

Corporate Frauds and their Prevention Under the New Companies Act



The term 'fraud' is very wide in scope. As per the Indian Contract Act, 1872, fraud includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party or his agent, or to induce him to enter into the contract: (1) the suggestion, as to a fact, of that which is not true by one who does not believe it to be true; (2) the active concealment of a fact by one having knowledge or belief of the fact; (3) a promise made without any intention of performing it; (4) any other act fitted to deceive; and (5) any such act or omission as the law specially declares to be fraudulent.

Curbing of Corporate Frauds under the Companies Act, 2013

Probably the first major corporate scam in Independent India was what is referred to as the Mundhra scam. Hari Das Mundhra, an industrialist and stock speculator, sold fictitious shares to the Life Insurance Corporation of India (LIC) and thereby defrauded the corporate by ₹ 1.25 crore in 1957. He was found guilty and was sentenced to imprisonment for 22 years.

An initiative has been taken for preventing and curbing corporate frauds by including the concept of fraud and provisions for stringent punishment under the Companies Act, 2013. The major provisions introducing the concept of fraud are contained in Section 447, which is re-produced below:

Section 447: *Without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found*



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to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud:

Provided that where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

Explanation—For the purposes of this Section—

- (i) “fraud”, in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;
- (ii) “wrongful gain” means the gain by unlawful means of property to which the person gaining is not legally entitled;
- (iii) “wrongful loss” means the loss by unlawful means of property to which the person losing is legally entitled.

The new act has included the concept of fraud which is inclusive, not comprehensive, and pertains only to the affairs of a company or body corporate. Certain terms used in the definition need elaboration. While the term fraud not only includes any ‘act’ but also ‘the omission, not to act’, concealment of any fact, and abuse of position by a person. Such an act, omission and concealment, can pertain to any person himself or by him with the connivance of any other person in any manner.

Act/Omission to Act: While an act of omission is the failure to perform an act expected to be done by a person, an act of commission is doing an act that causes harm. According to the *Oxford Law Dictionary*, the word ‘omission’ means ‘a failure to act’ that means when a person is bound to do an act

but he omits to do it or deliberately neglects that, it is called omission.

Fraudulent Concealment: The meaning of the word ‘concealment’ as found in the *Shorter Oxford English Dictionary*, 3rd Edition, reads, “In law, the intentional suppression of truth or fact known, to the injury or prejudice of another.” [*C.I.T. vs. J.K.A. Subravaniam Chettiar, (1977) 110 ITR 602, 608 (Mad). [Income Tax act, 1961, s. 271(1)(c)]*]

The word ‘fraudulently’, appearing in Section 206 of the IPC, cannot be interpreted as meaning nothing more than ‘dishonestly’. The two words do not mean exactly the same thing. A dishonest act is not necessarily a fraudulent act. The elements which make an act fraudulent are, first deceit or an intention to deceive and in some cases mere secrecy. Where there is neither an intention to deceive, nor secrecy, the act, though dishonest is not fraudulent [*1937 MWN 462;46 LW 139;AIR 1937 Mad 713(1937) 2 MLJ 802.*].

‘Fraudulent concealment’ means the deliberate hiding or suppression, with an intention to deceive or defraud other persons of a material fact or circumstances, by a person which he is legally bound to disclose. Any fraudulent failure to reveal the information which some one knows and is aware that he should, in good faith, communicate to another, such as the failure to disclose a defect in a product or omitting one’s assets from a bankruptcy scheme to keep them from being available for distribution to the creditors.

Fraud by Abuse of Position: Many cases of the most serious frauds and corruption are committed by the people at the top who have the power to conduct fraudulent transactions and cover them up. There are several things which suggest someone is abusing his position and could actually be committing fraud. A fraud by abuse of position is defined in section 4 of the Fraud Act, 2006 (UK), which reads:

Section 4: *Fraud by Abuse of Position*

- (1) A person is in breach of this section if he—
 - (a) occupies a position in which he is expected to safeguard, or not to act against, the financial interests of another person,
 - (b) dishonestly abuses that position, and

- (c) intends, by means of the abuse of that position—
 - (i) to make a gain for himself or another, or
 - (ii) to cause loss to another or to expose another to a risk of loss.
- (2) A person may be regarded as having abused his position even though his conduct consisted of an omission rather than an act.

Moreover, such an act, omission or concealment must be done with intent:

- (a) to deceive;
- (b) to gain undue advantage from someone; and
- (c) to injure the interest of (i) the company, (ii) a shareholder (iii) a creditor, or (iv) any other person.

Intent to Defraud Creditors: A person was acting dishonestly and fraudulently if he realises at the time when the debts were incurred that there was no reason for thinking that funds would become available to pay the debt when it became due or shortly thereafter. {*R. V. Grautham, (1984) 3 All ER 166, 170 (CA) (UK Companies Act 1948, S.332)*}

The main emphasis of this definition is on intent. In fact, the legal system in India is replete with concepts, like 'intent', 'public interest' and 'principles of natural justice'. This is particularly true about the Indian Penal Code and certain other legislations. The term intent is of paramount importance. It is the 'intent' of a person which determines whether his action, omission, concealment of facts, or abuse of position amounts to a fraud or not.

The intent of a person must be to deceive, to gain undue advantage, or to injure the interest of the other party. The other party can be a company, or its shareholder, creditor or 'any other person' (associated with the company concerned). In a majority of criminal cases, the main element involved is *mens rea* (criminal intent), which is an intention to commit offence and is related to the mind of the offender.

The term 'intent to defraud' contains two elements, deceit and injury. A person is said to deceive another if by false suggestion or suppression or by both intentionally induces another to believe a thing to be true. [*S. Harnam Singh vs. State, AIR 1976 SC 2140, 2145; IPC S. 477-A*]

Deceit: To deceive is to induce someone to believe that a false thing is true, and which the person

indulging in the deceit knows or believe to be false. Deceit is the state that prompts intentional concealment or perversion of truth for the purpose of misleading. Deceit is behaviour that is deliberately intended to make people believe something which are not true.

As per Section 415 of the IPC, a dishonest concealment of facts, or where there is a legal duty to disclose particular facts, a dishonest omission to disclose those facts, is a deception.

Wrongful Gain: The word 'wrongful' means prejudicially affecting a party in some legal right. Section 23 of IPC, defines 'wrongful gain' as a gain by unlawful means of property to which the person gaining is not legally entitled. A person is said to gain wrongfully when such a person retains something wrongfully, as also when he acquires it wrongfully. Wrongful gain includes a short-lived gain.

Wrongful Loss: As defined in Section 23 of IPC, 'wrongful loss' as the loss by unlawful means of property to which the person using it is legally entitled. A person is said to in case lose wrongfully, when such person is wrongfully kept out of any property as well as when such person is wrongfully deprived of the property. As in the case of a Wrongful Gain, Wrongful Loss also includes a short-lived loss.

Whoever does anything with the intention of causing wrongful gain to one person or wrongful loss to another person is said to do that thing 'dishonestly'. The wrongful gain or wrongful loss involves pecuniary or economic gain or loss.

Fraudulent Misrepresentation: A false statement as to a material fact, made with the intent that another rely thereon, which is believed by another party and on which he relies. It also includes by which inducement of act that causes injury to him. The statement is fraudulent if the speaker knows the statement to be false or if it is made with utter disregard to its truth or falsity. (*Cormack vs. American Underwriters Corp., 288 NW 2d 634*).

A misrepresentation is made with the express intention of defrauding someone, which subsequently causes injury to that person. In order for a statement to be 'deceit', it must be untrue, made with the knowledge of its falsity, or made in reckless disregard of the truth. The misrepresentation must be such that it causes and might cause harm to another individual.

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Offences Punishable for Corporate Fraud

A corporate fraud has to be controlled and it can surely be prevented if it is not curbed; it will spread, and will eventually lead to the demise of a company or its shareholder and irreparable loss to its stakeholders.

The measures for prevention and control of corporate frauds can be divided into two categories:

(1) Pre-fraud Measures: action to be taken prior to the committing of fraud; and

(2) Post-fraud Measures: action against persons committing fraud.

The ancillary provisions relating to the curbing of corporate frauds are contained in Sections 7 (5), 7 (6), 8 (1), 34, 36, 38 (1), 56 (7), 66 (10), 75 (1), 140 (5), 206 (4), 213 (*proviso*), 229, 251 (1), 266 (1), 339 (3), and 448 of the Companies Act, 2013 and offences punishable for fraud are given below in the Table.

Table: Offences Punishable for Fraud

S. No.	Relevant Sections	Events	Nature of Offences	Persons Liable for Offences
Pre-fraud Measures				
1.	Secs. 7(5); 7(6); and 8(1)	Incorporation of a Company	1. Furnishing false or incorrect information or suppressing material facts during incorporation 2. Fraudulently conducting affairs of Section 8-company (company having charitable objects).	1. Promoters, first directors, and persons giving declaration 2. Directors and officers of the company.
2.	Sec. 34	Company's Share Capital	Issuing prospectus containing untrue/misleading information.	Person authorising someone to issue prospectus
3.	Sec. 36	Inducing others to invest money	Inducing others to invest money on the basis of false, deceptive, misleading and concealed information and to obtain credit facilities from banks/financial institutions on false grounds.	Person inducing other persons
4.	Sec. 38 (1)	Impersonation for acquisition of securities	Making applications in fictitious names or multiple applications to acquire shares, or inducing the company to allot or register shares in fictitious names.	Person who makes the application and who induces the company.
5.	Sec. 46 (5)	Issuing of duplicate share certificates	Issuing of duplicate share certificates with an intent to defraud.	Officers in default.
6.	Sec. 56 (7)	Transfer/transmission of shares by depository	Transferring/transmitting of shares by depository with an intent to defraud.	Depository/depository participant.
7.	Sec. 66 (10)	Reduction of share capital	Concealing the name of the creditor who- (1) objects to the reduction of capital, or (2) who mis-represents the nature of debt amount or claim of any creditor.	Officers who conceal names or misrepresent.
Post-fraud Measures				
1.	Sec. 75 (1)	Repayment of deposits (Damages for fraud):	Accepting deposits with an intent to defraud or for fraudulent purposes, or failure to repay deposits/interest within the specified time.	Every officer responsible for acceptance of deposits.
2.	Sec. 140 (5)	Removal/Resignation of Auditors	Auditors acting in a fraudulent manner or found guilty of abetting or colluding in any fraud by the company or its directors or officers.	Auditor individually or firm or partner/partners of the audit firm jointly or severally.

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S. No.	Relevant Sections	Events	Nature of Offences	Persons Liable for Offences
Post-fraud Measures				
3.	Sec. 206 (4)	Carrying on of Unlawful Business	Carrying on of business by company for fraudulent or unlawful purpose.	Officers in default
4.	Sec. 213 Proviso	Inspection/ Investigation into Company's Affairs	Forming of a company with fraudulent/ unlawful purpose or conducting business to defraud members/creditors.	Officers in default and persons concerned with the formation of the company/managing its affairs.
5.	Sec. 229	Furnishing False Statement/ Mutilation/ Destruction of Documents	Furnishing false statement, or mutilating, destroying, concealing, tampering with, or removing any document relating to company's property, assets or affairs.	Person who furnishes false information or mutilates, destroys, conceals, tampers with, or removes any document.
6.	Sec. 251 (1)	Fraudulent Removal of Name from Register	Filing application for removal of name (voluntarily striking off of the name) for evading liabilities of the company or for defrauding its creditors or any person(s).	Person in charge of the management of the company.
7.	Sec. 266 (1)	Damages against Delinquent Directors	Misapplication of money or property found guilty of any misfeasance in relation to sick company.	Person found guilty of any misfeasance.
8.	Sec. 339 (3)	Fraudulent Conduct of Business	Carrying on the business with an intention to defraud creditors/ other persons.	Person who was knowingly a party to the carrying on the company's business.
9.	Sec. 448	False Statements	Furnishing of false statement, in any return, report, certificate, financial statement and prospectus, etc.	Person making such false statements.

Pre-fraud Measures

(1) Fraud in respect of Incorporation of a Company: Sections 7(5), 7(6) and 8(11) of the Companies Act deal with the action specified under Section 447, which provides that a company's promoters, first directors, and the persons who have given any declaration, shall be liable to the action provided under Section 447, if they have furnished any false or incorrect information or suppressed any material information with the Registrar of Companies for incorporating the company. They are liable at the time of formation or after formation of the company. Furthermore, if it is proved that if the affairs of the company formed with charitable objects were conducted fraudulently, then the directors and every officer of the company shall be liable for action under Section 447.

(2) Frauds related to Company's Share Capital:

Numerous Sections under the Companies Act, deal with the raising of share capital and its treatment by a company and offences under those Sections are liable to action under Section 447.

(a) Raising capital by misstatement in the prospectus: The penalty has been broadened in the new Companies Act. As per Section 34, a person who has authorised someone to issue a prospectus containing any untrue and misleading statement shall also be punishable under Section 447. The provisions read as follows:

(b) Fraudulently inducing others to invest money: Any person who induces others to invest money by making any statement which is false, deceptive, misleading or

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deliberately concealing any facts, shall be liable for punishment for fraud under Section 447. This offense is non-compoundable. The term investment here, means investment in all types of securities and is not limited to shares and debentures. Section 36 also provides for punishment to a person who induces another person on false grounds to enter into agreement to obtain credit facilities from any bank or other financial institution.

- (c) **Impersonation for acquisition of securities:** A person who makes an application in a fictitious name, makes multiple applications in different names or in different combinations of names, for acquiring or subscribing for securities, or induces a company to allot or register any transfer of securities in a fictitious name, shall be liable for punishment under Section 447.
- (d) **Issuing duplicate share certificates:** If a company issues a duplicate share certificate with an intention to defraud, every officer of the company who is in default shall be liable for action under Section 447 of the Act.
- (e) **Transfer/transmission of shares by depository:** Where any depository or depository participant, having an intention to defraud a person, transfers shares, such depository or depository participant, besides incurring the liability under the Depositories Act, 1996, shall be liable for punishment under Section 447 of the Act.
- (f) **Reduction of share capital under:** An officer of the company shall be liable for action under Section 447 of the Act, if he knowingly conceals the name of any creditor who was entitled to object to the reduction of share capital or knowingly misrepresents the nature or debt amount or claim of any creditor or encourages or assists or concerned to any such concealment.

Post-fraud Measures

- (1) **Repayment of Deposits:** Section 75(1) of the new Companies Act provides that every officer of the company who is responsible for acceptance of any deposit shall be liable to action under Section 447, if such company fails to repay the deposits or any part thereof or any interest thereon, within

the time specified, and if it is proved that the deposit was accepted with an intent to defraud the depositors or for any fraudulent purpose. Under this Section, an action can be taken by any person/group of persons or any association of person who had incurred any loss as a result of the company's failure to repay the deposit or part thereof or interest accrued thereon. The officer shall be personally responsible without any limitation of liability.

- (2) **Removal/Resignation of Auditors:** The new Act also imposes penalties on 'Independent Professionals'. While in the case of contravention of an auditor's duties, the penalty for the auditor has been made more stringent, if any partner/partners of the audit firm has or have acted in a fraudulent manner, they shall also be punishable for fraud. The Act specifically provides that the partner/partners of the audit firm and the firm shall be jointly and severally responsible for the liability, whether civil or criminal as provided in the Companies Act or in any other law for the time being in force. A duty has been cast on the auditors to immediately report any offence involving fraud to the Central Government. When the tribunal, either *suo motu* or an application from the Central Government or a person concerned, is satisfied that the auditors have acted in a fraudulent manner or found guilty of abetting or colluding in any fraud by the company or in relation to the company or its directors or officers, it shall direct the company to change its auditors and such auditor, individual or firm will be jointly or severally liable for action under Section 447. Moreover, such auditor shall not be eligible for appointment for a period of 5 years from the date of passing of the order.
- (3) **Carrying On of Unlawful Business:** The Registrar of Companies has been empowered to call for information, explanation of documents or inspect books of the company, either on the basis of information available with him or furnished to him or on a representation given to him by any person, if the business of the company is carried on for fraudulent or unlawful purposes. In such case, every officer of the company who is in default shall be punishable for fraud under Section 447.
- (4) **Inspection/Investigation into Company's Affairs:** The Central Government shall appoint one or more competent person as inspectors to

investigate into the affairs of the company. If after the investigation, it is found that the company was formed with a fraudulent or unlawful purpose or the business is conducted to defraud its members, creditors or any other person concerned in the formation of the company, or manage its affairs has been guilty of fraud, then every officer who is in default or any other person concerned in the formation of the company and managing its affairs shall be punishable for fraud under Section 447.

- (5) **Furnishing False Statement/Mutilation/ Destruction of Documents:** A new Section 229 has been added in the Companies Act which provides punishment as per Section 447 to such person who, during the course of inspection, investigation or inquiry, furnishes any false statement, or mutilates, destroys, conceals, tampers with, or removes any document relating to property, assets or affairs of the company.
- (6) **Fraudulent Removal of Name:** When the Registrar of Companies finds that an application for removal of name (voluntarily striking off of the name) has been filed with an objective to evade liabilities of the company or with an intent to defraud its creditors or any person(s), then the person in charge of management of the company shall be liable for punishment under Section 447. Such person(s) shall also be liable to the person(s) who had incurred loss or damages due to the dissolution of the company.
- (7) **Damages against Delinquent Directors:** Section 266 (1) empowers the Company Law Tribunal to assess the damages against delinquent directors during scrutiny or implementation of a scheme of a sick company. If the Tribunal finds that any person, who took part in the formation, promotion of or managing the affairs of such company has misapplied money or property of such company or found guilty of any misfeasance in relation to the sick company, such a person shall be punishable under Section 447.
- (8) **Fraudulent Conduct of Business:** During the course of winding up of the company, if it appears that any business of the company has been carried out with an intention to defraud creditors or any other person or for fraudulent purposes, then every person who was knowingly a party to the carrying off of the business, shall be liable for action under Section 447. The Tribunal on the application of the Official Liquidator, Company



Liquidator, any creditor or contributory of the company can declare such a person liable personally for debts or other liabilities of the company.

- (9) **Making of False Statement:** If any person makes a statement, in any return, report, certificate, financial statement, prospectus, statement or other document required by, or, for, the purposes of this Act, or rules there under, which is false or omit any material fact, shall be punishable for fraud under Section 447.

Penalty for Corporate Fraud

The new Act provides stringent penalties for corporate frauds. Any person who is found guilty of fraud shall be punishable with imprisonment for a minimum period of 6 months, which may extend to 10 years, and also a fine equivalent to the amount involved in the fraud, which may extend to three times the amount involved in the fraud. However, where the fraud involves public interest, the imprisonment shall be for a minimum period of three years.

Conclusion

The frauds can be either of civil or criminal nature. However the intention of the perpetrator of fraud is of paramount importance in establishing an offence as a fraud. The Companies Act, 2013, has included a comprehensive definition of fraud and stringent provisions regarding punishment for such frauds. Moreover, independent professionals shall also be held liable for action and proceeded against under the Act. ■