

# Critical Analysis of Trading Through Shell Companies

Janmejai Shukla

*Student, Department of Law, Christ University, Bengaluru, India*

**Abstract**—India being a developing nation has many new companies emerging in the corporate sector, the corporate sector serves a major role in the Indian economy, and not only Indian companies but many foreign companies have established their reign in the Indian market. However, as the number of companies in the market is increasing the instances of fraud, cheating also increases. Even though all the business carried on by these companies whether it be issuing of shares and debentures, trading in stock market, investing in other companies all are regulated either by the companies Act, 2013 or by various SEBI regulations, however still of all these regulation some companies still manage to find one or the other way to commit fraud. This paper will be dealing with one such type of problem in the corporate sector i.e. trading through shell companies. Neither SEBI Act nor any of its regulation have any provision which deals with companies trading with shell companies. Therefore this paper is critical analysis of trading through shell companies, is there any need for the regulation of the trading through shell companies. This paper extensively defines what shell companies basically are, what its consequences are and is it only used for unlawful purposes and why there is need for regulating it.

**Index Terms**— Shell Companies, trading, fraud

## I. INTRODUCTION

The corporate sector of India has been grossly developed over a decade. Various laws have been enacted to regulate the business of the companies. Whether it be issuing of shares, stock debentures, investment in various fields all are governed by various regulation, the most important being the SEBI Act and regulations. The securities exchange board of India is the highest authority which deals with trading in securities. The board issues various regulations which the companies are bound to follow, it also appoints adjudicating officers to look into the matters of the company, if found guilty of fraud or any misconduct the adjudicating officer has authority to ask the company to wind up. There are various kinds of economic crime which can take place or we can say which various companies can indulge itself into, however the SEBI regulation have provisions for every such kinds of crimes whether it be misstatement of prospectus, money laundering, tax evasion etc.

Despite the fact that so many regulations govern the business of corporate sector still there are some companies who find some or the other way to defraud the creditors or to launder money or to invade the taxes. One of the most practiced among them is trading through shell companies.

In Indian Law there is no such concept of “shell companies”. It is neither defined in the Companies act neither in the SEBI act. However this has been one of the most practiced type of fraud which the members of the company practice under the garb of being a corporate entity. Trading through shell companies in most of the cases have been only used for the purpose of money laundering, this paper will deal with some of the instances as to show how these companies are used and are it only used for unlawful purposes, or are there any other purposes of it. There is a need of regulating such type of shell companies because majority of these companies are used for illegal purposes only

## II. WHAT ARE SHELL COMPANIES?

In our Indian law there is no such definition of Shell companies. No such enactment talks about shell companies.

However in U.S. laws shell companies is defined as

“A company, other than an asset an asset-backed issuer, with no or nominal asset operations, and either:

- No or nominal asset
- Assets consisting of cash and cash equivalent.
- Assets consisting of any amount of cash and cash equivalents and nominal other assets”

In simple words we can also say that shell companies are companies on papers, i.e. these companies don't have any business of its own they are merely constituted on papers with no assets, carrying no business but are duly constituted through established procedures.

Apart from this there are companies in which due to the depletion of the valuable fixed assets the net worth of the company gets eroded and substantially it takes a form of shell companies.

Thus these companies even though constituted in a legal manner have no objectives as such and can be used for many purposes, few prohibited by law also.

## III. SHELL COMPANIES: A TOOL FOR INVADING TAX AND TO LAUNDER MONEY

Given the umpteen instances of individuals and corporate abusing shell companies, either to avoid taxes or use them as a conduit for money laundering, these are generally viewed as dubious and questionable enterprises. Companies with financial irregularities, set up by errant promoters for the sole purpose of

money laundering, can cause heartburn to the investors

Shell companies are usually constituted by a parent company for their own beneficial purposes, they are duly constituted by the established procedure, but as mentioned they do not have an active business of their own so what the members of the company do is that they invest in such type of companies, therefore this decreases their net annual revenue and hence they pay taxes only for those revenue which they generate after the investment, and hence pay less taxes.

There is involvement of natural persons in the complex web of shell companies only at the initial stage when the shareholders subscribe to the share capital of the shell company. After that many layers are created because there are company to company transactions and much more complex structure of shell companies comprising of the financial integration of nation is formed which makes it almost impossible the real beneficiary (natural person) involved in these shell companies. These shell companies have been used for the purpose of money at large scale. The fake pan cards have facilitated the enormous growth of shell companies which were being used for layering of funds and illegal transfer of such funds to some other companies/persons or parked abroad in the guise of remittances against import. The share capital of these shell companies are subscribed by fake shareholders through numerous bank account opened with the use of fake pan cards at the initial stage

Thus we see that how this is very unique way in which each and every step is legal either it be constituting company, investing into it but the whole intention or motive is to defraud the investors, creditors and employee of the company

One such instance of trading with shell companies was seen in the case of Sir Dinshaw Maneckjee petit, re in which sir Dinshaw was a millionaire earning huge income by way of dividend and interest. He formed four private companies and transferred his investments to each of these companies in exchange of their shares. The dividends and the income interest income received by the company were handed back to sir Dinshaw as a pretended loan. In this case also it was held that the company was formed by Dinshaw and was purely for the purpose of tax evasion.

A new company ‘C’ was created as wholly owned by the principal company ‘A’ with no assets of its own except those transferred to it by the company ‘A’ with no business or income of its own except receiving dividends from shares transferred to it by the company A and served no purpose whatsoever except to reduce the gross profits of the company ‘A’. The reduction of gross profit avoided payment of bonus to employees of company ‘A’. In this case also the court held company ‘A’ liable for committing fraud to its employees.

An article named “shopping for anonymous shell companies: An audit study of anonymity and crime in the international financial system” where the author has given three instances about how shell companies are used in an illegal manner. In the first instance a US senate report said that a person was interested in opening an offshore shell companies because he

wanted to protect his assets from Uncle Sam and his ex-wife.

In the second instance as a second example there was corruption probe into an \$43 billion (US\$ 86 billion) arms deal between the British company BAE Systems and Saudi Arabia. The U.K. government cancelled this probe in December 2006 following threats that the Saudi government would suspend all intelligence cooperation with the United Kingdom and cancel the deal if the investigation were not quashed.

In the third instance third example involves how corrupt heads of state and other senior politicians disguise the illicit origins of (that is, launder) the bribes they receive.

Another article named as “funding terror” where the authors have portrayed how shell companies are also used by the various terrorist organisations to manage their funds. The authors have quoted “As this Article examines in great detail, one of the most dangerous and accessible financial tools used by terrorists today is the anonymous shell company” which clearly shows how dangerous these companies can be, if not regulated in an orderly way.

An article named “Lifestyles of the Rich and Infamous: Confronting Dirty Money in US Real Estate” where the authors have depicted various instances as to how the drug traffickers as well as the corrupt politicians use shell companies to launder their illegal funds how they convert their black money into white.

These instances clearly show how people exploit these companies for their own beneficial purposes.

#### IV. WHY IS THERE A NEED FOR REGULATING TRADING THROUGH SHELL COMPANIES?

In India we do not have any such law which talks about shell companies, however the courts have in many cases lifted the corporate veil to identify the insides of the company, various instances have come up, it has been seen that companies have active business have invested in such type of companies which do not have any active business, then only it is identified that this investing is only done for some illegal purposes, but it may also happen sometime that a company earlier having a active business but due to the depletion of its fixed assets becomes merely a shell company and then it becomes hard to find that for what purpose this company is used now, SEBI has issued regulations for money laundering, tax evasion, fraud etc but neither of its regulation even in the SEBI FUTP(fraudulent and unfair trade practices) regulations talks about such type of shell companies.

The main concern is in this type of trading neither of the steps taken is illegal whether it is forming a company, investing into it, getting returns from the company in which the other companies have invested, but still the whole intentions behind this is fraud.

SEBI should come up with such regulations which are concerned with shell companies wholly. This can be done if SEBI keeps a proper check over the corporate sector that all the companies some or the other business, whether it be a parent

company or its subsidiary, what is the role of the each companies in the market.

Even though the adjudicating officers appointed by the SEBI and the Securities appellate Tribunals have been given with such powers so that they can lift the corporate veil and look into the insides of the company but still as there is no proper definition and provisions relating to shell companies, it's a very tough job for them also to identify whether a company is a shell company and it also becomes tedious task for them to identify whether any company is indulged in the process of trading through shell companies or not. Thus it becomes a very tough job for the authorities to find for a company to be indulged in such kinds of fraud, as each and every step taken in this process is legal and only the motive behind can identify whether the members were actually indulged in a fraud or not, and it also becomes very easy for the wrongdoers also to escape from this type of acts.

Thus it becomes extremely important to bring a proper regulation which deals with such kind of companies only, as to avoid fraudulent and unfair trade practices.

#### V. CONCLUSION

Increasing fraud in the corporate sector has made a great necessity that SEBI should come up with such type of regulation to keep a check on these types of fraudulent activities this paper was an attempt to bring about one such problem

which was emerging on a very fast rate and to provide solution to it. The ways these types of companies are formed are in no way illegal and even though investing in such type of companies are not prohibited by law. Having a proper regulation will keep a check on such type fraud and will protect the interest of not only the investors of the company but also the employees working under the company, who are aloof of such kind of activities which the members, owners of the company indulge themselves into.

Thus the securities and exchange board of India should make efforts to come up with such regulations as to avoid these fraudulent practices.

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