

# LEGALFOXES LAW TIMES

## CORPORATE SCANDAL

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### INTRODUCTION:

Corporate scandal can be defined as widely publicized incidents involving allegation of managerial wrongdoing, disgrace, or moral outrage of one or more members of a company.

Corporate scandals are about the illegal, illicit, unscrupulous, unethical actions that is done by someone or by group of people within corporation. These kinds of incidents becomes huge incidents and often known as scams in corporate. The authenticity of their work is putted into question, their morality and their taxation duties towards government as well these scandals when comes out in which are either allegedly illegal or actually illegal. That is why corporate scandals are about ethical practices or behavior, by legal decisions or combination of two. Generally when these types of scandals takes place the whole firms gets defamed even if the unethical act is done by a single person or group of people in the company because the suffering is ultimately to the investors, shareholder or consumers of the company and also because it was negligence of the company first that they couldn't judge the scenarios of fraud taking place in their own firm. typical schemes of frauds that has been traced repeatedly over the years are misstatement of financial figures on current, past or future investment or operations, failure to disclose information or delay information retention, bribery, insider trading, and any other illegal activities that hampers the investors, shareholders of the firm. Companies' misconduct has two main aspects:

Firstly, there will be fall in stock price making secondary equity offering increasingly diluting and costly;

Secondly, it will ultimately reduce, cancel altogether, managerial independence in making capital structure related decisions.

Managers, arguably, are aware of the risks associated with malpractices and therefore have strong incentive to make best out of it while it lasts. It is then obvious that will exploit this information to increase the amount of funds they collect to anticipate to potential capital constraints after scandal eruption. Funds can be utilized in various ways: to rebalance their low cost of financial structure of company, to enhance the liquidity stock, to deliver a steady stream of cash flows, distribute payments their investors and shareholders.

#### DIFFERENT KINDS OF FRAUDS:

The impact of fraud can be big on organization. it can significantly make difference to financial position of the organization.

#### FINANCIAL STATEMENT FRAUD:

This type of fraud is not very popular but this endangers the company to extent of defaming company and putting its shareholder s investments to risk. this fraud is done in following ways: overstating revenue, earnings and assets along with liabilities. Generally, by overstating revenue, earnings and assets the corporate tries to get rid of their taxation liabilities.

#### ASSET MISAPPROPRIATION:

This one is one the most common frauds that fall into the category of assets misappropriation, which businesses that closely related are endangered to.

#### SKIMMING OF CASH AND CASH LARCENY:

This involves withdrawing of cash before it even enters into company's accounting system. It's very hard to recover this loss in this type of fraud because its tuff to find evidence of how much and when cash is withdrawn from unrecorded amount of cash. it is more of sophisticated and popular choice of people to do fraud. Checking tampering, accounts receivable skimming, fake billing schemes, payroll schemes, fake or duplicate expenses reimbursement schemes and inventory schemes are also common examples of assets misappropriations.

#### MISUSE OF COMPANY ASSETS:

This type of fraud which is very common the assets are bought by company are misused by the company in many ways or sometimes this also happens that they are bought by managers on account of company and never show it in their books of accounts and even if they show they are not used well for the company completely. Which later also leads to liability to the others.

#### **THEFT OF INTELLECTUAL PROPERTY AND TRADE SECRETS:**

As of now in modern times our world is driven by IT sector, there is a lot of theft of intellectual property and trade secrets is taking place quite frequently.

#### **HEALTHCARE, INSURANCE AND BANKING:**

These industries are where billions of dollars are flowing through their systems, making them primary most target for this type of fraud. Bogus health, insurance claims and fraudulent bankruptcies are all ways individuals commit this type of fraud.

#### **CONSUMER FRAUD:**

Many people are targeted through cons, bogus telemarketing, email id theft, ponzi schemes, and other schemes, are all victim of consumer frauds. Frauds can take any shapes and can impact an organization in many ways not just financially.

#### **HOW CAN CORPORATES PREVENT SCANDALS?**

#### **REWARD HONESTY:**

We can prevent scandal by rewarding the honesty of employees rather than merely encouraging it. Some companies have a values statement or code of ethics that emphasizes honesty, but they still pay and promote salespeople based on the sales figures alone or give bonuses to supervisors based on short term profits without any other consideration. In such cases there are high chances that employees will go by unfair means to meet the sales target in order to gain the reward money/benefits. Hence the company's incentive structure programs should be based on employees ethics, behaviour compliance also in addition to volume targets. The companies should offer incentive trips in a team or individual instead of hard cash in order to avoid corruption and encourage fair competition among employees.

### CHANGING THE CULTURE:

Once unethical corporate culture is established, it is very difficult to root out. Even honest employees will be under constant pressure to conform to the prevailing culture. One way to solve this problem is to encourage employees who are honest and follow ethics & compliance in their day to day work. The companies should also reward and recognize honest employees to set an example for other and give encouragement to the other employees to practice ethical behaviour in their business dealings as well in their personal life. United Airline's incident took a massive hit reputation ally over its recent force removal of a passenger due to overbooking but nevertheless directly benefits from the fact that huge numbers of people continue to fly.

**REPUTATION:** The degree to which corporate scandals take consumers by surprise will influence the degree to which a brand feels the heat. One of the main reasons Volkswagon received such vulnerable reaction to their emissions scandal was because they are such a highly recognized brand. There was huge sense of disappointment that they had behaved the way they behaved. Nevertheless, the brand have used the momentum of the corporate scandal to benefitting effect. They further restructured their business, after looking at its processes again and chopping remuneration to get itself back on course. They have been able to offset the damage by drawing on their brand goodwill and by acting decisively and systemically to restore their standing.

### INVESTOR REACTION:

Every scandal is likely to provoke some level of short term reaction, the main benefit for the market lies in the long term effects on shareholder value and underlying stock prices. The fallout from the Petro Bras scandal in Brazil is an example of corporate scandal that has not only rocked a brand which Brazilians were proud to call their own, but then had ongoing impacts for the sectors and perhaps for the investment in that part of the world

**RESILIENCE:**

A brand's ability to move on from a scandal is critical to it achieving renewed traction in the market. While the Global Recall of the Galaxy Note 7 device is said to have cost the Samsung brand the better part of \$6 billion, the company rebounded quickly with the significant success of its Galaxy S8 and S8 plus handsets, to the point where Forbes declared, 'coupled with a positive reception from the critics, the Galaxy S8 and S8 are on course to return Samsung to the top of the android free tree for the first time in nearly a year, provide a strong challenge to apple's current and future Iphone line up, and to define what it means to be a smart phone in 2017. The secret is knowing what to respond to, when and how.

**DURATION:**

The length of the time that corporate scandals remain in the news can have detrimental effect on a brand's stability to recover. The negative publicity to a brand makes the consumers lose their trust and reliability on that brand and the longer it lasts the lesser time the brand gets to recover and bounce back into the market like in case of Nestle Maggie we witnessed that its infiltration and all it was also banned but the case on NESTLE Maggie did not last that longer and came back to the market because it faced not as much negative publicity as it had gained love from everyone who were fond of Maggie and of the opinion that it is healthy and tasty over the years.

**LANDMARK CASES ON CORPORATE SCANDALS:****CASE STUDY 1: SAHARA GROUP<sup>1</sup>**

This case came into radar of SEBI for the first time which ultimately led to arrest of Sahara India Pariwar Mr. Subrata Roy in 2014. This case was basically about conflicts in regulation. So the story is like this that there is one document called DRHP which stands for Draft Red Herring Prospectus and it is when a company wants to raise money from public, the company will have to give information of financial operation and business transactions so company has to submit a DRHP document which is like an offer document to SEBI for IPO which stands for initial public offering. Then SEBI decides to approve it or not so when the DRHP in this case was submitted to SEBI by Sahara for its two companies i.e. Sahara India Real Estate Corp Ltd. (SIRECL) and

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<sup>1</sup> SUBRATA ROY SAHARA v. UOI, (2014) 8 SCC 470

Sahara Housing Investment Corp Ltd (SHICL) which issues OFCD, which were before getting permission that too without submitting IPO was collected which obviously stood out as illicit collection. Meanwhile Sahara denied that SEBI had no jurisdiction in the matter.

When on 30 SEPTEMBER, 2009 SEBI received the application for the same then only SEBI had sensed that there was something illicit going on in the companies but then on 25 DECEMBER, 2009 and on 4 JANUARY, 2010 complaints were filed against these two companies then it was affirmed to SEBI that definitely something wrong was going on. the complaints said that this company has been raising funds from us without being registered to SEBI and it was then after investigation discovered that Rs. 24000 was raised from 2 to 2.5 crore investors. There was no transparency of how the funds were raised i.e. process of raising funds and where it had been used. Through OFCD which optional fully convertible debentures company took money from public. There is rule that if OFCD has to be issued to less than 50 people in public then permission of ROI is required and if OFCD has to be issued to more than 50 people in public then permission of SEBI is required. And there is another rule that fund raising process has to be completed within six months but Sahara continued to raise funds for OFCD for 2 continuous years.

Then SEBI went on to take action and banned Sahara India Real Estate Corp Ltd. (SIRECL) and Sahara Housing Investment Corp Ltd (SHICL) and asked to return public 's money along with 50 % interest in return to which Sahara went on to appeal in Allahabad High Court for the same and got stay orders in SEBI ' s orders. But then on 11 APRIL, 2011 the high court reversed its orders and imposed ban plus 50% interest to be paid back to the public from the money was borrowed. then to fight over this issue further this case was challenged again before Supreme court and supreme court suggested Sahara group to challenge this case before the Securities Appellate Tribunal(SAT). Then SAT also approved to SEBI's orders and ordered Sahara to follow it.

Then Sahara went back to Supreme court and stated that it was private placement which was limited only to people who were closely related to Sahara not for public as in he denied that it wasn't a OFCD due to which he further added by saying that SEBI has nothing to do with it. So SEBI shouldn't interfere in it. Then SEBI said that if there is more than OFCD offered to public or anyone then it must to take SEBI's permission which wasn't taken.

After detailed investigation it also came out that Sahara had fictitious investors there was money laundering being done i.e. the details of investors had not been provided. Then Sahara declared that most of money has been paid to investors i.e., around US \$ 3.9 billion, save for paltry US \$ 840 million, which was handed over to SEBI. Then this point was raised that who were these investors to which money was returned which later on came out that there were fictitious investors as well to whom money has been paid. No records of refunds were there with company. When Subrata Roy failed to deposit the remaining money to SEBI along with that he also didn't attend hearings, the supreme court of India issued an arrest warrant against Sahara head in FEBURARY 2014.

In between all of these rumors and money laundering and misuse of political connections, Sahara denied all accusations and continuously challenged SEBI. TheSupreme Court wanted to end this fight and finally pinned down Sahara chief Subrata Roy in 2014. In this victory of SEBI the need for regulatory body and administration of justice was discovered.

#### CASE STUDY 2: SARADHA CHIT FUND PONZI SCHEME<sup>2</sup>:

There has been a lot many ponzi schemes taking place that is an alternate banking options and many people has been taking advantage of this in India. In India banking system is useful to people but to many it's not in such a way that we have different classes of people not everyone can afford the banking schemes. There are still people who lack with the formal banks and that is why people rely on informal banks. This leads to scams and for looking towards informal banking people invest in alternate banking options. These schemes are approached by low income Indians, lacking to banking access often rely on informal banking. These informal banks consists of money lenders who charges inflated rates i.e. there rates were increased by

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<sup>2</sup> SUBRATA CHATTORAJ v. UOI, (2014) 8 SCC 768

themselves there was no protection to the person who was taking loans or giving money to investors for some sort of scheme informally and not only this but sometimes more methods were used conning investment schemes, non-convertible debentures, preference shares, as well as illegally hoax instruments in names of some fictitious construction projects.

These scheme are popularly taking places in north India but has been increasingly spreading all over India and the reason for this is that people are not aware of banking systems and facilities, fall in interest rates and if in case some frauds takes place then people are educationally. These schemes were ran by Saradha Group by collecting money from investors by issuing redeemable bonds and secured debentures and to trap people Saradha Group promised to investors that he will give prosperous and high profits from these investments.

Theponzi scheme run by Saradha Group collected money from investors by issuing redeemable bonds and secured debentures and promising incredulously high profits from reasonable investments. This scheme was conspired by Saradha Group by arranging some local agents from state of West Bengal and in return gave huge payouts from investor's deposits to expand prosperously, this scam continued and grew gradually and formed 200 companies. This conglomerates of 200 companies for money laundering to confuse SEBI. In APRIL, 2013 ugly phase of the investors of causing loss to investors of approximately US \$ 5 billion and caused bankruptcy to the investors.

SEBI did find something suspicious in the year 2009 because the company did not comply with companies act, 2013 which says that if company has to raise funds from public from more than 50 investors then they have to seek their permission and verification to start company by issuing a formal prospectus, and not just this company had many fictitious investors plus these investors were interconnected. This labored many complications for SEBI but SEBI didn't gave up rather SEBI investigated Saradha Group further. Then to save himself Saradha decide to deceit SEBI by restoring different financial schemes, collective investment schemes, and these schemes were covered by tourism packages, real estate projects, and others. In 2012, this all came up and investors were tricked through chit fund as well. They didn't even knew where there money actually going to get SEBI off its back because chit fund schemes falls under state jurisdiction not SEBI's jurisdiction. However, SEBI very soon realized that the group was doing wrong by getting capital raised through chit fund hence they immediately ordered Saradha to stop the



activities till the time SEBI gives clearance. In face SEBI has warned the Government earlier also in the past about Saradha Group's fraud chit fund schemes in 2011 but it was of no use. Both the Government as well as Saradha had ignored all the warnings and facts produced by SEBI till the time company finally revealed fraud in 2013. As soon as the scandal was revealed, Inquiry Commission made a group to investigate the Group activities and also worked with Government to give some relief to the investors who were from a low income group. They managed to get a relief money from Government USD 90 million. Finally this case was handed over to CBI for further detailed investigation in spite of strong interference in this case by political parties.

### CASE STUDY 3: SATYAM COMPUTERS<sup>3</sup>

Satyam computers company ltd. was found as well as chairman in 1987 by Mr. RamalingaRaju. In this case many accused were found guilty one of them was brother of Mr. RamalingaRaju, B. Rama Raju for criminal breach of trust. There were eight other accused also who were involved in this.

On 7 JANUARY, 2009 when RamalingaRaju resigned from satyam board after admitting that the company has been inflating the book of accounts and has cheated for six million shareholders. Thereafter, some shareholders filed complaints against him. After being held in Hyderabad jail on charges of cheating and inside trading then when the case came into hands of CBI in FEBURARY 2009, the losses of shareholders were compensated at Rs. 1400 crore. Over this the company had been charged with Rs. 2500 crore which was recovered by selling the family shares in satyam.

Raju first confesses all charged which brought him into trouble but later when on 9 JANUARY , 2009 he got arrested by Andhra Pradesh police then later when he came out of jail in 2011 he refracted from his statements saying that all the allegation against him of forgery, inflation of accounts, cheating and conspiracy are false. And also that he had made dummy companies to raise money and later bought lands for himself with scam money. The CBI was also involved in this and had filed case on raju on the basis of aforesaid grounds.

After this scam this company continued to work even without its chief Tech Mahindra took over satyam computers in an auction by government so both these companies merged with satyam. An

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<sup>3</sup> BYRARAJU RAMAA RAJU v. CBI (3) 2011 (1) SCC 694

economic offences court on DECEMBER 8 sentenced Raju and three others to six months imprisonment in six of the seven cases filed by the SFIO.

### CASE LAW 3: 2G SPECTRUM SCAM<sup>4</sup>

The year 2004 saw the advent in power of a ten-year reign of the UPA government and with it the series of scams that have become synonymous with the huge governmental machine of India. Despite many shocking scams later revealed, such as the CWG scam and the Coalgate scam, the biggest who left the country shocked was the 2G spectrum case. It remains the biggest scam in India with the total loss of treasure of 1.76 lakh crore, shrinking any other scam in the country and crowned it as the second biggest scam in the world after the magazine Watergate by Time.

The case of ten years that followed involved the acquittal of all the suspects, but from the beginning it became the focal point of the daily media coverage. The fraud found its origins in May 2007, when A. Raja assumed the position of minister of telecommunications. Raja was a four-time member of the DMP party (member of the UPA alliance) who had strong ties to the TN CM family. Shortly after the acquisition, the Telecom Department initiated the 2G licensing process. As indicated in the debit cards, it is considered that these licenses have been set at prices of 2001 and not based on their rating of 2007. In addition, licenses were issued based on the "First come, first served" error (FCFS) to select owners who were not eligible or deliberately falsified or who were using fraudulent methods to gain access to the auction. Many other telecommunications operators were not physically able to access the auction windows according to the minister's instructions. The DoT also advanced the last date to present offers to favor entities such as Swan Telecom and Unitech against the recommendations of both Prime Minister Manmohan Singh and the Ministry of Finance. Singh had written to Raja asking him to follow a transparent process and eliminate the FCFS method chosen by Raja. These tests showed that the cabinet was certainly aware of the deceptive process that the DoT decided to follow. Despite this, the auctioning process was completed with a full-spectrum sales license valued at 9200 crore. It was subsequently revealed that Swan, Unitech and Tata Teleservices immediately sold

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<sup>4</sup> CENTRE FOR PUBLIC INTEREST LITIGATION v. UOI & ORS. (2012) 3 SCC 1

licenses to other telecommunications companies with a significant premium. This was the difference that the CAG in its report was the net loss of the Treasury.

The scam first came to public attention due to a series of events beginning with an NGO's complaint to the central vigilance commission on the irregularities of the spectrum auction. He ordered the CBI to immediately begin an official investigation, but the scam took its modern form in the minds of people like the '2G scam' when the CAG released its first report with an estimated loss of 1.76 lakh crore total.

It was believed that Raja had accepted bribes of 200crore through swan investments in media companies Kalaignar TV Kanimozhi (daughter of TN CM). The CBI and ED claim that 3000 crores were transferred to Raja and his wife's accounts in Mauritius and Seychelles were bribes received from other beneficiaries during the scam. The resulting survey saw several high-profile arrests of politicians, bureaucrats and executives related to the case. KapilSibal replaced Raja as telecommunications minister, while there were similar substitutes from other subjects, including the then Secretary of Telecommunications, MD and vice president Anil DhirubhaiAmbani Group, vice president Essar, etc. Although the two sheets of cargo and CBI CAG report on all fraud, all defendants were acquitted in 2017 by the special court in New Delhi, although the CBI and ED have expressed their plans to challenge the verdict at the High Court of Delhi.

While there has been a decade since the 2G scam, it brings to light the serious inefficiencies and opacity of many government functions. He stressed the ministerial Raja hegemony that could operate and how industry and the government were involved in these scams. It also ensured that future auctions will be monitored closely and implemented transparently, while India's large population finally allowed cellular telecommunications (something that many unknown in 2000). Finally, it is also important to consider how this and other scams increased the public distrust of the UPA government by giving way to alternative AamAadmi party as the mass and victory of the NDA in 2014 on a mandate to fight corruption. This particular does not imply that the alternatives are cleaner, but the fight against corruption is a significant cultural gap between the minds of the public that acts as a deterrent to future frauds.

## **CORPORATE SCANDALS CAN BE DANGEROUS TO OUR ECONOMY IN MANY WAYS:**

1. Every Multinational or private company plays an important role to our country's economy in some or other way. Unfortunately, whenever such scandals occur it not only affects that company or its employees but it also affects our national economy, our government and in a big way to consumers. It leaves a bad impact on people and on their lives. The companies get involved in these scandals as they wanted to evade from taxes and do not want to pay taxes on time and correctly. To save taxes they hide their business and make bogus companies for misappropriation of funds e.g. DinshawMakhenjee Petit case.
2. The reduced investment leads to inadequate supply of required goods and services in the country and some extreme cases it leads to inflation. The reason for reduced investment is the extortion of bribes from entrepreneurs, especially foreign entrepreneurs. In the countries where corruption is at peak the foreign companies will not be willing to invest in such countries. In such countries they feel the investors avoid investment as the cost of doing business is too high considering the factors like scandals. Thus, this situation leads to not only reduced investment but also reduced goods and services in the country and reduction in gross domestic product and inflation. Only solution which is seen is importing the goods is the only way to deal shortfall in goods availability but this puts lots of pressure on Ghana's foreign exchange reserves and BOP.
3. Reduced commitment from the NGOs / Donor Agencies : These scandals reduce the effectiveness of subsidy flow through diversion of funds from the intended projects e.g. developing countries Ghana benefits tremendously from the aid flow from international donor agencies like UNICEF, NESCO, USAID etc. but due to increased rate of scandal and corruption puts these agencies in a dilemma that their aid money does not end up in the pocket of corrupt people/government officials and thus the purpose of providing aid is lost which is to help the growth of the country and its people. These agencies hence prefer to provide aids to the country who have a good, stable and honest government rule.

Recently the US state department has mentioned that corruption in Ghana is on the ascender and there are no serious efforts are being made to stop this danger to society.

4. Reduced FDI: As per the statement given by World Bank, FDI (Foreign Development Investment) is encouraged in the country where there is no corruption or corruption is systematic but only if the cost impact of scandal is affordable. In the countries where corruption rate is high it has a negative impact on FDI as the investors are hesitant to invest as the cost of doing business in such countries is very high thus high level of corruption add to the risk of Ghana being marginalized in the international economy.

5. Reduced tax revenues: Improper use of discretionary tax exemption is also a kind of scandal which brings down the loss of tax revenue.

6. Government inability to finance budget expenditure- Tax collection is badly impacted due to corruption. As the Government uses the tax money for financing the budget expenditure which they are unable to do in case of reduced tax revenue.



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