
CASE ANALYSIS: INFRASTRUCTURE LEASING & FINANCIAL SERVICES LIMITED SCANDAL, 2018

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INTRODUCTION

Background:

The Infrastructure Leasing & Financial Services Limited (IL&FS) Scandal of 2018 is considered to be one of the most significant corporate frauds in the Indian Financial sector. The IL&FS, an important non-banking financial company associated with the Reserve Bank of India was established in the year 1987 to encompass infrastructure financing and development. It operated through various subsidiaries which included diverse sectors such as energy, transportation, and other financial services. The company took loans to invest into a plethora of infrastructure developments. However, due to mismanagement, negligence, and financial oversight led to defaults in repayments which eventually resulted into systematic risks in Indian economy.

Facts:

- The company had amassed a total debt of approximately Rs.91,000 crore, along with, Rs.57,000 crore from public sector lenders by the year 2018.¹
- Between July-September 2018, IL&FS including their subsidiaries defaulted on various debt obligations, which included inter-corporate debts and short-term loans which indicated severe liquidity issues.
- In furtherance to this, the credit rating agencies had demoted the status of the company's debt instruments from high to low, which reflected the company's deteriorating financial health.

¹ GRM institute, ILFS Case study-AML; <https://grm.institute/wp-content/uploads/2021/05/ILFS-case-studyAML.pdf>

- In October 2018, the government decided to dissolve the IL&FS board owing to its managerial and negligence issues, and then also appointed a new board headed by Uday Kotak to reinstate stability and cover the losses incurred.
- The investigations that took place revealed that fraudulent activities and financial irregularities were happening within the entire system. The Serious Fraud Investigation Officer (SFIO) took into custody the top executives, including the former Vice Chairman, for granting loans to unreliable entities.
- The economic impact of the same triggered liquidity crisis and credit crunch in the Indian financial market which eroded investor dependency and shed light upon the significant lapses within corporate governance and regulatory oversight within the NBFC.

LEGAL ISSUES INVOLVED

1. Corporate Mismanagement and Fraudulent Transaction: The company failed to disclose its financial irregularities for years, which means deceiving the investors and lenders.
2. Lack of regulatory lapses: The RBI and Ministry of Corporate Affairs failed to observe and recognize financial deterioration within time duration.
3. Money laundering: An investigation report had also revealed money worth Rs 6,500 crores through shell companies and fraudulent contracts.

RELEVANT LEGAL PROVISIONS

I. THE COMPANIES ACT, 2013²

- Section 241: This section provides and allows the members of a company to apply to the NCLT if the affairs of a company are questionable or conducted in a manner which is prejudicial to public interest or is oppressive towards any members.

² The Companies Act, 2013 (Bare Act)

- Section 242: In furtherance to Section 241, the NCLT orders for remedies if it detects that the affairs of the company are prejudicial or is oppressive in nature. Remedies may include the regulation of the company's conduct, the purchase of shares, or the termination of agreements.
- Section 140: It permits the NCLT to direct a company to change its auditors, in case the previous ones had a fraudulent conduct or abetted any under the table deals. This provision ensures accountability and integrity of financial reporting.
- Section 199: This provision allows a company to recover remuneration from its managerial personnel if it is able to prove the misstatement on company's part due to any kind of fraud or non-compliance.

II. PREVENTION OF MONEY LAUNDERING ACT, 2002 (PMLA)³

- Section 3: It basically defines the offense of money laundering or any process or activity that takes place under such fishy conducts connected with a criminal proceeding projecting it as untainted property.
- Section 4: It provides for the punishment for anyone who commits felony regarding cases of money laundering, with rigorous imprisonment ranging from 3-7 years, extendable up to 10 years in exceptional cases.

APPLICATION & ANALYSIS

a) The IL&FS scandal not only was a shocker to the Indian financial market but also prompted a deep regulation into the legal frameworks that govern corporate governance, fraud and financial misconduct. The legal action taken in this case for investigation were the provisions under Companies Act, 2013, Prevention of Money laundering act, the judicial oversight of The National Company Law Tribunal (NCLT) and actions taken by other subsidiaries and RBI. These statutes were applied in order to restore the market confidence, protecting the interests of stakeholders, and punish the ignorant behavior of corporate leadership.

³ Prevention of Money Laundering Act, 2002 (PMLA)

b) The most significant step was the invocation of section of The Companies Act, 2013. They were pivotal as it provided a legal route to address the systemic mismanagement and alleged oppression undertaken by the board and senior management. The concealment and under table transactions came to light which alerted the investors, lenders and crediting agencies. The NCLT took the step of dissolving the board to stop the oppression and mismanagement, and directed to appoint a new board to exemplify the application of NBFC sectors. This step was not only meant to rectify mismanagement but also had served as a deterrent to various other corporate boards who might be tempted to prioritize short term profits over sustainable and transparent governance.

c) The auditors play a crucial role in ensuring that financial statements are recorded accurately in order to reflect a company's actual financial position. In this instant case, Deloitte Haskins & Sell and BSR & Co. (part of KPMG) were also heavily criticized for their failure to be unable to identify the financial irregularities and were hence held accountable to uphold their professional obligations.

d) Furthermore, the recovery of undue remuneration which is paid to the management in cases of fraud also was scrutinized. It was observed that the company's books were being misreported and certain executives were giving out excessive salaries and bonuses. Hence, due to the invocation of Section 199, the principle that ones responsible for their misconduct must not get financially benefitted. It emphasized upon the principle that accountability extends to every level of corporate hierarchy.

e) Following the defaults and the auditors' concerns, regulatory bodies like the RBI, SEBI, and MCA began looking into IL&FS. The purpose of these investigations was to determine the degree of financial mismanagement, fraud, and governance shortcomings in the organization. The public's awareness of the IL&FS case was greatly aided by media coverage. Investors, analysts, and members of the public paid close attention to the news outlets' coverage of the defaults, financial irregularities, and corporate governance issues. The case was made public in part because of the increased scrutiny and public demand for accountability. The case of IL&FS accounting and financial fraud was made public by a number of factors, including

defaults, downgrades in credit ratings, regulatory action, auditors' warning signs, investigations, media attention, and investor concerns. Due to these incidents, IL&FS's operations were subjected to a more thorough investigation, which resulted in the discovery of fraud and poor management as well as subsequent attempts at repair.

f) The PMLA was another key legal instrument which was designed to prevent money laundering and channel the illicit funds and penalize those who illegally obtain money through illegitimate assets. This legal strategy not only aimed to disrupt the flow off illicit funds but also put out a clear message to other corporate entities that such financial misrepresentations would not be entertained.

g) The NCLAT (National Company Law Appellate Tribunal) proceedings also ensured reliefs by restraining creditors from taking coercive actions against the company and its subsidiaries during the process of resolution to ensure orderly restructuring and prevention of further financial instability.

h) This scandal took place due to weak corporate governance amounting to no accountability among leadership, regulatory gaps which lacked real-time monitoring mechanisms, failure of professional auditing which if done timely would have prevented the financial crisis, and shadowing of banking risks which had operated without adequate regulatory scrutiny.

i) Additionally, the interaction between the PMLA and the Companies Act in this instance reflects the interrelated nature of financial regulation and corporate governance. Where corporate mismanagement is worsened by willful money laundering efforts, the ongoing legal proceedings are not singular events; they are part of an overall, integrated regulatory approach aimed at maintaining market integrity.

j) The IL&FS group had more than a hundred subsidiaries and is sitting on a debt of Rs 94,000 crore. The bankruptcy cases erased Rs.8.48 lakh crore of investor's wealth. Commercial Paper to the tune of Rs 300 Crores were sold at discounted price, which was of DHFL. Share market got impacted because retail investors were nervous enough to start offloading shares of other NBFCs and redeem it from mutual funds. IL&FS default created panic in the debt market and sucked out liquidity in the system

of 1 lakh Crore.

k) All other housing finance companies and infra companies stocks declined by as much as 60% of its stock prices. IL&FS engineering from Rs 45 to Rs 2.20, IL&FS transportation from Rs 166 to Rs 1.45 and IL&FS investment Rs 27 to Rs 2.40 share price excessively grew. Broadening of fiscal deficit that has negative impact on inflation, exchange rate, growth etc. Sensex lost almost 2,000 points in just one week, leading to a bloodbath in the market.⁴

l) The IL&FS scandal led to a thorough examination of India's governance procedures and regulatory environment. Stricter regulations were put in place for credit rating agencies, auditors, and NBFCs by regulatory organizations like the Securities and Exchange Board of India (SEBI). Enhancing transparency, fortifying risk management, and raising overall governance standards in the financial sector were the goals of these reforms. An attempt was made to bring IL&FS back to life and lessen the effects on investors and creditors.

To raise money, asset sales were started, and actions were taken to get defaulters to pay. As stakeholders attempt to recover as much value as possible and guarantee a just distribution of funds to impacted parties, the resolution process is still in progress.

IMPACT & AFTERMATH

- i. India's economy and financial sector were significantly impacted by the IL&FS fraud scandal. The stability of the financial system was significantly impacted by IL&FS and its subsidiaries' default. Mutual funds and other non-banking financial companies (NBFCs) were impacted by the crisis's liquidity shortage and contagion risks. Because of this, there was a decline in trust in the financial system, which made credit more difficult to obtain and raised borrowing prices. The Indian government moved quickly to restore stability after realizing the systemic risks the IL&FS crisis posed. In order to supervise the recovery process, the government replaced the IL&FS board with five new directors. Investigations into the fraudulent practices that led to the

⁴ IIUM Journal Publication, Vol.14, No.2, August 2023, Baranidharan Subburayan, <https://journals.iium.edu.my/ijcsm/index.php/jcsm/article/download/208/90/1001>

- company's demise were also started.
- ii. A thorough examination of India's governance and regulatory framework was spurred by the IL&FS scandal. More stringent regulations were put in place for credit rating agencies, auditors, and NBFCs by regulatory organizations like the Securities and Exchange Board of India (SEBI). These changes were intended to raise the financial sector's overall governance standards, improve risk management, and increase transparency.
 - iii. The impact on investors and creditors was lessened, and attempts were made to bring IL&FS back to life. Funds were raised through asset sales, and actions were taken to collect money from defaulters. A fair distribution of funds to impacted parties and the recovery of as much value as possible are the goals of the ongoing resolution process. The IL&FS crisis was, all things considered, a wake-up call for the Indian financial system. In order to avoid future failures of this kind, it emphasized the necessity of stricter laws, better governance procedures, and efficient oversight. The goal of government intervention and subsequent reforms has been to rebuild confidence in the financial system and establish a more robust structure that can endure future shocks.
 - iv. Public awareness of the IL&FS case was greatly aided by media coverage. Investors, analysts, and the general public paid close attention to the news outlets' coverage of the defaults, financial irregularities, and corporate governance issues. The case was made public in part because of the increased scrutiny and public pressure for accountability.
 - v. The IL&FS accounting and financial fraud case was made public by a number of factors, including defaults, downgrades in credit ratings, regulatory action, auditors' warning signs, investigations, media attention, and investor concerns. These incidents prompted a more thorough investigation into IL&FS's business practices, which resulted in the discovery of fraud and poor management as well as the subsequent attempts to address these issues.

CONCLUSION

In addition to disrupting India's infrastructure finance system, the IL&FS controversy revealed long-standing flaws in corporate governance, risk management, and regulatory

supervision. Once hailed as a cornerstone of India's growth engine, Infrastructure Leasing & Financial Services Limited's eventual demise provides priceless insights into the dangers of unbridled expansion and the vital role that accountability plays in the corporate sector. A combination of excessive leverage, opaque financial practices, and a breakdown in internal and external oversight mechanisms was the primary cause of the crisis. As IL&FS grew rapidly over the years, it accumulated a debt of about ₹91,000 crores by financing long-term infrastructure projects primarily through short-term borrowings. This asset-liability mismatch turned into a ticking time bomb, and the financial structure was unable to meet its responsibilities when default risks emerged. It was tough for investors, regulators, and auditors to properly evaluate the growing risks because of the company's extensive network of more than 250 subsidiaries and special purpose vehicles, which further masked its actual financial health. The lack of external oversight was equally important. Up until the very last minute, credit rating agencies—whose unbiased evaluations are essential for preserving market confidence—gave IL&FS's debt instruments deceptively high ratings. These overly optimistic assessments not only obscured the real dangers but also fostered a complacent mindset among creditors and investors. Likewise, the external auditors, who ought to have been the last line of defense against financial misreporting, were unable to identify or sufficiently draw attention to the irregularities. Later, it was alleged that Deloitte Haskins & Sell and its affiliated firms relied too much on management representations and lacked professional skepticism. The crisis grew worse because the company's dishonest practices went unchecked due to the absence of a strict external check.

Additionally, the regulatory framework was found to be too rigid. In contrast to traditional banks, IL&FS operated in a less strictly regulated industry as a non-banking financial company (NBFC). When regulatory agencies such as the Ministry of Corporate Affairs (MCA) and the Reserve Bank of India (RBI) finally stepped in, it was too late to stop the defaults' cascading effects. In order to stabilize the situation, the government eventually took control and appointed a new board with leaders like Uday Kotak. These actions, however, were taken after considerable harm had already been done to the financial system as a whole, where liquidity issues and a

decline in investor confidence had an impact on numerous subsidiaries of the company. From a wider angle, the IL&FS crisis is a clear reminder of how crucial moral behavior, openness, and responsibility are to business management. It demands that the structure of corporate

boards be reexamined and that independent directors with relevant industry experience be chosen instead of those who only fulfill legal requirements. Furthermore, the case has made managers' incentives more closely aligned with the company's long-term health rather than maximizing profits in the short term. The crisis highlights the necessity of closer examination of financial statements and a more proactive approach to risk management for both investors and regulators. The IL&FS scandal, in summary, serves as a warning example of how a combination of poor management, governance failures, and regulatory deficiencies can result in robust institutions to fall weak.