

A skewed view of corporate fraud

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The law goes too far in crucifying a company for the conduct of a handful of its employees

Even the most well-intentioned of legislations can be quite ineffective in providing succour to honest investors, protecting innocent employees and safeguarding interests of the company.

Whether it was a case of corporate fraud in Satyam and Enron, or even the case of product negligence in cases such as General Motors and Ranbaxy, criminal prosecution of the perpetrators does not provide monetary compensation for the erosion in investments and damage to credibility.

The failings of the law include the failure of regulators to distinguish between criminals who are employees and the company itself, recovery of proceeds from fraud, and balancing the rights of the company and shareholders.

A recent report by Economist Intelligence Unit and Kroll, a US risk consultancy, has found that 69 per cent of India's companies were affected by fraud in the last year. The most chilling aspect was that 89 per cent of the respondents surveyed indicated that the perpetrator was an insider.

The problem

We see companies being prosecuted and investigated when some of its employees engineer a scheme to commit a fraud. Since the law itself sometimes fails to recognise the distinction between the perpetrators and the company, aggrieved shareholders have no choice but to prosecute the company.

The new companies law seeks to strengthen shareholders' action against a company and, in future, this would only increase liability of the company and its directors for the unauthorised, illegal and criminal acts of some employees.

This incongruity is not restricted to scenarios under company law — fraudulent employees colluding with employees

of PSUs/PSEs who embezzle funds in public contracts can also cause the company to be blacklisted from participating in government contracts.

In such cases, it is imperative for directors and employees of the company to demonstrate that the company's decisions were in good faith and the actions of the fraudsters were unauthorised. Ironically, while the company is forced to compensate its shareholders for the actions of the fraudsters, the prosecution of the company affects the value of investments of the shareholders.

The solution

Given that instances of corporate fraud are on the rise, the board of directors of a company must ensure that actions of employees and directors are adequately documented. For their part, shareholders must also show greater participation in the decision-making process and in enforcing their rights. Shares are not a secured investment — every shareholder accepts certain risks and is therefore bound to exercise care and caution while attending shareholder meetings. With shareholders and employees keeping a watch, it would be easier for a regulator to prosecute the real culprits rather than prosecute the company — itself a victim of fraud.

The protection of shareholders' interests could have been addressed by incorporating in the new act a principle commonly referred to as 'proceeds from crime'. In the context of corporate fraud, proceeds from crime would be monetary benefit that has been appropriated by the perpetrator.

Under India's current law, regulators and enforcement agencies cannot attach proceeds from crime. While imprisonment may offer retributive justice to aggrieved shareholders, it does not compensate for the financial loss. Burdening the company with the financial obligation is an uneconomical apportionment of risk that only emboldens brazen criminals.

Innovative legislative measures of attaching properties acquired by fraudsters would ensure that proceeds from crime are restored to the rightful owners.

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(This article was published on July 15, 2014)