Deterrence through Laws: Are the new laws tightening the noose?

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The collateral damage of economic prosperity combined with higher industrialisation and formalisation is the rising incidence of corporate fraud, money laundering and complex web of subterfuge. In the last decade, India has seen a rise in corporate misdemeanour and fraud, almost doubling in number, which routinely go unpunished and offenders often seek refuge overseas, making a mockery of our laws and its enforcement[1].The rise in quantum, increased level of sophistication used in deception, use of technology along with low conviction rates make fraud almost a profitable venture with low risk of detection or consequence. Mr Bibek Debroy, now in Niti Ayog has estimated the probability of conviction in India for a white collared crime to be .002%, which almost makes economic crime rewarding.

Thirty-Eight listed banks have a sum of Rs. 10.17 lakh crore[2] of loans classified as Non-Performing Assets due from borrowers who have been labelled "wilful defaulters" i.e. borrowers who have a capacity to repay but have intentionally declined to pay and often have diverted the loans for personal use. Many such persons like Vijay Mallya, Mehul Choksi, Nirav Modi have now set a dangerous trend wherein those guilty of defaulting on loans find an easy escape from paying by leaving the country.

Most Indian banks have majority government ownership which means any failure to recover large loans from businesses in fact gets underwritten by citizens, many of whom live below the poverty line. Our laws and their application have for decades denied justice; new legislations attempt to blow winds of change and have already created a flutter in corporate India as the status quo of the current dispensation has been challenged.

Do our current legislations create effective accountability?

Private capital in India was always scarce and those who had access to capital could leverage their positions with loans from government banks to run businesses. Many large business houses till the mid- 1980's were controlled by industrialists with less than 20% ownership but enjoying equivalence of being wholly owned. When businesses failed they were referred to Board of Financial Reconstruction (BIFR), an agency to bailout industrialists with larger bank rolls. Owners never lost control but risks got transferred to citizens. The common refrain was "businesses go bankrupt in India but never its promoters"

BIFR rarely helped turn around companies and since the law of liquidation was cumbersome, India had piles of underutilised assets. A Securities and Financial Reconstruction law was much needed and SARFESI Act was enacted to galvanise recovery and redeployment of non-performing loans. It permits recovery through either securitisation or asset reconstruction or enforcement of security from the defaulter without the intervention of courts which eases the already burdened judiciary. The Act permits banks or creditors to recover secured assets of the borrower or to even take over the management of the business of the borrower. The SARFESI Act is regarded as being far more effective than Debt Recovery Tribunal (DRT). According to a study, in the years 2015-2016, the amount of loan recovered under the SARFESI Act was Rs.1318 crores out of an amount of Rs. 8,010 crores involved but under the DRT, only an amount of Rs. 637 crores were recovered out of Rs. 6934 crores[3].

Debt Recovery Tribunal was the mechanism under Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI) for recovery of secured debts by attaching and selling borrower's assets by the Bank. However, the RDDBFI was not helpful in debt recovery for various reasons. First, only Banks could approach the tribunal to recover bad loans. Second, Banks could approach the Tribunals for recovery only if the debt amount exceeded Rs. 10 Lakhs, the pecuniary jurisdiction of the tribunals. The SARFESI Act rectified some of these shortcomings of RDDBFI, leading to better recovery rates.

Another legislation for dealing with ill-gotten gains is the Prevention of Money Laundering Act, 2002 (PMLA) where the Enforcement Directorate (ED) can attach property that are the proceeds of crime and are likely to be concealed, transferred or dealt with in any manner which may frustrate the proceedings relating to confiscation of such property. However, conviction rate under the PMLA is poor. Since 2005, the ED has carried out only two convictions[4] despite initiating 118 cases for prosecution in 2017-2018.[5] One of the reasons for such a poor conviction rate is due to the shortage of staff as the ED is only using 50% of the available staff despite an increase in the rate of searches and investigations[6].

Winds of change are blowing

Studies indicate an increase in the number of corporate frauds, with the nature of fraud ranging from Ponzi, hawala and cheque forgery scams in the 1990s to tax evasions and loan defaults in the 2000s. The reasons for this steady increase in corporate frauds has been pegged to several reasons including lack of resources with agencies, lack of manpower to clamp down on these frauds and bribery and corruption at high levels which have made it harder to detect fraud at an early stage[7]. A framework of accountability is set by the Companies Act, 2013 whereby an owner can lose control of the company in cases of fraudulent activities committed along with criminal and punitive civil liabilities. These stringent provisions have made fraud prevention a significant activity in the board room, under the oversight of the independent directors.

In terms of enforcement, setting up of institutions such as the Serious Fraud Investigation Office (SFIO) have also helped in the investigation and prosecution of fraudulent cases and activities. In the year 2015-2016, 39 investigations were completed and 44 prosecutions were filed[8] in the National Company Law Tribunal. However, the conviction rate by the SFIO is very poor, with the production of only 6 investigative reports that have led to convictions.[9] –the number of cases referred to the SFIO in the year 2017-2018 were 209 whereas the number of cases referred to in 2016-2017 were 111.[10] One of the biggest reasons for this poor performance of the SFIO is lack of manpower and capacity of staff to tackle the backlog and growing number of fresh cases.[11] While the concept of SFIO is laudable to tackle the rise of corporate frauds, the operations of the SFIO must be reformed to ensure optimal efficiency.

The Insolvency and Bankruptcy Code was introduced in 2016 to create separate insolvency resolution processes for companies and individuals and importantly sets a maximum time limit for the completion of the insolvency resolution process. It is a crucial economic reform as for the first time a separate law, solely dedicated to corporate insolvency and bankruptcy was enacted. Proceedings are divided into two stages; Insolvency Resolution Process when the financial creditors assess the viability of the debtor's business to continue and the second is Liquidation when the insolvency resolution process fails or financial creditors decide to wind down and distribute the assets of the debtor.

Between August-December 2017, there were ten cases whose resolution plan was approved by the Code and the financial creditors were able to recover 33.53% of total claims or recovery of Rs 1,854.40 crore out of the total claims of Rs 5,530.30 crore.[12] This code is a new piece of legislation and yet since its introduction, there has been a rise in the recovery of claims and bad loans by creditors which is an immense economic reform. The biggest change brought about by the code is the defaulting owners cannot bid for the distressed assets whether directly or otherwise, making the possibility of losing their company a reality. In earlier regimes like BIFR this was not possible and promoters milked the assets at public cost with impunity.

The provisions in the PMLA have been used to seize and auction assets belonging to those who default on loans such as Vijay Mallya[13]. These legislations are also recognized by foreign jurisdictions which permit Indian banks to freeze and auction assets of loan defaulters in foreign jurisdictions[14]. Under, the PMLA Act, the ED has attached properties worth Rs. 170 Crores belonging to Nirav Modi.[15] However, the laws cannot exist in isolation and the investigation institutions need to be strengthened.

The Fugitive Economic Offenders Bill, 2018 (FEO) is a crucial piece of legislation introduced to clamp down on fraudulent activities. According to the principle of territorial jurisdiction, once a person escapes to an overseas country, he cannot be tried by the courts in that country and only by the Indian courts since the offence is one recognized under Indian law and is committed in the territory of India. Once a defaulter leaves the country, the process to attach assets is longer, cumbersome and expensive since parallel cases are filed and heard in India and in foreign jurisdictions. Often foreign courts have to rule on orders passed by the Indian courts such as Judge Henshaw in the Mallya case who upheld an order that permitted a global warrant to seize Mallya's assets.[16]

However, these new laws hardly break new ground. Existing legislations (Code of Criminal Procedure and PMLA) already contain provisions that permit seizure of property belonging to loan defaulters or to recover debts. The new legislation does not set itself apart from the existing legislations and is yet another law.

The biggest hurdle currently is the inability to bring the fugitives back to the country for prosecution. This crucial loophole in the law is one that this FEO Bill in unable to tackle. All it states is that failure to appear would result in the person being declared a fugitive economic offender and confiscation of his property. Therefore, the bill does not do much to compel the return and prosecution of these fugitives. It seems more viable for India to formulate terms of global cooperation and enter into bilateral treaties that facilitate a smooth and fast extradition process of these fugitives.

Yet, the evolution and enactment of various legislations and setting up of investigation institutions is slowly tightening the noose around corporate fraud and their perpetrators. The mounting public pressure to prosecute is also helping the cause. However, several hurdles prevail, prime being lack of manpower in institutions set up to tackle corporate fraud along with corruption and bribery whereby such cases do not come to the forefront of investigations and public knowledge. This too is slowly changing with even bank and government officials being tried and convicted of fraud and corruption which helps to put fear of the law in various stakeholders. Gradually, relevant laws are being put to their intended use and cracking down on the guilty. The other enabler is use of technology –different databases where economic transactions and information resides like banks, tax, accounting etc. are being integrated and through use of analytics there is convergence of information for effective enforcement.

There are three pillars which hold the fabric of the society- effective laws, enforcement and outlook of the society. The laws we legislate are among the finest, which is borne by many independent studies, our enforcement systems are gearing up with the aid of technology and refinement to stand up to the challenges and outlook of the society is undergoing a metamorphosis. The framework of accountability through public scrutiny, judicial process and media is strong; the younger population, whose tolerance to bribery, corruption and social crimes is lower than the earlier generations is a key driver of this change.

The current winds of change will hopefully blow away the dispensation that works against public interest and disrupt the status quo of entitlement of the corrupt. Justice will be quick, efficient and just. That is the society we all wish to see and live in.

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