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CSR and Ghost Beneficiaries: The New Age Fraud Mechanism

Kushal Tekriwal*

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Abstract

Corporate Social Responsibility is a concept that rests on the idea of giving back to society while taking the benefits it offers to the business. This concept is meant to drive private funds and expertise for the public's welfare. This concept as added in the Companies Act, 2013 under Section 135 where, unlike other countries, Corporate Social Responsibility has been made mandatory in India for all those companies who qualify the conditions given in the section. Hence, it opens up various avenues to scrutinize companies and increases compliance thus, it makes a lot of room for criticism on compliance and regulatory mechanisms and how the current law may not be sufficient or effective in ensuring Corporate Social Responsibility which takes place in the country. It has certain loopholes within the system which provides for companies to exploit, leading to corporate frauds. One of the new age fraud mechanisms has been in the form of ghost beneficiaries. This research paper discusses the concept of Corporate Social Responsibility Frauds focusing on Ghost Beneficiaries and criticising the current regulatory framework in its functioning to tackle the effect of such transactions. It considers various nuanced aspects involved for companies to undertake such illegal routes, thereby addressing the detection to be paramount within the legal framework. The Authorities have indeed placed a robust and vigilant system to maintain a system of checks and balances and provide for a government cum investigation mechanism. The paper also in light of the above, provides certain recommendations which could make the system more efficient.

* Student, 4th year, BBA.LLB., Jindal Global Law School, O.P. Jindal Global University, Sonipat, India.

What are CSR Frauds? – A Perspective

There has been an evolution in Corporate Social Responsibility (CSR) Frauds and despite the initiatives taken by the Government and Legislature, the issue of such frauds still pertains, and many go unreported and undetected. The mandate of CSR via Section 135 of the Companies Act (referred to as Act), 2013 has made various companies adapt the social costs and acts more as a source of compulsion opening up areas of non-compliance with the law.[1] It can be very well said that when the CSR was a voluntary activity, the events of frauds were quite low as compared to a situation today resulting in a regressive impact.[2] Since CSR has become mandatory with Section 135, several companies have come under the scrutiny of CSR Frauds. However, the current law is insufficient to detect CSR Frauds specifically for ghost beneficiaries acting as a challenge for the authorities to track the offending company which is acting behind the veil of such beneficiaries.

When CSR was made mandatory, it was already pointed out that the risk of exploitation was quite vulnerable considering the charitable trusts and organizations which are present and the number of companies to which it would apply.[3] As per Ratan Tata, it would lead the 'venal' companies to escape and attempt to 'short-circuit' the funds back to the company from the organizations with which they are connected.[4] This often leads the promoters to gain all the wealth as he is behind the majority of such transactions.

Fraud, as defined under Section 447, refers to company affairs including an act/ omission/ concealment of any fact or abuse of position with an intention to deceive and gain undue advantage or injuring the interest of the company/shareholders/creditors irrespective of leading to a wrongful gain or loss.[5] Culling out the principle from the above, CSR frauds may be defined as those fraudulent activities whereby the said company conceal the required funds which are to be shown in its books of accounts and retain the majority of the funds which can happen in various forms with an intent to deceive. Such gains which are concealed from various external stakeholders and the public at large who are unaware of

1 The Companies Act, 2013, No. 18, Acts of Parliament, 2013, § 135 (India).

2 Qamar Ali Jafri, *Triumphs and Failures of Corporate Social Responsibility in India*, Ipleaders (Jul. 25, 2018), https://blog.ipleaders.in/csr-triumphs-failures/ (Last visited on August 13, 2021); *see also* Sachin P. Mampatta, *As CSR Spends Touch Rs 12,000 Crore, Investigators Stalk Ghost Beneficiaries*, The Wire (Dec. 13, 2019), https://thewire.in/business/as-csr-spends-touch-rs-12000-crore-investigators-stalk-ghost-beneficiaries.

3 Panchali Guha, *Why comply with an unenforced policy? The case of mandated corporate social responsibility in India*, 3(1) POLICY DESIGN AND PRACTICE at 58, 67 (2020).

4 *Id.*

5 The Companies Act, *supra* note 1, at §447.

such fraudulent activities leads to promoting a positive social image and reputation which in turn benefits such companies.

Taking cognizance of such matter, many regulatory authorities and even companies such as Deloitte and Ernst & Young (EY) who specialize in such monitoring and implementation of activities being exposed to such occurrence of frauds by the companies, have often issued guidelines from time to time in order to refrain from such malpractices.[6]

Need and Interest to Legal Community

There has been a significant increase in the CSR expenditure in India over the past few years whereby close to INR 12,000 crores was spent as of March 31, 2019.[7] Since then, the economy has been hit by major blows including the COVID-19 Pandemic, whereby, the object and purpose of CSR become even more important, which the Government has been cognizant of and has been taking appropriate steps.[8] Additionally, white-collar crimes in India even after stringent measures included by various regulatory mechanisms has increased in the corporate sector due to the failure on the part of the company and the regulatory authorities to act on such deviations resulting in an increase in frauds.[9]

The legal community comprising of the Government, various Regulatory Authorities, and legal professionals thus, have a major role to play to remove such hindrances and set guidelines towards mitigating such frauds from a holistic perspective to cater the needs of all who are affected by it. The implementation of CSR during such a crisis has a major role to play to promote the social behaviour of the businesses. The legal framework as a whole can eradicate the issues arising out of the non-legal sphere i.e., being the issues of governance, transparency, monitoring, implementation etc. resulting in the creation of CSR Frauds. Moreover, in a situation like this, the need for vigilance is of the utmost importance coupled with the execution and implementation process.

6 Deloitte, *Corporate Social Responsibility Advisory Services: Reducing Risk, Increasing Value* (2017); Ernst and Young, *Corporate Social Responsibility in India: Re-Engineering Compliance and Fraud Mitigation Strategies 6* (2020).

7 Sachin P. Mampatta, *supra* note 2.

8 Divya J Shekhar, *Inside the reshaping of CSR in India during Covid-19*, Forbes India (May 06, 2021), https://www.forbesindia.com/article/take-one-big-story-of-the-day/inside-the-reshaping-of-csr-in-india-during-covid19/67821/1.

9 Ernst & Young, *Weak governance and lack of due diligence pose a grave risk to CSR programs: EY survey*, (May 06, 2020), https://www.ey.com/en_in/news/2020/05/weak-governance-and-lack-of-due-diligence-pose-a-grave-risk-to-csr-programs.

Types of Frauds

CSR constitutes of a variety of frauds as mentioned above which exposes the company. The list is merely an illustrative one and not an exhaustive one. Firstly, CSR is often used by companies to increase their reputation even though the ultimate goal isn't served, instead, it acts as a marketing tool for instance in the case for Lifebuoy soap whereby they conducted awareness programmes relating to their product to drive behaviour change of consumers towards their brand acting as a marketing strategy.[10] Secondly, the issue of conflict of interest arises during the formulation of the CSR Policy whereby its members direct the funds towards certain trusts and NGO's (set up even by various political parties) extracting private gains as well as political gains from the allocated expenditure such as in case of ghost beneficiaries which will be explained later. Furthermore, there are a few projects which are carried out by various political parties where various funds are being misappropriated under the purview of CSR, for instance, the establishment of the Statue of Unity where five PSU's contributed around INR 150 crores marking it as CSR under conservation of national heritage which was categorized as totally unauthorized.[11] Such transactions lead to wrongful classification in order to dodge the liabilities and go against the notions of disclosing a true and fair picture of the business.

Why are CSR Frauds Committed?

The key to the successful implementation of a CSR Policy for a company lies with proper monitoring of law along with ensuring checks and balances at each stage. Checking the efficacy of the CSR Programmes involves utilizing and implementing various aspects including the strategy, assessment of the external and internal risks and the integrity shown by the companies who have the onus to implement such programmes. The Report by EY on CSR states the major reasons for the occurrence of CSR Frauds lies in the non-maintenance of proper governance structure and lack of due diligence on the implementation partners.[12] The Report further highlights major findings, one of which shows the over reliance on the third party to execute programmes without a proper due diligence policy and checking of the past record of implementation partners.[13] Due diligence policies provide a certain

10 Arundhati Ramanathan, *What qualifies as CSR and what does not?*, Livemint (Mar. 25, 2015) https://www.livemint.com/Companies/bAKkTMlOxdT5VZigmD7p3H/What-qualifies-as-CSR-and-what-does-not.html.

11 Pushpa Sundar, *Using CSR Funds for Political Gain*, The Wire (Dec. 22, 2018) https://thewire.in/business/modi-government-csr-political-gain.

12 Ernst and Young, *supra note 6.*

13 *Id.*

structure to a program and act as a precautionary step for the company to advance into a fraudulent situation.

Further, the concept of ghost beneficiaries has also emerged in regard to the commission of CSR Frauds by companies. A ghost beneficiary is a concept whereby the parent company (who is initiating the CSR), transfers funds to some third-party individuals or organizations for the purposes of CSR activities, however in reality such existence of third-party individuals and organizations is questionable. It extends to a situation whereby a new company is floated by the parent company who is spending the CSR funds itself. Though the legitimacy of the formation of such a company under the same group could be valid, however, the transactions of the company for the purpose of CSR and its due accounting makes it a complicated issue.[14]

For instance, a company allocated capital for livelihood creation under its CSR program whereby money was supposed to be spent on a well to help in the irrigation needs for the farmers, however on analysing the project reviews, it was observed that the planned well wasn't suitable to cater the needs for irrigation and the reason 'irrigation purposes' was nothing but false assertion to deceive the regulatory authorities.[15]

There have been instances whereby the misuse of CSR funds have come into light with respect to ghost beneficiaries, one of them being the incident where a social activist was paid 45% of total CSR funds in the form of 'consultation fee' amounting to INR 13,36,500 from an NGO in Karnataka who in turn received from a company.[16] Similarly, another NGO came under scrutiny for supporting the concept where such NGO received funds from a European manufacturer and aviation company Airbus.[17]

There exist few people with dishonest intent who attempt to de-fraud the authorities by implementing CSR policies through organisations with a questionable existence, though not necessarily. Lack of transparency by the requisite authorities and the management of such companies is one of the factors which could hide the activities of these beneficiaries from scrutiny.[18] There also exists ineffective structuring of the CSR projects due to ineffective

14 Sachin P. Mampatta, *supra* note 2.

15 *Id.*

16 Yathiraju, *45 per cent of CSR funding paid to activist as 'consultation fee' to avail funds*, The Indian Express (Jul. 15, 2018) https://www.newindianexpress.com/states/karnataka/2018/jul/15/45-per-cent-of-csr-funding-paid-to-activist-as-consultation-fee-to-avail-funds-1843525.html.

17 Rajesh Ahuja, *CBI files FIR against corporate lobbyist, NGO over misuse of CSR funds*, Hindustan Times (Nov. 17, 2017) https://www.hindustantimes.com/india-news/cbi-files-fir-against-corporate-lobbyist-ngo-over-misuse-of-csr-funds/story-278i8W6UCK8l2hIdl8lr0M.html.

18 Ernst and Young, *supra note 9.*

setting up of committees and the lack of dedication of the Board of Directors (BoD) to implement the projects which in turn has led to the creation of fake CSR Projects. Thus, in the light of poor governance mechanism, the issues of detection and investigation become critical as also highlighted by the survey conducted by EY.[19]

Detection of CSR Frauds

In order to prevent the fraudulent acts occurring in relation to the CSR activities, detection of such activities at an early stage becomes crucial. One of the primary steps for detection then necessitates undertaking a fraud risk assessment at a periodic basis by the company which would help in bringing to light any transactions or any scheme which would probably invite legal trouble for the company.[20]

In the existing framework set up by the Legislature, the focus has been on the anti-corruption laws whereby stringent measures have been placed for an offence being committed under its ambit. Proper records need to be maintained for countering such measures but, in cases involving such ghost beneficiaries, even proper records are unable to lead towards the result. The organizations and trusts under whom such funds are transferred by the parent company, need to provide a report to incorporate CSR via Form AOC-4. This form becomes the essence of the current topic because the form is not accountable to be audited by external auditors as compared to other documents and acts as a lacuna, stated by Bhaskar Chatterjee.[21] In this regard, the concept of auditing emerges whereby conducting an external audit extending to such forms can be helpful to detect the CSR Frauds, even for ghost beneficiaries. Any such transaction or a policy implementation implying fraudulent activities having come under the scrutiny of the Auditing Company, empowers them to report such fraudulent to the Central Government and thereby acting as a major obstacle for the companies to carry out their dishonest intentions in relation to CSR. In this light, the scope of forensic audit has been expanded to encompass all the fraudulent activities and closes any existing legal loopholes.

Furthermore, it has been observed that there hasn't been any centralized repository for public

19 Ernst and Young, *supra note 6.*

20 Federation of Indian Chambers of Commerce and Industry (FICCI*), Corporate Resiliency: Managing the Growing Risk of Fraud and Corruption A Holistic Approach 12 (Sep., 2013) https://ficci.in/spdocument/20310/FICCI-Deloitte.pdf.*

21 Dinesh Narayan, *How Indian companies are misusing public trusts to launder their CSR spending*, The Economic Times (Oct. 21, 2015), https://economictimes.indiatimes.com/news/economy/finance/how-indian-companies-are-misusing-public-trusts-to-launder-their-csr-spending/articleshow/49474584.cms.

trusts where any information could be available on such trusts unlike for the companies which have the Registrar of Companies, hardly making the former come under the radar of the regulatory authorities. While the Indian Trusts Act may provide for such a repository, it covers only private trusts and thus, makes public trusts susceptible to the preferred mode for fraudulent activities by the companies in the nature of ghost beneficiaries.[22]

Investigation of CSR Frauds

The Companies Act emphasises on a better way to regulate companies from a holistic point of view including stringent penal provisions. The provisions for fraudulent activities extends to any suspicious nature of the defaulting company which may include non-rotation of the auditing partners in a short period of time to conflict of interests between shareholders and the BoD to the formation of the company etc.[23] Moreover, the problem of non-rotation of auditing firms was highlighted by the Naresh Chandra Committee of 2002 in light of the auditing failures and thus tried to recommend bridging such gaps.[24] The issue of non-auditor rotation was prevalent under the 1956 Act whereby the auditors were appointed for a long period establishing a good client base, thus raising suspicion over concealing fraudulent transactions. However, that issue has been solved to an extent via Section 139 (2) of the 2013 Act.[25]

Section 206 – 229 under Chapter XIV of the Act deals with the various provisions in regard to the investigation.[26] These provisions imply the seriousness of an offence to be classified as a fraud as per the legislature. Moreover, it specifies that a violation should have sufficient backing for initiating an investigation under the Act as specified in the above-mentioned provisions.[27]

The provisions also list down the establishment of vigilant whistleblowing mechanisms and places emphasis on the importance of an independent director who may be given a larger role to play in relation to any third-party transaction and disclosures. The statute further provides for an appointment of a Serious Fraud Investigation Office (SFIO) under Section

22 *Id.*

23 The Companies Act, *supra* note 1, at § 7-8,36,38,66,76A & 140.

24 Ministry Of Finance, Report Of The Committee On Regulation Of Private Companies And Partnerships (July, 2003) http://reports.mca.gov.in/Reports/3-Naresh%20Chandra%20committee%20report%20on%20regulation%20of%20private%20companies%20and%20partnerships,%202003.pdf.

25 The Companies Act, *supra* note 1, at § 139 cl 2.

26 The Companies Act, *supra* note 1, at § 206-229.

27 *Id.*

211 and 212 of the Act to tackle such fraudulent acts committed by the companies.[28] SFIO is a fraud investigation agency set up by the Central Government which has experienced experts over various sectors involving banking, corporate affairs, taxation, forensic audit, capital markets etc.[29]

The role of an SFIO is towards detecting and investigating probes in relation to any frauds being carried out. The Investigating Officer by the SFIO has been empowered under Section 217, whereby he can extract all the information and documents from employees for the alleged fraud committed by the company.[30] On such procurement of all the information and guidance, then report is to be submitted to the Government within the specified period upon which the latter may initiate the proceedings before a Special Court and the provisions in tandem to the Code of Criminal Procedure, 1973 shall apply.[31]

Conclusion and Suggestions

It is observed in India where a concentrated shareholding pattern is followed, the majority of board members do not involve themselves as much as they are supposed to in such activities, and even if they do, they act as mere cronies to the promoters which act as a detriment for the interests of the company and the people associated with it. Though Section 135 ensures the creation of a CSR Committee, such committees have very less involvement of the top management as required for supervision implying less control over the functioning of the committee. In order to have a proper governance and monitoring mechanism, the system of checks and balances within the committee can act as an aid to provide for such gaps. Under the present regime, the committee requires a minimum of one independent director which in effect may not hold enough authority and thus they could have no effect on the decisions taken by the committee. With regards to this, having a majority of independent directors should be mandatory so that the committee will exercise its mind to the best of its ability and ensure the protection of the existing minor shareholders of the company. The duty of an independent director extends to implement best policies for corporate governance and ensure a proper framework towards unscrupulous activities going against the conduct laid down by the company for the protection of the interests of various persons.[32]

Recently, the policy of a stringent mechanisms for whistle-blower policy has also emerged

28 The Companies Act, *supra* note 1, at 211-212.

29 *Id.*

30 The Companies Act, *supra* note 1, at § 217.

31 The Code of Criminal Procedure, 1973, No. 2, Acts of Parliament, 1974 (India).

32 The Companies Act, *supra* note 1, at Schedule IV.

as explained above. An establishment of a whistle-blower committee can itself solve the issue to an extent where the composition doesn't involve the top management and anonymity with respect to such complaints are given the highest priority. Such morals can help the members of the company itself to restrict the unscrupulous activities in mitigating CSR Frauds to an extent.

Another system of checks and balances can occur by imposing stringent measures with related to the committee's functioning via a periodical review over the activities being conducted as well as via checking their efficacy through the appointment of auditors as per the Act. Moreover, since the aim is to foster a robust compliance mechanism and proper review of the work, a Secretarial Auditor as per Section 204 of the Act,[33] Rule 8 of the Companies (Meetings of Board and its Powers) Rules[34] and Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules[35] may also be an alternative whereby such appointment provides for a disciplined approach to evaluate and improves effectiveness for ensuring proper checks and balances. In addition, every Secretarial Auditor can monitor a company that is eligible for carrying out CSR activities, thereby ensuring that companies do not escape from their CSR obligations.

Lately, through the Companies (Amendment) Act, 2019, provisions for CSR violations have been made specific and vigilant measures for monitoring unspent CSR funds have now been accounted for.[36] The positive impact of CSR can be truly beneficial to the society. However, companies try to avoid such expenditure and after looking at the above analysis, it can be said that there exist various anomalies in the law with respect to ghost beneficiaries which the companies take an advantage of. In light of this, the role of SFIO becomes essential to establish itself as the nodal agency for matters pertaining to frauds. For the SFIO to fulfil its duties, certain compliance measures should be undertaken as mentioned above in order to reduce CSR Frauds through Ghost Beneficiaries.

33 The Companies Act, *supra* note 1, at § 204.

34 The Companies (Meetings of Board and its Powers) Rules, 2014, Notification G.S.R. 240(E), 2014, Rule 8 (India).

35 The Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, Notification G.S.R. 249(E), 2014, Rule 9 (India).

36 The Companies (Amendment) Act, 2019, No. 22, Acts of Parliament, 2019, § 21 (India).