

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 6 | Issue 4

2023

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Disrobing Shell Companies Combating Maliciousness through Corporate Governance

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ABSTRACT

The term shell company is derived from a shell which has an outer covering but nothing inside. The terminology of “nothing inside” signifies the fact that it doesn’t have tangible operations. Shell corporations could be viewed as a planned system set up to engage in dishonest acts. The expansion of shell firms in the market is no longer surprising. What’s shocking is that how quickly these corporations are mushrooming across the globe. Nonetheless, such businesses are legitimate till the time their illegal actions are concealed and unchallenged. Our paper will outline the efforts adopted by the government to eliminate shell corporations in attempt to regulate illegal financial activities, facilitate clarity, and promote overall improved governance practices. In addition, we tried to cover the law surrounding the shell firms. Part I discusses about the introduction to shell firms and the motive behind setting up these companies. Part II deals with the steps initiated by the Ministry of Corporate Affairs by “Operation Clean Money”. Part III represents our analysis and certain suggestions we could develop in our minds through the research.

I. INTRODUCTION

Meaning of Shell Companies. What is the ambit of Shell Companies and what is the motive behind setting up of Shell Companies?

The dilemma of shell companies is that till date, it has not been defined under any of the Indian Legislations such as the Companies Act, 2013; The Indian Contract Act, 1872, The Income Tax Act, 1961 or any other provisions.³ However, OCED (The Organization for Economic Cooperation and Development) through one of its publications defined shell companies as **“A shell company is a company 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. Shells tend to be conduits or holding companies and are generally included in the description of Special Purpose Entities”**.⁴ The shell corporations are

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³ RAJ ARYAN & DHARNA RAJPAL, SHELL COMPANIES: ILLEGALITY IN FUNCTIONING & REGULATORY FRAMEWORK, THE DAILY GUARDIAN, SEPT 30’ 2020.

⁴ Shell Companies in India - Obhan & Associates (obhanandassociates.com)

generally formed as a subsidiary to assist in the business takeover or property acquisitions; however, it manages to function as a transactional platform in these acquisitions despite being dormant in nature and having shortage of funds.⁵ A shell firm owner, for instance can move currency from a foreign state to their home state by avoiding tax. Such corporation can also be put on hold and said to remain idle till a proprietor requires it. The shell companies are not that active in taking part in the business transactions, but they are the non-trading firms which are listed in the stock exchange market. By virtue of being listed in the stock exchange, it provides the parent company to escape unwanted attention that it may attract while conducting businesses on the stock exchange.⁶ They also, serve as a shield against the identity of the company owners as most nations permit the true owners to stay nameless, thus allowing easier conditions for hiding and laundering money. A shell company may be defined as a company having shares of another firm or a corporation with money but possessing no significant assets. Certain shell companies might have been active in the past but now have dwindled due to dormancy or mismanagement.⁷ Such circumstances facilitate them to exist mainly on paper and thus, can contribute to tax avoidance, fraudulent activities, and money laundering actions. Majorly the shell companies are located in countries with weak taxation regulations. Although shell corporations are frequently perceived critically as it can be used for certain illegal purposes, *prima facie*, these companies aren't illegal and some of the corporations utilise them for legitimate economic purposes. Shell businesses are lawful in certain circumstances.

The above explanation to the scope of shell companies helps in identifying it from other corporations. It's vital to examine such companies in order to monitor their illegal activities which has time and again proved to be detrimental to the nation's economy. Thus, it is also at the same time important to know the *motive behind setting up such companies*. **Firstly**, many corporations and affluent people tend to avoid taxes by establishing shell companies in jurisdictions where they aren't required to pay as high taxes as compared to the off-shore areas such as British Virgin and Cayman Islands, Bahamas and Switzerland etc. **Secondly**, shell firms by virtue of lacking existence physically, aids in concealing the real owners of companies that have placed their assets in them. **Thirdly**, shell companies help in laundering of currency by converting the black money into white and using it in mainstream businesses. To legitimise the cash, the corporation sometimes do also fabricate bogus bills and receipts, giving an impression of a real corporate operations.

⁵ Varun Chopra and Subin Thattamparambil Govindankutty, Lifting the Corporate Veil on Shell and Shadow Companies - An Indian Overview, CNLU LJ (7) [2017-18] 96, 97

⁶ Ibid

⁷ <https://marketbusinessnews.com/>

For instance, this is an illustration to help you understand how the illegal transaction using a shell company can work. Supposedly, Company A is into an iron and steel manufacturing business and has a subsidiary shell company B. Company A is going into huge losses and is on the verge of liquidation. Now, company A can transfer its remaining valuable assets to company B. On liquidation of company A, their creditors won't be able to recover the funds as the company has none of the assets on their name. Later on, the promoters of company A can use the assets transfer to B as and when they wish to.

II. THE PANAMA PAPER CASE REPORT

The Panama Paper leaks have provided information regarding the companies that sued various people in higher positions and companies, who were trying to save or earn money and exploit the safeguards provided by having a distinct legal identity. The International Consortium of Investigative Journalists (ICIJ) released a report that unveiled all concealed documents which were over 2 Lakh off-shore organisations located all across the globe. The data contains the details about firm owner and intermediaries in tax havens. ICIJ hasn't revealed the bank details, the communications transferred or the cash activities disclosed in the records, of such firm owners and intermediaries. However, many reporters around the globe probed into the details in the documents for a long time, which lead to the disclosure about the involvement of leaders all over the world. These documents included various politicians, affluent people from different countries and the directors from the companies that had already been de-registered in the past by the law enforcement agencies. According to the Panama Papers leak, aides of Russian President Vladimir Putin fraudulently moved up to \$2 billion via banks.⁸ Following the Panama case and the devastating data they revealed, it is clear that much focus has to be dedicated towards this apparent misuse of shell firms by both inside and across the nations. In wake of this, CBI also investigated many scams which gave disturbing results of crores of rupees being laundered and tax evaded in lieu of these shell companies.

Furthermore, **not all shell companies work illegally**. Some of them can be used to create small businesses, as initially they are not stocked up with large investments and commence as firms existing on paper only. Small businesses might not have enough assets as they sustain themselves on minimal assets. Such firms who do not have an evil intention, can be mistaken as illegal shell corporations.

For example, Adidas established a new shell firm named as Adidas Originals to enter into

⁸ Marina Walker Guevara, ICIJ releases database revealing thousands of offshore companies, ICIJ, <https://panamapapers.icij.org/blog/20160509-offshore-database-release>

fashion apparels which was different from their *USP* of athletic shoes. A merger of this type enabled the parental business to invest into endeavours without risking its name, in case the project tends to be unsuccessful. Thus, it is extremely essential to isolate the legal shell companies from the illegal ones while trying to curb the threat of illegal activities. *SEBI* also pointed out two parameters through which it can be done. *Firstly*, that whether the address provided in the memorandum by the company is legitimate or not. *Secondly*, it included the necessity to monitor business transactions, as the biggest evident flaw in illegal shell companies is that it doesn't engage themselves in actual operations.

In light of the following efforts adopted by SEBI, the government also brought certain *development* in the companies act, *Section 3* with regard to shell corporations.⁹ It amended the minimum requirement of paid-up capital in cases of both public and private companies. This tries to eliminate shell firms that are formed with little capital for the purpose of earning profits, as the new required capital clause ensures that companies would require assets to offer remuneration and fulfil legal duties¹⁰. In addition, the new amendment in tax laws would also mandate the firms to pay tax, irrespective of whether they were incorporated in India or Abroad as long as their administration made critical business judgements in India.¹¹ Thus, the revised legislation makes it impossible for persons to incorporate companies in tax havens yet manage those in India.

III. DETERMINING 'LIFTING OF CORPORATE VEIL'

India being the world's fastest growing economies has been able to encourage and accost the incorporation and activities of various companies, whether multinational corporations or subsidiaries, which has led to the creation of economic activity within the country and has created a fierce market globally.¹² Fraudulent companies are prevalent in India too. These companies hide behind the corporate veil and utilize it as a cloak and use it as a prevention from getting perceived equitably.

There are cases of scams where fraud and other illegal acts that are being carried out by many corporations, only because their shareholders and officers want to gain perks and when they are being held liable in the court of law, the most preponderant defence they use is that of

⁹ Varun Chopra and Subin Thattamparambil Govindankutty, Lifting the Corporate Veil on Shell and Shadow Companies - An Indian Overview, CNLU LJ (7) [2017-18] 96, 97

¹⁰ Ibid

¹¹ Shruti Srivastava, Government amends I-T Act to put curbs on shell companies, The Indian Express, March 2nd, 2015.

¹² Varun Chopra and Subin Thattamparambil Govindankutty, LIFTING THE CORPORATE VEIL ON SHELL AND SHADOW COMPANIES - AN INDIAN OVERVIEW, SCC Online Web Edition: <http://www.sconline.com>.

corporations have a separate legal identity for their shareholders or officers. According to the Common Law, a corporation once it is incorporated becomes a separate legal entity and the owners or shareholders cannot be held accountable for the actions of the company. This principle was first explored in *Salomon v. A. Salomon & Co. Ltd.* where the House of Lords upheld the doctrine by stating that the primary shareholder cannot be held liable personally in case, he discharges the debt of the company. This principle which was propounded by the House of Lords has been given credence to in India as ballast for company law.¹³ This doctrine had exposed a lot of means of escape that companies have been exploiting to derive personal gains. The recognition of a separate corporate personality is impeccable, a person can take advantage and use such a legal identity by taking any legal action which may be exploitative of his own legal personality.¹⁴ Companies are legal entities too, and they can overthrow burden by creating subsidiaries in the form of shell companies which have either minimal, or zero assets to indulge in illegal and risky business thereby ensuring limited liability of the parent company. The rationale behind undertaking no operations in a shell company is that the money invested by the owner remains non-taxable. The court is entitled to lift the corporate veil and to pay regard to the economic realities behind the legal facade if it is used for tax evasion or to circumvent tax obligation.¹⁵

IV. MEASURES INITIATED BY THE GOVERNMENT

(a) A TASK FORCE SET UP BY MINISTRY OF CORPORATE AFFAIRS FOR COMBATING SHELL COMPANIES:

The government of India has facilitated ‘Operation Clean Money’, to strengthen corporate governance. The Registrar of Companies (‘RoCs’) issued public notices on April, 2017 to remove the company’s name from the RoC, and to dissolve them and such a notice is excusable only if a cause in contrary within thirty days. Subsequently, the government reported over 2.09 lakh companies that had been struck off from the RoC for not acting in compliance to the regulatory requirements. The Government took this step to scrutinize the financial irregularities that prevailed in the country through the shell companies which acted as a channel to convert black wealth into white while not conducting business operations or keeping significant assets.¹⁶

The Ministry of Corporate affairs initiated a press release which highlighted three important points:

¹³ *Salomon v. A. Salomon & Co. Ltd.*, [1897] A.C. 22.

¹⁴ *Ibid*

¹⁵ AIR 1967 SC 819.

¹⁶ MINISTRY OF CORPORATE AFFAIRS, available at <http://www.mca.gov.in/MinistryV2/roc.html>.

A. Restricting towards operating of bank accounts: In accordance with the Department of Financial Services (DoFS) instructions, all banks were instructed that the directors or their authorized signatories to be restricted, from the operation of bank accounts of such companies so as to prevent them from siphoning off money from the accounts of these deregistered companies.

B. Invoking Section 447 of the Companies Act, 2013.: In case a director or authorized signatory of any company who was removed, tries to draw off money from their bank account, then they may attract punishment of imprisonment for not less than six months which could be also extendable up to 10 years. If the fraud comes in conflict with the public interest, the punishment shall not be less than 3 years (imprisonment) and a fine may also be imposed up to three times the amount involved.¹⁷

C. Vacating offices: The directors of the shell corporations who haven't filed returns for three years or above, will be disqualified from any other company and such companies will not appoint them as a director. They also won't be re-appointed in the companies where they were an ex-director. This may result in debarring of two to three lakhs directors.¹⁸

The Government has also resorted towards striking off the names of the companies from the RoC in case they are not operative i.e., those companies which failed to file their financial statements along with annual returns for a period of exceeding two years would be removed from the registered members. This is in fact a prominent effort in controlling the siphoning of funds by shell companies. The **section 248 of the Companies Act, 2013** specifically states that the RoC has the power to struck off the name of the companies from its Register if the registrar deems it so reasonable i.e. :

- (a) If the company concerned has not commenced its transactions after a period of one year since it had been incorporated.
- (b) If the concerned company has not engaged in any business or operation for a period of the preceding two financial years and has not applied for dormant company status.
- (c) If the subscribers to Memorandum haven't paid subscription amount which they were obligated to pay and any declaration regarding the same hasn't been provided within 180 days from company's incorporation.¹⁹

¹⁷ Nikita Snehil, Strengthening Corporate Governance by "Operation Clean Money" In Corporate Sector – Ministry's move to checkmate black money, (2018) 2.3 JCLG 11, SCC Online.

¹⁸ MINISTRY OF CORPORATE AFFAIRS, available at <http://pib.nic.in/newsite/PrintRelease.aspx?relid=170579>.

¹⁹ The Companies Act, 2013, § 248, No. 18, Acts of Parliament (India).

There has also been an insertion of a new Section, namely **10 A in the Companies Act, 2013**; which mandated the director of the company within 180 days from its incorporation to ensure that every subscriber to the memorandum paid the value of shares, they had agreed to.

Where there hasn't been any filing of declaration as per the **Section 10 A**, and the Registrar has **reasons to believe that the company is not operative**, the registrar may take action to remove the name of the company from the RoC.²⁰

The Amendment Act has also inset sub-section (9) in **Section 12** of the Act. This would empower the Registrar to cause a **physical verification of the registered office** of the company if it finds reasonable.²¹

The Amendment Act has broadened the spectrum **powers entrusted to the Serious Fraud Investigation Office** to facilitate speedy and efficient enforcement.²²

(b) THE ACTION TAKEN IN CONSONANCE TO THE PRESS INFORMATION BY THE MINISTRY:

According to the Initial Press Information, The Ministry of Corporate Affairs has certified that the Professionals, Chartered Accountants/Company Secretaries/ Cost Accountants that are associated with shell companies and are involved in fraudulent activities have been recognized in certain cases and the actions adopted by such professional institutions such as ICAI and ICSI are being examined. As a result, the RoC's have begun issuing of notices to provide clarification to many professionals in relation to the certification of compliances.

The second Press Information released by the Ministry in November, 2017 demonstrated the following:

- The information regarding such companies that have been involved in illicit transactions post the era of demonetization, have been shared with enforcement authorities which included CBDT, FIU, DFS and RBI etc., for taking necessary steps.
- The Special Task Force (STF) was constituted under the guidance of Joint Chairmanship of Revenue Secretary and Secretary, Corporate Affairs, to look into the drive against such defaulting companies with the assistance of various enforcement agencies and is envisioned to assist against dispersing of black money.
- The evidence in reference to the exploitation of corporate structure via multi-layering, not

²⁰ The Companies Act, 2013, § 10A, No. 18, Acts of Parliament (India).

²¹ The Companies Act, 2013, § 12(9), No. 18, Acts of Parliament (India).

²² The Journals of India, <https://journalsofindia.com/shell-companies/>.

above two layers are now allowed beyond the wholly owned subsidiary which already existed and restricted a company to make investment through more than two layers.

- There is an action being taken against those who are guilty of fraud with the help of a High-Level Committee (HLC) which has been constituted for reconstructing the disciplinary mechanisms of Chartered Accountants, Company Secretaries and Cost Accountants.
- National Financial Reporting Authority (NFRA), which is an independent body, is being organised to test, inspect Financial Statements, prescribe Accounting Standards and initiate disciplinary action against the errant professionals.

Therefore, the above steps taken by the Ministry and its continuous undertakings to control illegal financial transactions, growth and facilitation of pellucidness and the growth of corporate governance, will help our nation to develop entirely and will also boost our performance globally.²³

V. EXTRA JUDICIAL INSIGHTS OF SHELL COMPANIES IN DEVELOPED COUNTRIES

Whenever it comes to shell firms, each country has its own set of rules. We however, can take insights as to how the developed countries such as the US. and UK. respond to the malpractices which are committed by establishing such shell firms. The Corporate Transparency Act ("CTA"), which went into effect on Jan 1, 2021, made significant modifications to the transparency obligations of organisations registered in the US.²⁴ Now, Anonymous shell firms cannot conceal the names of its owners. The goal of CTA is to restrict people' capacity to conceal operations under anonymous shell firms. CTA's action will help to erase the perception of the United States as a "safe haven" country and to eliminate the practices of anonymous shell firms in the state.²⁵ Similarly, in the British Overseas Territories and crown dependencies, they were obligated to provide the genuine names of shell company proprietors when asked by authorized law enforcement officials.²⁶ On December 31, 2020; The United Kingdom mandates jurisdictions to disclose the identities of shell company owner's publicly. It was the newest attempt to combat the widespread corruption as well as tax evasion in Britain's overseas assets.²⁷

²³ MINISTRY OF CORPORATE AFFAIRS, available at <http://pib.nic.in/newsite/PrintRelease.aspx?relid=173244>.

²⁴ Robert Appleton, The End of the Anonymous Shell Company in the United States, Harvard Law School Forum on Corporate Governance, (3rd Oct, 6:14 PM), The Harvard Law School Forum on Corporate Governance | The leading online blog in the fields of corporate governance and financial regulation.

²⁵ IBID

²⁶ UK moves to trace tax-avoiding overseas shell firm owners | News | DW | 01.05.2018

²⁷ Ibid

VI. ANALYSIS

Pertaining to the Research Question, we understand that through the public notice issued by the ROC; Section 248 empowers the ROC to cut off the company's names under two circumstances i.e.,

- (a) When a corporation failed to commence its business within one year of its incorporation;
- (b) Where a company isn't indulging in any business or operation for two immediately preceding financial years **and** the said company has not made any application within this period to obtain the status of a dormant company under section 455 of the Act.²⁸

But in the contrary, it is important to understand that almost every shell company does not seem to have actuate the conditions mentioned on the basis of which they deregistered the shell companies. There are other indicators under which a bogus shell company falls, which they fail to incorporate under the prescribed provisions. **We as researchers have found a defect in the Companies Act, 2013 which has not been successful in determining shell companies.**

“Consequently, A question of validity of the actions by the ROC arises!”

There has been a perplexity in understanding the difference between shell companies and inactive companies.

As per Section 455(1)(i) of the Companies Act, 2013- The ambit of inactive company is as follows:

- That hasn't carried any business or operation.
- Hasn't made any transactions during the preceding two financial years.
- Hasn't filed financial statements and annual returns within the previous two financial years.²⁹

To understand better, let's analyse a different section which authorises the ROC to remove the name of a company from the Register of Companies under Section 455 of the Act, that talks about dormant companies:

- When a company doesn't file financial statements and annual returns for two financial years, a notice is issued by the Registrar, and the name of such a company is entered under dormant companies.³⁰

²⁸ The Companies Act, 2013, § 248, No. 18, Acts of Parliament (India).

²⁹ The Companies Act, 2013, § 455, No. 18, Acts of Parliament (India).

³⁰ The Companies Act, 2013, § 455 (4), No. 18, Acts of Parliament (India).

- Subsection 5 refers to the provisions that a dormant company is required to maintain to retain its status of dormant companies or draft an application to convert itself as an active company.³¹
- The Registrar shall remove the name of a dormant company from the register of dormant companies, those who have not acted in compliance with the requirements.³²

The aforementioned provisions make it evident that ROC is authorized to enter and remove the name of a company *'to and from the register of dormant companies' only*.³³

Nonetheless, in the present situation, the procedure mentioned above has not been duly followed by the ROC's and names of such companies are being straightaway removed from the register of members because the above provisions specifically talks about the dormant companies, and not shell companies.

The government has not been able to bring clarity between the conception of shell companies and dormant companies, on the basis of which, the ROCs have been striking off the names of the companies where there was no filing of financial statements and annual returns during the past two financial years. Thus, the cause of the action relates to section 455 (dealing with dormant companies) while on the contrary, the result is associated to section 248 (dealing with striking off of the companies).³⁴

Therefore, a clarification is required that explains the enabling provisions which have facilitated such action of the ROC.

We understand that the Task Force set up by the Ministry of Corporate affairs have led to the reduction in the menace of the companies indulging in illegal activities that includes facilitation of tax evasion under the name of shell companies and has made the process more systematic. In December 2021, the ministry had informed the lower house that since the inception of 'Task Force', there has been decline in the number of shell companies. During 2019-2020, there were only 48 dormant companies and the number fell to 19 in 2020-2021. **However**, we hope that the government soon comes with a better provision of shell companies, and includes a section specifically for it in the Companies Act. A well-defined shell company is the need of the hour.

³¹ The Companies Act, 2013, § 455(5), No. 18, Acts of Parliament (India).

³² The Companies Act, 2013, § 455(6), No. 18, Acts of Parliament (India).

³³ Nikita Snehil, Strengthening Corporate Governance by "Operation Clean Money" In Corporate Sector – Ministry's move to checkmate black money, (2018) 2.3 JCLG 11, SCC Online.

³⁴ Ibid

VII. CONCLUSION

As per our understanding, a lot of affluent people in India use a significant amount of shell corporations for unlawful operations, tax avoidance and other malpractices. There are recurring scams that we hear in India, for the sole purpose of earning money illegally. The recent scams in India according to the evidence provided by CBI and ED, included “Yes Bank Scam”, in which the owner along with his family established about 100 shell companies for misappropriating the funds and financial manipulation.³⁵ The famous “P. Chidambaram scam” in which he was linked in issuing illegal Foreign Investment permits to receive the bribes. Those bribes were made illegally via shell firms that were run by his son. The investigative agency discovered multiple shell businesses created globally with investments totalling more than Rs. 300 crores.³⁶ The “PNB Scam” where Nirav Modi, laundered a huge amount of money with help of 17 shell firms outside India.³⁷

Shell firms facilitate money laundering, illicit capital transfers, and tax avoidance, all of which have economic consequences. The shell businesses pose a significant concern to investors. The lack of comprehensive definition of shell companies is a challenge for the investors to differentiate a genuine shell company from a bogus one. Such entities jeopardise both the investors as well as shareholders’ interest in the company. As a result, shell businesses are difficult to track down since they conceal their owners in order to avoid legal oversight.

The authors would like to point out certain **suggestions** as to governance of the shell companies:

1. To acknowledge a clear definition under The Companies act, 2013 as the inability to do so, has been one of the major challenges impeding investigations and convictions of companies associated with financial crimes.
2. Capital market regulators must develop a comprehensive method to differentiate between real shell businesses and ones employed for laundering money.
3. The country's taxation system must foster trust rather than undermine countries economic goals. It is expected to increase capital formation and global competitiveness.³⁸ The setting up of shell companies for the sole motive of illegal transactions and money laundering should be heavily penalised.

³⁵ Shell companies: Illegality in functioning & regulatory framework - The Daily Guardian

³⁶ Ibid

³⁷ Ibid

³⁸ Vodafone International Holdings BV v. Union of India : case analysis - iPleaders

4. Instead of the requirements spread in various and disconnected laws, the parliament must simplify and integrate them into a compact framework of corporate governance.
