having no independent operations, significant assets, current business activities or employees.¹ Shell Companies have not been defined under the Indian Companies Act, 2013, however, the “Organisation for Economic Co-operation and Development (OECD) Glossary” defines a Shell Company as “A company that is formally registered, incorporated, or otherwise legally organized in an economy but which does not conduct any operations in that economy other than in a pass-through capacity. Shells tend to be conduits or holding companies and are generally included in the description of Special Purpose Entities.” They are also known as “paper”, “briefcase”, “post-box”, “shelf”, and “dabba” companies. These companies provide the perpetrators an ideal cloak for safeguarding their misconduct behind the veil of a separate legal entity.

A shell company is registered as an ordinary regular company at the time of incorporation. The different vehicles used for incorporating shell companies are as follows; Companies, Limited Liability Partnerships, Trust, Foundations, Operational Entities, and Fictitious entities. It has been noticed that almost all “shell companies” are incorporated as “private limited companies”. It has now become a widespread practise for the promoters to float shell companies with the objective of effectuating frauds on the government and financial

¹ OECD Report 2001 ('Behind the Corporate Veil -Using Corporate Entities for Illicit Purposes')

institutions alike. Such frauds include but are not limited to the misuse of financial funds, siphoning off of finances, malfeasance, embezzlements, breach of duty, tax evasions, etc., Several scandals across the world such as the Panama Papers, Bahamas leaks, Azerbaijani Laundromat, Enron Corporation Scandal, and the Paradise Papers, have brought the corrupt nature of corporate vehicles to light and have emphasised on the urgent need to lift the veil of such vehicles. The notion of a shell company in the form of a vanishing entity, first came to light in India in the widely known “Teak Plantation Companies Scam” where the public funds were misused by the so called “vanishing companies” in the agro-forestry sectors in the late 1990’s.

However, shell companies as a disturbing phenomenon caught widespread public attention in India when the Ministry of Corporate Affairs made a public disclosure in mid-September of 2017 of 1.06 lakh disqualified directors owing their association to “shell or on-paper companies”. Also 83 percent of cases relating to money laundering done by shell companies are reported by ED after the note ban i.e., demonetization that is done in 2017.² The registration of 2.10 lakh companies was also cancelled by the Registrar of Companies on account of failure to provide proof of financial activities for a continuous period of three years.³ Subsequently, 50,000 shell companies were further deregistered in a week by the MCA u/s. 248 of the Companies Act, 2013 in first week of August 2018.⁴

Till now, 3.38 lakh shell companies are identified and has been de-registered by the Ministry of Corporate Affairs. Delhi tops the list of Shell Companies with 75,000 companies identified as shell companies and it is followed by Mumbai with 73,000, AP and Telangana together with 46,000 and then Kolkata with 16,000 companies as shell companies which are used for Tax Evasions, Obscuring Real Ownership, Money Laundering and in purchase of benami

² https://www.business-standard.com/article/economy-policy/83-of-money-laundering-cases-post-note-ban-related-to-shell-cos-realty-117112000331_1.html, [Accessed on 30th Dec, 2020]

³ Pib.nic.in. (2019). Ministry of Corporate Affairs (MOCA) identifies more than one lakh directors of shell companies for disqualification. [online] Available at: <http://pib.nic.in/newsite/PrintRelease.aspx?relid=170719> [Accessed 8 Feb. 2019]; Upadhyay, J. (2019). Shell companies: Names of disqualified directors made public. [online] <https://www.livemint.com>. Available at:

<https://www.livemint.com/Politics/tDCNTrHKuWxdGaynoZv5XJ/Shellcompanies-Govt-makes-names-of-55000-directors-public.html> [Accessed 30 Dec. 2020].

⁴ Arora, R. (2019). Ministry of corporate affairs deregisters 50,000 shell companies in a week. [online] The Economic Times. Available at: <https://economictimes.indiatimes.com/news/economy/policy/ministry-of-corporate-affairsderegisters-50000-shell-companies-in-a-week/articleshow/65361314.cms> [Accessed 30 Dec. 2020].

properties. Most of them are ordered to be shut down by the government of India.⁵ The growing number of shell companies increase the associated risk of corporate frauds and thereby, it becomes imperative for the regulators to introduce stringent regulatory mechanisms to curb such menace.

SHELL COMPANIES IN INDIA

The most saddening part when it comes to shell companies in India is that the shell companies are not defined under any law in India.⁶ This situation has led to many unsolvable and complicated situations. There is an example in this regard that is in 2019, the Mumbai's Securities Appellate Tribunal has set aside the harsh actions taken by the SEBI against one of the shell companies listed by Ministry of corporate Affairs. In that situation the SAT does not even look into whether it is a shell company or not but outrightly dismissed the actions of SEBI supporting the Shell Companies. Sometimes such observations are questionable.

The Gauhati High Court in the case of “*Assam Company India Ltd. and Anr. v Union of India*”⁷ tried to understand what constitutes a Shell Company. The question for determination before the court is whether SFIO & SEBI are justified to label a company as Shell Company, and it has raised because the SFIO and SEBI considered the company straightaway as shell Company and then did the investigation to substantiate that it is a shell company. While considering that question the Court held that,

“In popular parlance as well as from the perspective of the Government and its agencies, a shell company is ordinarily identified with dubious activities concerning serious economic offences, such as, tax evasion, money laundering, benami transaction, conversion of black money into white, round-tripping with host of other associated offences. The general perception is that presence of shell companies and its potential use for illegal activities threatens the very economic foundation of the country and severely compromises its economic foundation and ultimately sovereignty.”

The Court went on to consider the negative implications that would crop up when a company is labelled as Shell Company. The Court further held that the Principles of natural

⁵<https://www.firstpost.com/india/strict-punishment-in-offing-for-3-38-lakh-shell-company-owners-centre-to-deploy-dri-fiu-cbdt-cbi-for-probe-ed-to-verify-how-funds-are-managed-laundered-7447881.html>, Last Accessed on 2nd June, 2021

⁶ Devashish Krishan & Debkanya Roy Chaudhury, Legal Regime Relating to Money Laundering, 11 Student ADVOC. 93 (1999)

⁷ Assam Company India Ltd. and Anr. v Union of India, Case No.: WP(C) 2572/2018

justice are violated as there is no notice provided or any reasonable chance of hearing to the company as to why and on what base the company is alleged to be a Shell Company. The court held that this condemnation is in violation of principles of natural justice. Thus, it is obligatory on the part of Union Government to issue a notice and to hear the party before branding it as Shell Company.

Hence, we can understand that the primary object behind the formation of a shell company is to indulge in illegal activities.⁸ These companies often undertake fake financial transactions to justify their legal existence. There are majorly four kinds of fraudulent transactions that are done under the veil of a shell company. They are Tax Evasion, Terrorist Financing, Corruption and Money Laundering. The author mainly focuses on Shell Companies with respect to Money Laundering.

MONEY LAUNDERING BY SHELL COMPANIES

This is one of the noteworthy purposes for which shell companies are utilized is for money laundering. The source for black money comes from unlawful activity and hence need to be hidden from legitimate transactions that are subject to scrutiny. This process is done in three stages⁹: -

- a) The illicit process through which money is obtained.
- b) the series of transactions that involve shell companies. and
- c) the return of the money to the enterprise that owns it.

A company which requires cash for several transactions, issues a cheque to a shell company and records it in its books of accounts as the payment of commission. The shell company then returns this money to the company in cash after deducting its cut. This way the company procures cash for various illicit payoffs but has turned it into white money.¹⁰ Further, the money received by the shell company are projected as 'contractual income' in its accounts. This amount is then made to another shell company as a fulfillment of a contract. The money is further diverted to several other shell companies who show it as their share capital. Hence, the

⁸ MONEY LAUNDERING: AN ECONOMIC CRIME AND ITS IMPACT by Kulvinder Singh, Scholarly Research Journal for Inter-disciplinary Studies, ISSN: 2278-8088

⁹ Dragos-Andrei Nedelcu, Money Laundering by Means of Offshore Companies, 2019 LAW Annals TITU Maiorescu U. 173 (2019)

¹⁰ MONEY LAUNDERING: THE DIRTY CRIME ERODING THE BANKING SYSTEM by Enakshi Jha, HNLU Journal, ISSUE I, VOLUME II, November, 2016

shell company acts as a medium for converting black money into white money.¹¹ This money is then transferred to the actual company's account by means of small cash payments. This process results in the buyer gaining control of a company holding 'clean' assets by paying only a portion of the cost in white. In India Hawala Transactions are also used to launder money along with the shell companies.¹² Another way of transferring funds is buying shares in a company that is owned by the beneficiary inflated valuations. Further, to make the transaction untraceable, the process of layering is undertaken wherein black money is subjected to multiple transactions through various shell companies.¹³ In the recent times there are many instances where the shell companies are involved in Money Laundering in India. The author discusses each incident below.

In the case of Yes Bank¹⁴, In March 2020 the Yes Bank's Management was taken by the RBI and the residence of its founder Rana Kapoor was raided by the ED. Then they have found that almost 13,000 Crore rupees were siphoned off through 79 Shell Companies by the DHFL which is one of the major defaulters of Yes Bank. It was alleged that 2000 crores out of 13000 crores siphoned off money was given Rana Kapoor and he was arrested. After a week the ED disclosed that the Kapoor and DHFL¹⁵ has used almost 102 shell companies that are controlled by themselves for laundering money. There is also an allegation that another Yes Bank's defaulter that is "Infrastructure Leasing & Financial Services Ltd" [IL&FS]¹⁶ has also used many shell companies for claiming non-existent expenses from various infrastructure projects and wanted to deviate funds for a commission. In this way the Yes Bank has helped in laundering the money using Shell Companies.

In the case of Nirav Modi, In 2017, Nirav Modi is a fugitive billionaire and a diamond merchant who has laundered 5921 crores through 17 sham companies based in India after duping

¹¹ Global Shell Games: Testing Money Launderers' and Terrorist Financiers' Access to Shell Companies by Michael Findley, Daniel Nielson and Jason Sharman, 2012

¹² Jacob W. Petterchak, In Defence of Hawala: Rethinking Regulation of Customary Banking, 4 SOAS L.J. 107 (2017).

¹³ Adebayo E. Iyanda, The Role of Misinvoicing in the Money Laundering Cycle, 3 JACL 144 (2019)

¹⁴<https://www.businessstoday.in/current/economy-politics/taxing-the-untaxed-india-shell-companies-threat-global-economy-indian-economy-black-money/story/399411.html>, Last Accessed on 2nd June, 2021

¹⁵ The DHFL is NBFC that has been sent to bankruptcy proceedings by Reserve Bank of India in 2019 November where it has almost 83,000 crore rupees debt.

¹⁶ It is a non-deposit taking NBFC that has directly gone to the NCLT in 2018 September for protecting itself.

PNB bank by using fake letter of undertaking with 14,000 crore rupees, was caught by ED.¹⁷ The ED has also found out that the Nirav Modi's Uncle Mehul Choksi who is also a fugitive has controlled so many shell companies. Those were handled by Nirav Modi and Mehul Choksi for laundering the money. The ED has qualified some of the Shell Companies out those many and has started investigating.

In the case of Chanda Kochhar¹⁸, The Enforcement Directorate has filed a money laundering charge sheet against Chanda Kochhar. Her husband along with her are alleged to have used various shell companies for converting the bribe money of 64 crores which are given by Videocon Group. The ICICI bank has paid out the Videocon International Electronics Ltd with Rs 300 crores but they have disbursed only 283.45 Crores. The 64 crore rupees had been transferred to Nu Power Renewables Ltd [NRL], which is owned by Videocon Chairman MD Venugopal Dhoot and Kochhar's Company, through Supreme Energy Pvt Ltd [SEPL] which is also controlled by Kochhar's Company. The ED has alleged that Chanda Kochhar has also been part of that decision making process. Thus, the Kochhar Company has involved in laundering the bribe money through Shell Companies.

In the INX media Case¹⁹, Former Minister P. Chidambaram has given clearances to get bribes by granting illegal foreign investment (FIPB). The Bribe money is laundered through Shell Companies and is given to his son. The Enforcement Directorate has disclosed that many Shell Companies which are in India and abroad, are involved in that money laundering process and they have laundered more than 300 Crore rupees. His son also received huge amounts of payments from various shell companies that are located outside India. Thus, the former minister has indulged in money laundering for converting the bribe money into white money.

Therefore, from these examples three things are clear. They are:

- (a) In Indian economy, Sham or Shell companies are an integral part
- (b) Most of the Shell Companies are being used for illegal purposes
- (c) The regulatory mechanism of Shell Companies in India is not up to the mark.

LEGAL MECHANISM TO PREVENT MONEY LAUNDERING BY SHELL COMPANIES

¹⁷ <https://www.indiatoday.in/india/story/enforcement-directorate-cbi-nirav-modi-laundered-rs-5921-crore-using-17-shell-companies-1205021-2018-04-05>, Accessed on 30th Dec, 2020

¹⁸ <https://www.hindustantimes.com/india-news/chanda-kochhar-2-others-named-in-ed-s-money-laundering-chargesheet/story-XL76tygEIVJ2NRDOIwKTxL.html>, [Last Accessed on 2nd June, 2021]

¹⁹ <https://www.latestlaws.com/latest-news/detailed-analysis-sc-grants-bail-to-former-union-minister-p-chidambaram-in-inx-media-case/>, Last Accessed on 2nd June, 2021

The money laundering done by shell companies is regulated by various legislations in India. The legislations are Companies Act, 2013, Prevention of Money Laundering Act 2002, Indian Penal Code, 1860, Criminal Procedure Code, 1973

1. *Companies Act, 2013:*

One of the few provisions in the Companies Act, 2013 that seeks to curtail shell companies is Section 248.²⁰ The registrar has the power to remove the name of any company from the RoC if the company fails to start the business within one year of incorporation under section 248 of the Companies Act, 2013 or when the company is not active for preceding two financial years and also did not apply for dormant company status then also the registrar can remove the company name from the RoC.²¹ Also, the Companies (Amendment) Act, 2019 (“Amendment Act”) (which received the President's assent on July 31, 2019) supplements the provisions of Section 248²².

2. *Prevention of Money Laundering Act, 2002:*

The PMLA, 2002 is applicable to all financial institutions, banks mutual funds, insurances companies and their financial intermediaries. The punishment for the offence of Money Laundering under PMLA, 2002 is rigorous imprisonment for a term not less than 3 years extending to 7 years and shall be liable to fine up to Rs 5, 00,000., but if the crime involved in Money Laundering deals with any of the offences specified under para 2 of part A of the schedule then the maximum punishment awarded shall extend to 10 years. The offence referred in para 2 of part A deals with offences under Narcotics Drugs and Psychotropic Substances Act, 1985. The Act also deals with confiscation of property in accordance with chapter 111 of the said

²⁰ India: Shell Companies In India by Ashima Obhan and Nishtha Jaisingh, Obhan & Associates, 29 August 2019, [https://www.mondaq.com/india/corporate-and-company-law/841132/shell-companies-in-india#:~:text=A%20careful%20balancing%20act%20is,the%20definition%20of%20shell%20companies.&text=ii%20Section%20248\(I\)%20of,\(Amendment\)%20Bill%2C%202019](https://www.mondaq.com/india/corporate-and-company-law/841132/shell-companies-in-india#:~:text=A%20careful%20balancing%20act%20is,the%20definition%20of%20shell%20companies.&text=ii%20Section%20248(I)%20of,(Amendment)%20Bill%2C%202019), Last Accessed on 2nd June, 2021

²¹ Section 10A(I)(a) of the Companies (Amendment) Bill, 2019.

²² Some of the measures contained in the Amendment Act are:

“1. A new Section 10A has been inserted which stipulates that a declaration is to be filed by a director within a period of a 180 (hundred and eighty) days from the date of incorporation of the company in the manner prescribed with the Registrar, affirming that every subscriber to the Memorandum has paid the value of the shares agreed to be paid by him on the date of making such declaration

2. Where no declaration has been filed in accordance with Section 10 A, and the Registrar has reasonable cause to believe that the company is not carrying on any business or operations, the registrar may initiate action for removal of the name of the company from the ROC.

3. The Amendment Act has also inserted sub-section (9) in the Section 12 of the Act, which empowers the Registrar to cause a physical verification of the registered office of the company on reasonable cause.

4. The Amendment Act has also widened the ambit of powers assigned to the Serious Fraud Investigation Office (“SFIO”) to ensure speedy and more effective enforcement”

Act. The attachments are done by the Director or any person below the Deputy Director authorized to do so.²³

1. IPC, 1860:

If the money is acquired by criminal means, then the Indian Penal Code applies. The people who are guilty of money laundering are punishable under Section 403²⁴, Section 406²⁵, Section 408²⁶, Section 409²⁷, and Section 415²⁸ of the IPC.

2. CrPC, 1973:

Section 4²⁹ of money laundering act read with second schedule of the Cr. P.C, makes clear that offences under PMLA are cognizable offences. Also Section 45 of the Money Laundering Act also provides that offences under the PMLA are cognizable and non-bailable. All these laws have helped to find out the culprits behind the big scams all over the country. A few of them have been discussed above. For example, Nirav Modi was charged with an offence under PMLA in PNB Bank Scam; Rana Kapoor in Yes Bank Scam was booked for misappropriation of funds and financial manoeuvres.³⁰

CONCLUSION

This scenario of Indian corporate world depicts a major loophole and highlights the pertinent need to establish a specific legal definition of such companies under the Indian Companies Act, 2013 and include stringent regulatory mechanisms such as those in Western countries to curb such menace. India's own investigating agencies like Enforcement Directorate (ED), Central Bureau of Investigation (CBI), Income Tax Department (ITD) and Serious Fraud Investigation Office (SFIO) have found enough evidence that shell companies are now an essential part of the

²³ Combating money laundering national and international perspectives, 2017 by Awasthi, Neha. Available at: <http://hdl.handle.net/10603/200014>, Last Accessed on 2nd June, 2021

²⁴ Section 403 of IPC states that, “whoever dishonestly misappropriates or connects to his own use any movable property shall be punished with imprisonment of either description for a term which may extend to two years, or with fine, or with both.”

²⁵ Section 406 of IPC states that, “Whoever commits criminal breach of trust, shall be punished with a term for three years, or with fine or with both.”

²⁶ Section 408 of IPC states that, “If criminal breach of trust is done by clerk or servant, he will be imprisoned for seven years, and will be fined”

²⁷ Section 409 of IPC states that, “If criminal breach is done by a banker, he will be imprisoned for ten years and shall also be liable to fine.”

²⁸ Section 415 of IPC states that, “If a person conceals a fact dishonestly will be liable for cheating, and shall be either imprisoned for a term which may extend to one year or with fine or both”

²⁹ Section 4 of PMLA, 2002 states that, “Offence of money laundering is punishable with rigorous imprisonment for three years and upward but not more than seven years”

³⁰ <https://thedailyguardian.com/shell-companies-illegality-in-functioning-regulatory-framework/>, [Last Accessed on 2nd June, 2021]

economy. That, however, poses a great challenge for the Indian regulatory authorities. Without a better understanding of their activities and effective oversight, the chances of shell companies being misused are very high. Thus, there should be strict regulatory mechanism on the Shell Companies.

SUGGESTIONS

1. In India, The PMLA 2002 and its further amendments doesn't encompass all crimes. Here the anti-money laundering provisions apply only to drug offences, terrorisms and specific series of offences. Hence, it is recommended that it should be applied to all crimes.
2. There should be a standard definition to Shell Companies in Companies Act, 2013 like the US and UK Laws so that there won't be any ambiguity.
3. People are needed to be educated and taught, that Money laundering is a serious offence it has been harmful effects on the society, which need to be stopped
4. It is suggested that the special unit dealing with money laundering activities, should be formed on the line of Economic Intelligence Council (EIC) exclusively dealing with research and development of AML. This special unit should have access and it should be able to share and exchange information about these types of offences with INTERPOL and other international organizations dealing with AML.