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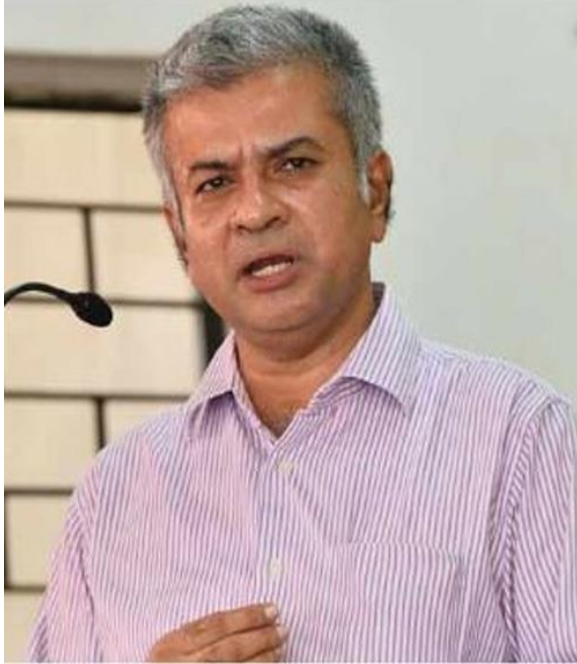
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**CORPORATE FRAUD AND MISMANAGEMENT IN INSOLVENCY CASES- LEGAL
IMPLICATIONS**

By – Megha Mahesh

NATIONAL ACADEMY OF LEGAL STUDIES AND RESEARCH

ABSTRACT

This abstract provides an overview of the key issues, causes, consequences, and potential solutions related to corporate fraud and mismanagement in insolvency cases.

Corporate fraud and mismanagement in insolvency cases occur when individuals within or associated with a company engage in deceptive practices or fail to fulfill their fiduciary duties, leading to financial distress and eventual insolvency. These instances of misconduct can take various forms, including asset misappropriation, financial statement fraud, and breaches of fiduciary duties by company executives. Weak corporate governance structures, inadequate internal controls, and ethical lapses are often cited as underlying causes of corporate fraud and mismanagement in insolvency cases, creating opportunities for fraudulent behavior and misallocation of resources.

Regulatory frameworks governing corporate insolvency play a crucial role in addressing corporate fraud and mismanagement. However, regulatory gaps, inconsistencies in enforcement, and jurisdictional complexities can hinder effective oversight and enforcement efforts. Stakeholders affected by corporate fraud and mismanagement, including creditors, shareholders, employees, and consumers, face vulnerabilities and financial losses, exacerbating the social and economic impacts of insolvency.

The impact of corporate fraud and mismanagement in insolvent companies extends beyond financial losses to broader implications for financial markets, investor confidence, and the stability of the economy. Instances of fraud and mismanagement can erode trust in corporate institutions, leading to market volatility, reduced investment, and systemic risks. Addressing these challenges requires a multifaceted approach that includes strengthening corporate governance practices, enhancing regulatory oversight, promoting transparency and accountability, and fostering a culture

of integrity and ethical conduct within organizations.

Technological advancements present both opportunities and challenges in combating corporate fraud and mismanagement in insolvency cases. While technologies such as data analytics, artificial intelligence, and blockchain hold promise for detecting and preventing fraud, they also introduce new risks and vulnerabilities that require careful consideration and mitigation strategies.

In conclusion, corporate fraud and mismanagement in insolvency cases represent complex and multifaceted challenges that require coordinated efforts from stakeholders, regulatory authorities, and the broader community. By addressing the root causes of fraud and mismanagement, strengthening regulatory frameworks, promoting ethical conduct, and leveraging technological innovations, it is possible to mitigate the risks associated with corporate insolvency and promote trust and confidence in the corporate sector. Hence is the purpose this research paper would serve.

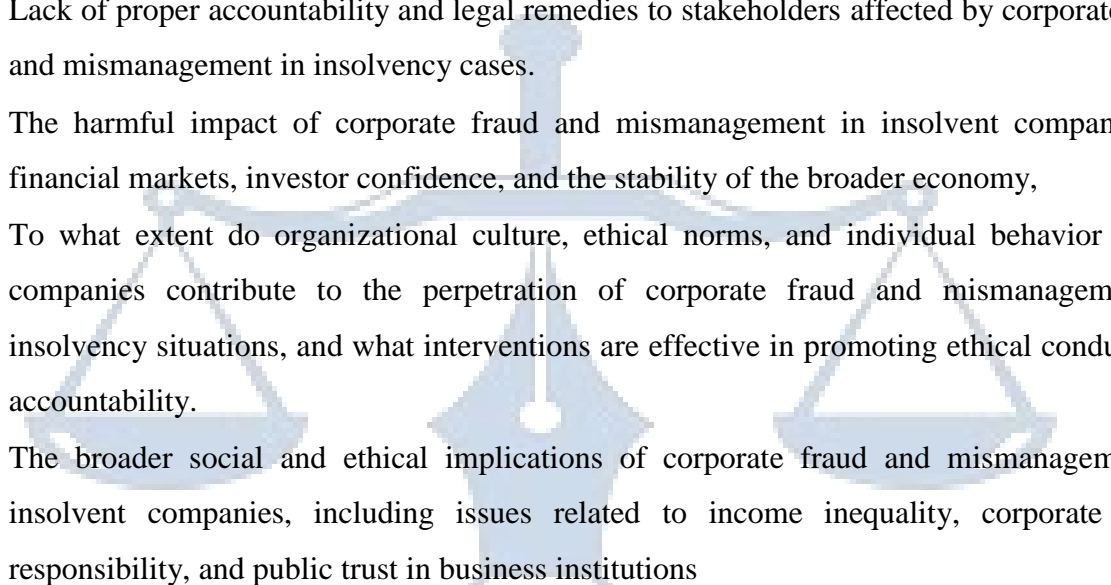
KEY WORDS: Corporate Fraud and Mismanagement, Asset misappropriation, Financial Statement Fraud, Corporate Governance Practices, Regulatory Frameworks.

RESEARCH QUESTIONS

- What are the underlying causes and contributing factors to corporate fraud and mismanagement in insolvent companies?
- What are the most common types of corporate fraud and mismanagement observed in insolvent companies, and how do they affect stakeholders such as creditors, shareholders, and employees?
- What role do corporate governance structures, internal controls, and ethical leadership play in preventing corporate fraud and mismanagement in insolvency cases?
- What legal remedies and enforcement mechanisms are available to stakeholders for addressing instances of corporate fraud and mismanagement in insolvency proceedings?
- What are the financial and reputational consequences of corporate fraud and mismanagement in insolvent companies for stakeholders, including investors, creditors, and regulatory authorities?

RESEARCH PROBLEMS

- Lack of accuracy in detecting corporate fraud and mismanagement in insolvent companies.

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- Existence of gaps in regulatory frameworks governing corporate insolvency has impacted the enforcement of laws and regulations at preventing and addressing corporate fraud and mismanagement.
 - Vulnerabilities faced by different stakeholders has been a major drawback and hampering them, from further investments.
 - Deficiencies in corporate governance structures and oversight mechanisms contribute to the occurrence of corporate fraud and mismanagement in insolvent companies, and what reforms are needed to strengthen governance practices?
 - Lack of proper accountability and legal remedies to stakeholders affected by corporate fraud and mismanagement in insolvency cases.
 - The harmful impact of corporate fraud and mismanagement in insolvent companies on financial markets, investor confidence, and the stability of the broader economy,
 - To what extent do organizational culture, ethical norms, and individual behavior within companies contribute to the perpetration of corporate fraud and mismanagement in insolvency situations, and what interventions are effective in promoting ethical conduct and accountability.
 - The broader social and ethical implications of corporate fraud and mismanagement in insolvent companies, including issues related to income inequality, corporate social responsibility, and public trust in business institutions

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RESEARCH OBJECTIVES

- To identify the common types and patterns of corporate fraud and mismanagement observed in insolvent companies.

- To examine the underlying causes and contributing factors to corporate fraud and mismanagement in insolvency cases.
- To assess the effectiveness of existing regulatory frameworks and enforcement mechanisms in addressing corporate fraud and mismanagement during insolvency proceedings.
- To analyze the impact of corporate fraud and mismanagement in insolvent companies on stakeholders such as creditors, shareholders, employees, and consumers.
- To explore the legal remedies and accountability mechanisms available to stakeholders affected by corporate fraud and mismanagement in insolvency cases.
- To evaluate the implications of corporate fraud and mismanagement in insolvent companies for financial markets, investor confidence, and the stability of the broader economy.
- To identify technological challenges and opportunities for detecting, preventing, and addressing corporate fraud and mismanagement in insolvency cases.
- To investigate the social and ethical implications of corporate fraud and mismanagement in insolvent companies, including issues related to corporate social responsibility, income inequality, and public trust in business institutions.



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TENTATIVE CHAPTERISATION

ABSTRACT

CHAPTER 1- INTRODUCTION

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CHAPTER I- INTRODUCTION

“FRAUS OMNIA VITIATE”- Fraud Vitiates Everything. Corporate fraud and mismanagement in insolvency cases represent critical issues that have significant implications for stakeholders, regulatory authorities, and the broader economy. When companies face financial distress and

insolvency, the pressure to preserve value and protect interests can sometimes lead to unethical or fraudulent behavior by company executives and stakeholders. This research paper provides an overview of the complexities and challenges surrounding corporate fraud and mismanagement in insolvency cases, highlighting their impact, causes, and consequences.

Definition and Scope: Corporate fraud and mismanagement involve deceptive practices, breaches of fiduciary duties, and governance failures causing financial harm to a company and its stakeholders. Insolvency cases can involve financial manipulation, asset diversion, insider trading, and conflicts of interest. These issues extend beyond individual misconduct to systemic failures in governance, internal controls, and regulatory oversight.

Significance of corporate fraud mismanagement: Corporate insolvency cases are complex, involving legal, financial, and operational aspects. Allegations of fraud and mismanagement in these cases pose significant stakes, threatening creditors, shareholders, and employees, and undermining trust in the sector and financial markets. Understanding these dynamics is crucial for maintaining insolvency process integrity. Insolvency cases are complex, involving multiple stakeholders and legal rights. Allegations of fraud and mismanagement increase complexity. Investigation, forensic analysis, and legal expertise are required. Cross-border transactions, jurisdictional challenges, and international regulator coordination add to the complexity of resolution.

Causes and Contributing Factors: Corporate fraud and mismanagement in insolvency cases are influenced by weak governance structures, inadequate internal controls, ethical lapses, financial pressures, and ineffective regulatory oversight. Financial pressures, such as mounting debt and declining revenues, may incentivize executives to engage in fraudulent activities.

Impact and Consequences: Corporate fraud and mismanagement in insolvency cases have significant social and economic consequences, eroding trust in institutions, undermining investor

confidence, and destabilizing financial markets. Employees may lose jobs, creditors may suffer losses, and shareholders may lose their investments. Effective prevention, detection, and remediation measures are crucial to address these complex challenges. This introduction lays the groundwork for further exploration, exploring the dynamics of these issues, legal and regulatory frameworks, and potential solutions for mitigating risks associated with corporate insolvency.

CHAPTER 2- ROLE OF RESOLUTION PROFESSIONALS IN FRAUDULENT TRANSACTIONS- PRACTICAL ASPECTS



Over Rs 40,000 crore worth of fraudulent transactions has been reported by resolution professionals (RPs) in charge of corporate insolvency resolution programs in India. Two accounts, Bhushan Steel and Electrosteel, accounted for the majority of these recoveries. Only one fraud case—the Jaypee Infratech case—has resulted in orders from the National Company Law Tribunals (NCLT). Additionally, the NCLT has mandated that Bhushan Steel be sold to Tatagroup. Due to incidences of animosity and non-cooperation, as well as claims that promoters are manipulating workers, the situation has raised risk for RPs.

CHAPTER 3- LIABILITY OF LIQUIDATORS IN CORPORATE FRAUDS

Insolvency powers can be used to compensate victims of fraud or corruption, especially when a company is involved in such schemes. A state can request a liquidator to be appointed over the company, who can bring claims against former directors and dishonest third parties. The goal is to repatriate recoveries to the victim state, subject to the rights of other creditors.

The Court in *Jetivia SA & Anor v Bilta (UK) Ltd (In Liquidation) & Others*¹ decided that directors could not defeat a claim by liquidators on the basis that the wrongdoing of the directors should be attributed to the company, even where all directors and shareholders had knowingly participated in the wrongdoing.

After Bilta (UK) Ltd was dissolved in November 2009, its liquidators brought legal action against its CEO, Mr. Brunschweiler, and former directors, Jetivia SA (Jetivia), alleging they had engaged in a fraudulent "carousel" scheme to deceive UK tax authorities. Under section 213 of the Insolvency Act 1986 (IA 1986), which gives the court the authority to rule that any parties who are aware of their involvement are responsible to contribute to the company's assets, the liquidators requested direct donations. The Supreme Court unanimously rejected the appeal and maintained the rulings of the lower court, holding that the directors' misconduct or knowledge could not be a defense against a claim made by the company's liquidator against them. The court decided that victims can sue a company, and a firm can sue its dishonest directors. The ruling has raised concerns following the *Stone & Rolls Ltd (In Liquidation) v Moore Stephens*², which showed that a fraudulent sole director or group of directors acting together could defeat a claim brought by a company or its liquidators based on the argument that the wrongdoing should be attributed to the company. The law of illegality is widely considered confusing and complex, and the proper approach to the defense of illegality needs to be addressed by the Supreme Court.

CHAPTER 4- CASE STUDIES ON CORPORATE FRAUD- LEGAL IMPLICATIONS

In *M/s Embassy Property Developments Pvt. Ltd. versus State of Karnataka & Ors*³, the Supreme Court decided that although the National Company Law Tribunal (NCLT) and National Company Law Appellate Tribunal (NCLAT) can look into fraud claims, they are not allowed to make decisions on matters pertaining to public law or that involve decisions made by statutory or quasi-judicial authorities.

¹ [2015] UKSC 23

² 2009 UKHL

³ Civil Appeal No. 9170 of 2019

The two main questions that the Honourable Supreme Court addressed were whether the High Court could interfere with the National Company Law Appellate Tribunal's (NCLAT) order in cases brought under the IBC of 2016 and if NCLT/NCLAT could investigate and rule on the issue of fraud in cases brought under the IBC of 2016. The appellants contended that the grievances ought to have been handled by the statutory forum in accordance with Section 61 of the IBC, 2016, and that the High Court had no right to hear a writ suit challenging the orders of the NCLT, Chennai. Additionally, they contended that throughout the moratorium period, the Resolution Professional need to protect the corporate debtor's assets and uphold the status quo. The NCLT was also considered authorized to look into claims of fraud. Attorney General Sh. K.K. Venugopal, on the other hand, contended that the NCLT's jurisdiction is limited to matters involving contracts between parties and that orders issued by statutory or quasi-judicial authorities under special legislation such as the MMDR Act, 1957, are public law in nature, meaning NCLT is not equipped to judicially review such orders. The court concluded that IBC, 2016 is an exhaustive code on the subject matter of insolvency, corporate entities and others.⁴

B. VIDEOCON CASE

- Redress for repressive, discriminatory, mismanaged, and fraudulent behavior by companies or their members is provided by the Companies Act of 2013. The Central Government may petition the Hon. National Company Law Tribunal (NCLT) under Section 241(2) of the Act to get relief from a company's conduct that are harmful to the public interest. During a corporate insolvency restructuring process (CIRP), resolution professionals can also apply to have advantageous, undervalued, and fraudulent transactions avoided. The case of *Union of India v. Videocon Industries Limited and Others (2021)*⁵ underscores the challenges associated with bringing cases before the NCLT for a company's prejudiced actions that go against the public interest. A Director may be held liable by the Central Government for unfair and negligent behavior, however Section 241 proceedings against the Director following bankruptcy procedures will not be under the Tribunal's scope.

- **CURRENT TRENDS AND PRACTICES**

Diversion of Funds: Diversion of funds by corporate entities, where funds meant for a particular purpose or project are diverted elsewhere, is a common form of fraud. This can involve siphoning

⁴ Section 2 MMDR Act, 1957

⁵ CP - 288/2021

off funds for personal gain or using them to support other failing ventures.

Preferential Transactions: Some companies engage in preferential transactions to benefit certain creditors or related parties over others, which is prohibited under the IBC. This can include transferring assets at undervalued prices or giving preference to certain creditors in repayment.

Fraudulent Conveyance: Companies might engage in fraudulent conveyance by transferring assets out of the reach of creditors or the insolvency resolution process. This could involve selling assets at below-market prices or transferring them to related parties to avoid liquidation.

Bogus Transactions and Shell Companies: Creation of shell companies or engaging in bogus transactions to inflate revenues or understate liabilities is another form of corporate fraud. These transactions are designed to deceive creditors and inflate the company's financial position artificially.

Fraudulent Practices during Resolution Process: During the insolvency resolution process, fraudulent practices might include withholding crucial information, providing false data to resolution professionals, or colluding with stakeholders to manipulate the outcome of the resolution.

Non-cooperation with Resolution Process: Some companies resort to non-cooperation with the resolution process, deliberately hindering efforts to recover debts or restructure the company. This could involve hiding assets, refusing to provide necessary documentation, or challenging the legitimacy of the resolution process through legal means.

Regulatory Arbitrage: Companies may exploit regulatory loopholes or engage in regulatory arbitrage to evade compliance requirements or exploit weaknesses in the IBC framework for their advantage.

Hence, combating corporate fraud under the IBC requires a coordinated effort from various stakeholders, including regulatory authorities, creditors, insolvency professionals, and judicial bodies. Additionally, ongoing amendments to the IBC and changes in regulatory frameworks can influence the nature and prevalence of corporate fraud within the insolvency ecosystem.

CHAPTER 5- PENAL PROVISIONS UNDER IBC, 2016

Under Section 65 of the Indian Companies Code (IBC), anyone who starts a business insolvency resolution process (CIRP) with the goal to deceive or harm the firm may be fined up to INR10 million. Adjudicating Authorities are entitled to enter a proceeding to highlight fraudulent or collusive initiation. The Adjudicating Authority is mandated by Section 65 to make sure the CIRP is only utilized for insolvency or liquidation resolution. According to the National Company Law Appellate Tribunal (NCLAT), adjudicating authorities have the right to use their discretion to keep corporate debtors out of CIRPs. Under Section 7(5)(a), the Supreme Court of India has the discretionary authority to accept financial creditor applications for the beginning of CIRP. The discretion entrusted with the Adjudicating Authority under Section 65 requires a prima facie satisfaction for levying a penalty. In this respect, the NCLAT has held that no penalty can be saddled under Section 65 without recording an opinion that a prima facie case of fraudulent or malicious institution of proceedings has been established –*M/s James Hotels Ltd v Punjab National Bank*⁶.

The Ministry of Corporate Affairs (MCA) of the Indian government has made modifications to the Insolvency and Bankruptcy Code (IBC) to address the issue of fraudulent or malicious procedures starting. According to the MCA, certain activities submitted to the adjudicating authority are exempt from the Section 65 penalty, but fraudulent or malicious admission procedure starts are. In compliance with other pertinent IBC regulations, the MCA states that the Adjudicating Authority must have the power to penalize an individual for filing frivolous or vexatious applications. Furthermore, the MCA has ruled that an application submitted under Section 7 must be accepted upon proof of a default. It will be fascinating to observe how the IBC's proposed revisions correspond with the intent and goals of Section 65, which obliges adjudicating authorities to consider more than just the existence of a debt and a repayment default when assessing whether applications were submitted maliciously, fraudulently, or for collateral. With great curiosity, the Indian finance legal community anticipates the resolution of the challenge presented in *Maganlal Daga HUF and Anr v. Jag Mohan Daga and Ors.*⁷

⁶ 7 September 2017

⁷ 15 May, 2023

CHAPTER 6- APPROPRAITE FORUM & PERIOD OF LIMITATION

As per the ruling of the National Company Law Tribunal (NCLT), the Insolvency and Bankruptcy Code, 2016 (IBC, 2016) cannot be used as a platform for deciding cases involving fraud or forgeries. The Tribunal determined that the debt pertains to 2014–15, and on November 14, 2022, eight years later, the petition was submitted. The Tribunal determined that the fraud went undetected since the Corporate Debtor neglected to file statutory returns, income tax returns, and present in arbitration proceedings, contrary to the Operational Creditor's argument that the limitation does not start until the applicant uncovers the crime. The Tribunal cited the 2017 NCLAT ruling in *Uttam Galva Steels Limited v. DF Deutsche Forfait AG & Anr.*,⁸ which determined that a Section 8 notice and a Section 9 petition had to be filed.

CHAPTER 6- LEGAL AND REGULATORY FRAMWORK

- Over the past two decades, India has experienced numerous corporate frauds, resulting in thousands of crores of public money. These incidents have severely impacted the industry and financial system, necessitating changes in regulatory authorities like RBI and SEBI. To address these issues and formulate corporate governance policies, the Indian government initiated three high-level committees: the Naresh Chandra Committee, appointed by the Union government to examine audit committees, and the Kumara Mangalam Birla Committee and Narayana Murthy Committee, appointed by SEBI to examine corporate governance aspects. The following committees have reached a conclusion:
 - Appointing independent directors to the listed companies' audit committees. CEO and COO certification of the annual audit accounts.
 - Establishing an impartial quality review board to evaluate audit, secretarial, and cost accounting businesses on a regular basis and offer feedback on the standard and adequacy of their infrastructure, processes, and procedures.
 - Establishing a corporate serious fraud office (CSFO) inside the Company Affairs Department.
 - For improved compliance, ROC offices should be strengthened. Contracting out non-statutory work; tightening the law on sectorial compliance violations by

⁸ CP No. 5/Mah/2017

adding a section akin to section 233A that permits the government to conduct special compliance audits.

- The listing agreement between the businesses includes clause 49. Additionally, by placing a strong focus on disclosure policies and the appointment of independent directors to a listed company's board, who would be in charge of maintaining the company's ethical culture.

SEBI GUIDELINES CLAUSE 49- LISTING AGREEMENT

The suggestions of the Narayan Murthy Committee have been included by SEBI into clause 49 of the Listing Agreement for all Indian stock exchanges. This clause addresses a number of corporate governance topics, such as committee makeup, pay rules, and board practices. The responsibility of supervising the financial reporting process, a primary conduit for corporate fraud, falls on the Audit Committee. Three directors who are independent and qualified make up the committee. The committee is able to look into events, ask staff members for information, get expert advice, and arrange for specialists to be present. The committee's responsibilities also include authorizing auditor payments and supervising the company's financial reporting procedure. It also makes recommendations on the appointment, reappointment, replacement, or removal of statutory auditors. Additionally, it examines quarterly and annual financial accounts, statutory and whistleblower methods, internal investigations, internal audit function, internal control systems, and internal auditor performance. The committee also looks into the causes of substantial payments to creditors, shareholders, debenture holders, and depositors that go unpaid.

CORPORATE GOVERNANCE REPORT: A company's Annual Reports should contain a distinct part on corporate governance that explains the reasons for any non-compliance with necessary regulations as well as the company's compliance with them. Annual operational plans, capital budgets, quarterly reports, minutes from audit committee meetings, and details on senior officer hiring and compensation should all be included in this area. Notices of cause, demand, prosecution, and penalty, among other notices that are deemed materially essential, ought to be included in the report. In addition, details about significant labor issues, joint ventures, sales of material assets, foreign exchange exposures, dangerous events, fatal accidents, material financial obligations, public or product liability claims, and non-compliance with regulatory, statutory, or listing requirements should be included. Significant labour issues, noteworthy advancements in human resources, and non-compliance with shareholders' services should all be highlighted in the

report.

CHAPTER 6- CONCLUSION & SUGGESTIONS

Corporate fraud and mismanagement in insolvency cases are pervasive issues that have far-reaching consequences for stakeholders, regulatory authorities, and the broader economy. As companies face financial distress and insolvency, the pressures to preserve value, protect interests, and navigate complex legal and financial challenges can sometimes lead to unethical or fraudulent behavior. Throughout this exploration, this paper touches the importance, definition, scope, complexity, causes, and consequences of corporate fraud and mismanagement in insolvency cases. In this conclusion, we summarize key insights and underscore the importance of addressing these issues through coordinated efforts from stakeholders, regulatory authorities, and the broader community. Therefore, addressing these issues is imperative for safeguarding the interests of stakeholders, maintaining market stability, and promoting a fair and transparent business environment. Insolvency cases are complex, involving multiple stakeholders with competing interests and legal rights. Allegations of fraud and mismanagement increase the complexity exponentially. Investigation, forensic analysis, and legal expertise are required for determining wrongdoing, tracing assets, and holding responsible parties accountable. Cross-border transactions, jurisdictional challenges, and coordination with international regulators add further layers to the resolution process. Root causes of corporate fraud and mismanagement include weak corporate governance structures, inadequate internal controls, and ethical lapses. Financial pressures, such as mounting debt and declining revenues, may incentivize executives to engage in fraudulent activities. Ineffective regulatory oversight, regulatory arbitrage, and gaps in enforcement exacerbate the risk of fraud and mismanagement in insolvency cases. The impact of corporate fraud and mismanagement extends beyond immediate financial losses, eroding trust in institutions, undermining investor confidence, and destabilizing financial markets. Employees may lose their jobs, creditors may suffer losses, and shareholders may lose their investments. Effective prevention, detection, and remediation measures are urgently needed. Addressing corporate fraud and mismanagement in insolvency cases requires a multifaceted approach that includes legal and regulatory reforms, enhanced corporate governance practices, and fostering collaboration among stakeholders, regulatory authorities, and international partners. In conclusion, corporate fraud and mismanagement in insolvency cases represent complex challenges that demand urgent attention and concerted action from all stakeholders involved. By

understanding the dynamics, root causes, and consequences of these issues, and by implementing effective prevention, detection, and remediation measures, we can mitigate the risks associated with corporate insolvency and uphold the integrity of the corporate sector. Only through collective efforts can we ensure that companies operate ethically, transparently, and responsibly, thereby fostering trust and confidence in the corporate sector and financial markets.

Recommendation for Stopping Corporate Fraud-

Establishing a policy to prevent fraud

There are four primary components to the fraud prevention process:

1. The implementation of corporate governance
2. Putting into practice transaction-level control procedures, often known as the internal accounting control system.
3. Retrospective audit studies that look back at governance and control procedures.
4. Examining and fixing issues that are alleged or suspected.

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COPRORATE INSOLVENCY RESOLUTION PROCESS AND LIQUIDATION UNDER THE
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- IBC Laws produced a video on May 25, 2022, titled "Corporate Insolvency: Fraudulent Transactions and Look-Back Period," by Ms. Sanjana Sachdev and Mr. Pranav Dwivedi. The video discussed corporate insolvency in relation to oppression and mismanagement under the Companies Act.
- The article "Preventing Fraudulent and Malicious Initiation of Insolvency Proceedings in India" was posted on April 21, 2023, on the AZB Partners website.



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