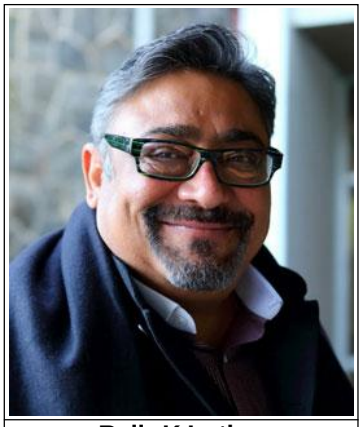
Shell Companies In India: future challenges in regulation



Rajiv K.Luthra
Founder & Managing Partner
L & L Partners

Sahil Arora
Senior Associate
L & L Partners

The country has, for many years, dealt with the menace of 'paper companies' (popularly referred to as 'shell companies'), that are seen as entities devoid of any business or operations, and have been formulated with the sole objective of money laundering, tax evasion and in some cases, association with fraudulent ponzi schemes and corruption. There have also been growing instances of companies using such 'shell companies' to convert undeclared income or 'black' money into 'white' by using layers of companies that exist only on paper. The directors of such companies are mere 'name lenders' and often receive a fixed amount for signing documents for the purpose of registration and other compliances. Many a times, even though IT officials are able to trace such directors, it becomes particularly cumbersome (in some cases, impossible) to trace the actual beneficial owner of such companies.

The Government, in line with its stated policy objective to curb the menace of 'black' money, has sought to tighten the noose around the unscrupulous use of such shell companies and undertaken various measures in this regard. However, in doing so, it has encountered various challenges including having taking measures that have the potential of having the unintended consequence of impacting legitimate business vehicles and hampering the 'ease of doing business' in India.

Hiccups and Challenges: SEBI's actions against 'shell companies'

In 2017, the Securities Exchange Board of India ('SEBI') had issued a communiqué to the stock exchanges, seeking to place the trading in 331 suspected shell companies in Stage IV of Graded Surveillance which entails severe trading restrictions. SEBI justified its action on the basis of a letter issued by the Serious Frauds Investigation Office ('SFIO') of the Ministry of Company Affairs ('MCA') which had identified a list of 331 suspected shell companies. The exchanges were also asked to verify the credentials and fundamentals of those companies and even appoint a forensic auditor, if necessary, for the purpose of investigation.

While SEBI's move could be compared with the US Security and Exchange Commission's ('SEC') action of suspending 379 dormant companies in the year 2012, it was different in one crucial aspect. SEC's action against such companies was backed by some preliminary investigation unlike in the case of SEBI where it merely relied on the letter from the SFIO.

With SEBI's action not being accompanied by a public disclosure on the parameters or legal basis for 'branding' the companies as 'shell companies', it was wholly unclear as to what legal provisions were violated by the targeted companies. It accordingly came as little surprise that the courts and tribunals came down heavily on SEBI for branding companies as 'shell' without any investigation and putting trading restrictions.

The above action by SEBI is reflective of the common problems that regulatory agencies around the world face while initiating actions against shell companies. Even the SEC's move against 379 dormant companies was bereft with failure to find sufficient evidence of manipulation and securities fraud against the controller of such companies.

No definition of 'shell' companies

In India, the very first hurdle that arises in investigation and prosecution of such entities is the lack of a comprehensive legal definition for 'shell companies'.

While the MCA has received suggestions from a multi-agency Task Force and appears to be keen on adopting the definition of 'shell companies' given by Organisation for Economic Co-operation (OECD) which has defined a shell company as a firm that is formally registered, incorporated or otherwise legally organised in an economy but which does not conduct any operations in that economy other than in a pass-through capacity. It may also look at the definition of Shell Companies in The Securities Act, 1993 of the United States where a shell firm is one that has no or nominal operations and assets, with the assets consisting mainly of cash and cash equivalents with very little other assets. In other words, a shell company should not have active business operations or assets.

Crackdown under the Companies Act

While the government is yet to come up with a definition and comprehensive legal framework governing the illegal uses of shell companies, the MCA has taken significant steps under Companies Act, 2013 in order to start identifying dormant and deregistering them.

For instance, in December 2016, MCA notified Sections 248 to 252 of the Companies Act, 2013, with which the Registrar has the power to remove the name of a company from the Register of Companies if it has reasonable cause to believe that a company has failed to commence its business within one year of incorporation or has not being carrying on business or operation for a period of two immediately preceding financial years without applying for the status of a dormant company within such a period. The procedural aspect of striking off has also been notified by the MCA in the Companies (Removal of Names of Companies from the Register of Companies) Rules, 2016. The MCA has also exercised powers under sections 1649 and 167 to disqualify directors of the companies that have not filed annual returns for the past three years. In addition to this, the Companies (Amendment) Ordinance, 2018 has inserted Section 10A which has reintroduced the requirement of declaration of commencement of business by the directors of the company. This is in addition to the norms relating to significant beneficial ownership and general KYC related compliances that have been included to identify the beneficial owners of Indian entities.

The issue of Geo-Tagging

More recently, the MCA went a step further, and mandated every company incorporated on or before the 31st December 2017 to file the particulars of the company and its registered office, in e-Form ACTIVE (Active Company Tagging Identities and Verification) which includes geo-tagging the registered office location and photographs of offices.

The Companies' that are found to be non-compliant would be red-flagged, with the companies and its directors labelled non-compliant and face restrictions in operations, with the possibility of facing action from government agencies like the income tax department, the enforcement directorate and SEBI.

While the intent of the government is not in doubt, and is in fact, laudable, the instant move to require geo-tagging of offices could cause difficulties for start-ups and small businesses working out of places such as co-working spaces. The implementation of the rule would accordingly be closely examined by legal practioners and businesses alike.

The Road Ahead

The steps taken by the government to address the issue of shell companies, reveals an over-emphasis on 'striking off' of the names of companies. However, the causal link being seen between striking off dormant companies and addressing the issue of money laundering posed by shell companies, does not necessarily address the menace, and in fact poses the risk of there being unintended consequences.

Shell companies should not, per se, be considered as illegal entities because they have been commonly used in conducting reverse mergers and instead of setting up an IPO, many private companies prefer to acquire dormant listed shell companies in order to convert itself to a public company. Apart from this, 'shell companies' are often used as 'single or special purpose vehicles', and there are instances of companies creating such shell companies so as to transfer and safeguard their intellectual property. Other legitimate uses of shell companies include avoidance of unfavourable tax consequences, joint ventures and to isolate liability. Therefore, the government must balance the need for 'ease of doing business' while keeping up with the mission of prosecuting controllers of shell companies.

Accordingly, the policy objective of the government should not be only confined to identification of dormant companies and striking them off but to also investigate for an 'element of fraudulent intent'. A clear distinction must be created between cases of irregular filings and fraudulent conduct. The first step of any regulatory policy concerning 'shell companies' should be to come up with a comprehensive legal definition where apart from 'financial irregularities', several other parameters should be employed by the government in identifying shell companies and classifying them accordingly. Otherwise, the government would certainly be running the risk of its actions being judicially challenged or severely impacting the 'ease of doing business' as well as the cause of start-ups, which the government has sought to champion.

Mr. Rajiv K. Luthra is Founder and Managing Partner of L&L Partners (formerly, Luthra & Luthra Law Offices) and Sahil Arora is a Senior Associate at L&L Partners. The views expressed are personal and are intended for general information purposes and are not a substitute for legal advice.