CHAPTER – 2
CORPORATE GOVERNANCE AND CORPORATE ILLEGALITY

The present chapter builds up the theoretical background to understand the relationship between corporate governance and corporate illegality. Beginning with an introduction to corporate governance, the chapter moves on to describing the global initiatives towards developing good corporate governance practices and theories allied to corporate governance. Further, corporate illegality is discussed with its definitions and the Indian regulatory framework and theoretical background.

2.1 INTRODUCTION

The recurrent episodes of corporate failures and frauds have raised an alarm about the performance of the companies and their governance systems. Humongous economic loss, loss of investor confidence, the mass of people affected, reputational costs to directors, and difficulty in detection of fraud are a few of the innumerable problems associated with illegality. Since the integrity of a company is essential to meet the stakeholder’s expectations, a well framed corporate governance structure can ensure accountability of the top management team towards the outsiders. Hence, a compelling need has been felt by the regulators and corporations to revisit the current corporate governance modalities.

Corporate governance is an aggregation of policies and processes according to which an organization is operated and regulated to safeguard the interest of the stakeholders. It is fundamentally a control mechanism which facilitates the implementation of effective management aspects that can guarantee ethically sound actions and promise stability in the long run. Corporate governance covers various corporate dimensions like bankruptcy and securities regulations, accounting and reporting rules, investor protection guidelines, and rights and duties of the corporate insiders and outsiders. Its inter-disciplinary approach involves concepts from the field of psychology, economics, law, finance, accounting, sociology, and political science (Sarkar and Sarkar, 2012).

Corporate governance is a discipline defining the relationships among the corporate actors. The board of directors, the management, and shareholders are the main elements of a company. The shareholders elect the board of directors to act and
take crucial policy decisions on their behalf. Owing to the complexities in corporations and the enormity of operations, the board delegates the responsibilities to management. So, the chief duty of the board is to check the actions of management and safeguard the shareholders’ interests. The misalignment of objectives of the three groups gives rise to the agency problems. The composition and structure of the board of directors is the epicentre of good governance and is characterised by its proficiency to reduce agency costs. Thus, the prime goal of a corporate governance charter is to warrant harmony among the interests of the corporate actors. In the words of Larcker and Tayan (2011, p. 8), “corporate governance is a collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders”. The definition portrays the existence of agency problem and the fiduciary relationship of the management with the shareholders of the company.

The roots of agency problem lie in the separation of ownership and control. Self-interested managers are inclined towards making decisions that benefit them or the company and abuse shareholder’s trust. This may be due to information asymmetries, lack of expertise, presence of firm-specific factors, or to fulfil their personal financial aspirations. The ubiquitous corporate illegality is an off-spring of the same phenomenon which results in agency costs. Shleifer and Vishny (1997) suggested that such irregularities can be controlled by disciplining the managers and devising monitoring mechanisms (e.g., audit committee, whistle-blower policy). In this vein, numerous authors (e.g., Kesner and Dalton, 1986; Haniffa and Cooke, 2002; Lurie and Frenkel, 2003; Lessing, 2009; Varottil, 2009; Larcker and Tayan, 2011) have described corporate governance as a mechanism which can thwart abuse by top management and enhance shareholder value. Therefore, it can be concluded that an examination of corporate governance structure can reveal board characteristics that act as a check on manager’s dubious activities and help in diminishing the principal-agent conflicts arising from dispersed ownership.

This chapter describes the international and national developments, theoretical background, and regulatory framework in the domain of corporate governance and corporate illegality. Section 2.2 centres around the definitions of corporate governance, the international and national initiatives, and the theories associated with corporate governance. Section 2.3 elaborates on corporate illegality, white-collar
crime theories, models of illegality, the Indian legal set-up for corporate illegality, and the status of corporate illegality in India. Section 2.4 presents a brief synopsis of the chapter.

2.2 AN OVERVIEW OF CORPORATE GOVERNANCE

The influence of corporate governance on the profitability and growth of a company makes it an indispensable subject of discussion and policy making. Corporate governance largely consists of rules that configure the powers, position, duties, and the functions of the top executives in a company. It is an arrangement of inter-relationships of the board and the management with the stakeholders. The next subsection presents the corporate governance definitions given by policy makers, corporate governance committees, and scholars.

2.2.1 Definitions of Corporate Governance

Being a multi-dimensional concept, corporate governance has been elucidated from various perspectives by regulators, practitioners, theorists, and scholars. A few noteworthy definitions of corporate governance have been cited in Table 2.1. Skimming through the definitions, it can be observed that corporate governance can be classified as a narrow as well as a broad concept. The narrow concept pivots around the operational interactions of the company with the directors including the regulatory framework, compensation, rights and duties, monitoring methods, and the like. It basically focuses on the features of good governance like transparency, accountability, and responsibility of the management to the shareholders that can add value to the performance of the company. In the broader sense, the concept of corporate governance extends to the honest and ethical working of a company which is crucial for the development of capital markets, growth of the company, better resource allocation, and strengthening country’s industrial base.

According to some authors, corporate governance is meant to enhance shareholder value and maximise their wealth. They contend that the efforts of the management and their strategic decision making should target at aligning objectives of the management and shareholders thereby amplifying company profits for its equity holders.
Table 2.1: Definitions of Corporate Governance

<table>
<thead>
<tr>
<th>Scholar</th>
<th>Definition</th>
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<tbody>
<tr>
<td><strong>Panel A: Academicians</strong></td>
<td></td>
</tr>
<tr>
<td>Friedman (1970)</td>
<td>“Corporate governance is to conduct the business in accordance with the owner’s or shareholders’ desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs.”</td>
</tr>
<tr>
<td>Jensen and Meckling (1976)</td>
<td>“The purpose of corporate governance is to minimize the total cost in aligning managers and shareholders’ incentives and in unavoidable self-interested managerial behaviors.”</td>
</tr>
<tr>
<td>Tricker (1984)</td>
<td>“Corporate Governance is concerned with the way corporate entities are governed, as distinct from the way businesses within those companies are managed. Corporate governance addresses the issues facing Board of Directors, such as the interaction with top management and relationships with the owners and others interested in the affairs of the company.”</td>
</tr>
<tr>
<td>Parkinson (1994)</td>
<td>“The process of supervision and control intended to ensure that the company’s management acts are in accordance with the interests of the shareholders.”</td>
</tr>
<tr>
<td>Cannon (1994)</td>
<td>“The sum of activities that combine the internal regulation of the business in line with the obligations that are being placed on the company by legislation, the ownership, and control which also includes the control over assets, management and operations.”</td>
</tr>
<tr>
<td>Rezaee (2009)</td>
<td>“A process through which shareholders induce management to act in their interest, providing a degree of confidence that is necessary for capital markets to function effectively.”</td>
</tr>
<tr>
<td><strong>Panel B: Practitioners and Regulators</strong></td>
<td></td>
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<tr>
<td>Cadbury Committee (1992)</td>
<td>“Corporate governance is the system by which companies are directed and controlled. The board of directors is responsible for the governance of their companies. The shareholders role in governance is to appoint the directors and the auditors and to satisfy themselves that appropriate governance is in place.”</td>
</tr>
<tr>
<td>Confederation of Indian Industry (CII) – Desirable Corporate Governance Code (1998)</td>
<td>“Corporate governance deals with laws, procedures, practices and implicit rules that determine a company’s ability to take informed managerial decisions vis-à-vis its claimants - in particular, its shareholders, creditors, customers, the State and employees. There is a global consensus about the objective of ‘good’ corporate governance: maximising long-term shareholder value.”</td>
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### Corporate Governance and Corporate Illegality

<table>
<thead>
<tr>
<th>Organization</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Corporate Governance Forum, World Bank (2000)</td>
<td>“Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.”</td>
</tr>
<tr>
<td>OECD (2001)</td>
<td>“Corporate governance refers to the private and public institutions, including laws, regulations, and accepted business practices which together govern the relationship in a market economy, between corporate managers and entrepreneurs on one hand, and those who invest resources, in corporations on the other hand.”</td>
</tr>
<tr>
<td>Securities Exchange Board of India (2003)</td>
<td>“Corporate governance is all about ethical conduct in business.... Corporate governance deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders. It is about openness, integrity and accountability.”</td>
</tr>
<tr>
<td>N.R. Narayana Murthy Committee on Corporate Governance (2003)</td>
<td>“Corporate Governance is the acceptance by management, of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company”</td>
</tr>
</tbody>
</table>

Source: Researcher’s compilation

Other scholars lay much stress on the company’s accountability towards its stakeholders of which shareholders are only a part. The advocates of stakeholder view argue that a corporation has societal obligations and should therefore formulate policies which generate employment opportunities, provide low-risk investment prospects, lend a good standard of living to workers, and employ methods for sustainable resource consumption. It is obvious that a company cannot adopt both the perspectives that have opposing views with regards to corporate governance structure.

### 2.2.2 Global Perspective: The Historical Development of Corporate Governance

The potential of good governance to act as a check on corporate frauds has increased the pace of developments in this area by manifold. The innumerable cases of corporate fraud in Australia (e.g., Baring Bank, HIH Insurance), India (e.g., Satyam...
Computers, Sahara Group), Italy (e.g., Parmalat), the United Kingdom (U.K.) (e.g., Barlow Clowes, Tesco), and the United States of America (U.S.) (e.g., WorldCom, Enron, Adelphi Communications) have acted as a motivation to regulate and institutionalize governance laws. The regulators and governance experts around the globe have shown their interest in formulating, revising and revisiting the corporate governance rules from time to time. A timeline of international developments in the arena of corporate governance has been summarised in Table 2.2.

**Table 2.2: A Timeline of International Developments in Corporate Governance**

<table>
<thead>
<tr>
<th>Year</th>
<th>Initiative</th>
<th>Organization</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>The National Commission on Fraudulent Financial Reporting (The Treadway Commission)</td>
<td>Committee of Sponsoring Organizations (COSO)</td>
<td>U.S.</td>
</tr>
<tr>
<td>1995</td>
<td>The Study Group on Directors’ Remuneration (The Greenbury Committee)</td>
<td>Confederation of Business and Industry</td>
<td>U.K.</td>
</tr>
<tr>
<td>1998</td>
<td>The Committee on Corporate Governance (The Hampel Committee)</td>
<td>The Financial Reporting Council</td>
<td>U.K.</td>
</tr>
<tr>
<td>1999</td>
<td>The Blue Ribbon Committee</td>
<td>The Securities and Exchange Commission</td>
<td>U.S.</td>
</tr>
<tr>
<td>1999</td>
<td>CalPERS’ Global Governance Principles</td>
<td>The CalPERS Investment Committee</td>
<td>U.S.</td>
</tr>
<tr>
<td>2002</td>
<td>The King Committee on Corporate Governance (The King Report)</td>
<td>The Institute of Directors in Southern Africa</td>
<td>South Africa</td>
</tr>
<tr>
<td>2002</td>
<td>The Sarbans-Oxley Act</td>
<td>The United States Congress</td>
<td>U.S.</td>
</tr>
<tr>
<td>2003</td>
<td>ASX Corporate Governance Council Report</td>
<td>ASX Corporate Governance Council</td>
<td>Australia</td>
</tr>
<tr>
<td>2003</td>
<td>The Higgs Report</td>
<td>The Secretary of State for Trade and Industry (The Government of the United Kingdom)</td>
<td>U.K.</td>
</tr>
<tr>
<td>2010</td>
<td>The Dodd-Frank Wall Street Reform and Consumer Protection Act</td>
<td>The United States Congress</td>
<td>U.S.</td>
</tr>
</tbody>
</table>

Source: Researcher’s compilation
2.2.1.1 The United States of America

The establishment of the Securities Exchange Commission (SEC) in the U.S. in 1934 is one of the earliest initiatives taken to shape up the corporate governance framework in the U.S. The SEC’s primary objective is ensuring investor protection and prevention of fraudulent activities while supervising and regulating the operations of the stock markets (e.g., New York Stock Exchange, National Association of Securities Dealers Automated Quotations). The SEC is also responsible for maintaining the accounting quality and reporting standards. Moreover, it is conferred with powers to take enforcement actions against defaulting companies. A non-profit organisation, Financial Accounting Standards Board (FASB) was formed in 1973 constituting industry experts, academicians, audit companies, and investors. The primary role of FASB was drafting accounting standards after taking in public comments. The Treadway Commission was formed in the year 1985 in response to the gigantic corporate failures. The Treadway Commission Report (1987), i.e., the Report of the National Commission on Fraudulent Financial Reporting intended to put forth the crucial factors that stimulate fraudulent financial reporting and devise methods to control the menace.

Following the massive financial fraud at Enron Corporation in 2002, the U.S. congress floated the Sarbanes-Oxley Act (SOX) of 2002. The SOX set forth stern reforms to enhance the financial disclosure regulations and safeguard the investors from accounting fraud. The important provisions of the SOX included the certification of financial reports by the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), limiting loans to the executives, restricting the auditors from performing non-audit tasks, and making audit committees independent. In response to the financial breakdown in 2008, the Dodd-Frank Financial Reform Act was passed in 2010 which stipulated laws for the disclosure of executive fees and formation of independent compensation committees. The Act also provides for the formation of SEC credit ratings that will provide accurate, non-biased, and reliable credit evaluation to businesses.

2.2.1.2 The United Kingdom

There has been progressive establishment and execution of corporate governance practices in the U.K. The commissioning of the Cadbury Committee in 1992 was a
revolutionary step towards establishing corporate governance norms in the U.K. The committee presented its report ‘Code of Best Practices’ which suggested the uncoupling of the office of the CEO and board’s chair, appointment of independent directors on the board as well as the audit committee. Though voluntary in nature, the standards were set for all companies listed on the London Stock Exchange. The Greenbury Committee (1995) was formed to restructure the remuneration processes for the executives. It also suggested that compensation committees should be completely independent of the management control. Thereafter, the Hampel Committee was instituted in 1998 which combined the suggestions of the Cadbury Committee and the Greenbury Committee. The recommendations of the report operated on ‘comply or explain’ basis, i.e., the company either follows the guidelines or gives an explanation for non-compliance in its annual report.

The next initiative was in the form of the Turnbull Report (1999) which laid emphasis on strengthening the company’s internal control systems and risk assessment mechanisms. The committee advocated the establishment of techniques which could assess, control, and review the corporate risk annually. Advancement towards better governance was also evidenced in 2002 when the Directors Remuneration Report Regulations were issued. The regulations empowered the shareholders by granting them with an advisory vote in the matter of executive compensation. This guideline was later adapted in countries like Australia, India, Norway, Sweden, and the U.S.

The importance of institutional investors was emphasised in the Myners Report (2001). The role of institutional investors as trustees and their participation in underperforming companies was expected to achieve high shareholder value. In 2003, the Higgs Committee amalgamated its recommendations with the Turnbull report. The prominent suggestions that found place in the Higgs report included the appointment of fifty percent or more non-executive directors to the board with the term of office not exceeding six years and the leadership of the nomination committee be given in the hands of a non-executive member. The Financial Reporting Council in 2003 issued the Smith Report. The review centred on the role of audit committees to act independent from the management and function as an overview mechanism to the financial statement reporting and internal control systems. Overall, the emphasis was laid on director and audit committee independence to enhance shareholder value.
Lately, an amendment has been made to the Combined Code on Corporate Governance in 2016. The new code, i.e., the UK Corporate Governance Code includes specific regulations for listed companies with regards to the independence of non-executive directors, separation of the office of the CEO and chairman of the board, and transparency in directors’ selection and evaluation processes. Besides, it requires the companies to state in their financial statements if the principle of going concern appropriately applies to them and disclose their ability to pay their liabilities in the concerned assessment period. The code is supposed to be followed on ‘comply or explain’ basis.

2.2.3 Indian Initiatives for Corporate Governance

The advent of globalisation and liberalisation in India brought to the forefront the need for good governance. The developments have been cited in Table 2.3 and explicated hereinafter. The emergence of corporate governance can be dated back to the year 1996 when the Confederation of Indian Industry formed a National Taskforce on Corporate Governance under the chairmanship of Mr. Rahul Bajaj (former President, CII and Chairman, Bajaj Group). The committee submitted its report in the name of ‘Desirable Code of Corporate Governance: A Code’ in 1998. The code mentioned various corporate governance policies in tune with international best practices that could be voluntarily adopted by companies and stock exchanges. A few important recommendations of the code encompassed areas like the appointment of independent directors, the frequency of board meetings, the maximum number of directorships, disclosure of financial information, and issues of the similar nature which could enhance public confidence in companies.

The CII’s code was a welcome step by the Indian industry but only a few progressive companies chose to incorporate it. In this vein, Securities Exchange Board of India (SEBI) acknowledged the need for codified corporate governance whereby it constituted the Kumar Mangalam Birla Committee in 1999 under Shri Kumar Mangalam Birla’s leadership, to make recommendations in relation to the board structure and composition, prevention of insider trading, and increasing financial and non-financial disclosures that would elevate the pedestal of corporate governance in the Indian corporate segment. The report advocated that the prime object of corporate governance is the protection of stakeholders’ interests and giving
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foremost priority to the shareholder and investor’s expectations from the company. The recommendations regarding disclosures applied to all listed companies and were mandatory in nature.

To codify the rules on corporate governance, the SEBI institutionalised the recommendations of the Kumar Mangalam Birla Committee (with minor changes) by structuring it into Clause 49 of the Listing Agreement which primarily encompasses the corporate governance regulations for corporations listed on Indian stock exchanges. Besides other regulations, the Clause mandatorily prescribed for the appointment of independent directors, setting up of the audit committee and shareholder’s grievance committee, annexing a corporate governance report in the company’s annual report, and disclosure of compensation to non-executive directors. Clause 49 was first implemented in the financial year 2000-2001.

Table 2.3: A Timeline of National Developments in Corporate Governance

<table>
<thead>
<tr>
<th>Year</th>
<th>Initiative</th>
<th>Organization</th>
<th>Nature</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>Desirable Code of Corporate Governance</td>
<td>Confederation of Indian Industry</td>
<td>Non-mandatory</td>
</tr>
<tr>
<td>1999</td>
<td>Kumar Mangalam Birla Committee</td>
<td>Securities Exchange Board of India</td>
<td>Mandatory and Non-mandatory</td>
</tr>
<tr>
<td>2000</td>
<td>Clause 49 of the Listing Agreement</td>
<td>Securities Exchange Board of India</td>
<td>Mandatory and Non-mandatory</td>
</tr>
<tr>
<td>2002</td>
<td>Naresh Chandra Committee on Corporate Audit and Governance</td>
<td>Department of Company Affairs, Ministry of Corporate Affairs, Govt. of India</td>
<td>Mandatory and Non-mandatory</td>
</tr>
<tr>
<td>2002</td>
<td>Narayan Murthy Committee</td>
<td>Securities Exchange Board of India</td>
<td>Mandatory and Non-mandatory</td>
</tr>
<tr>
<td>2004</td>
<td>Expert Committee on Company Law (the J.J. Irani Committee)</td>
<td>Securities Exchange Board of India</td>
<td>Mandatory and Non-mandatory</td>
</tr>
<tr>
<td>2009</td>
<td>The Companies Bill</td>
<td>Ministry of Corporate Affairs, Govt. of India</td>
<td>Non-mandatory</td>
</tr>
<tr>
<td>2010</td>
<td>ACGA White Paper on Corporate Governance in India</td>
<td>The Asian Corporate Governance Association, Hong Kong</td>
<td>Non-mandatory</td>
</tr>
<tr>
<td>2013 &amp; 2015</td>
<td>Amendment to the Companies Act, 1956</td>
<td>Ministry of Corporate Affairs, Govt. of India</td>
<td>Mandatory</td>
</tr>
</tbody>
</table>

Source: Researcher’s compilation
The years 2000 and 2002 saw the Ministry of Corporate Affairs taking initiatives for good governance. A report on Corporate Excellence was issued in 2000 which laid stress on equitable distribution of wealth among the stakeholders by implementation of good corporate governance. This was followed by the constitution of Naresh Chandra Committee on Corporate Audit and Governance in 2002. The committee gave a detailed account of the duties and responsibilities of the audit committees through its mandatory and non-mandatory guidelines. It was mandatory for publically listed companies to have at least one ‘financially literate’ member on their audit committee which had to review company’s financial statements, upkeep the disclosure records, and communicate the related party transaction information. These recommendations were integrated into the Companies (Amendment) Bill, 2003.

In the same year, the SEBI also established the Narayana Murthy Committee headed by Mr. N. R. Narayana Murthy to suggest measures for improving corporate governance standards and review the then Clause 49. Akin to the Birla Committee, this working group examined vital governance characteristics that required immediate attention. The chief observations of the committee were on defining the role and composition of the independent directors and the board, structure of the audit committee, disclosure norms, and code of ethics. The key recommendations were accepted in 2003. Suitable amendments were made in Clause 49 of the Listing Agreement of the Indian stock exchanges that came into force from January 2006. The next notable effort was the constitution of the J.J Irani Committee by the SEBI under Dr. J. J. Irani on whose recommendations the Companies Bill, 2008 was moved in the Indian Parliament. The Companies Bill of 2009 replaced the Bill of 2008 on the dissolution of the fourteenth Lok Sabha. The contents of both documents remained same.

In the aftermath of the financial scam in Satyam Computer Services Ltd., the CII’s Task Force in 2009 started devising stringent yet voluntary corporate governance rules. The team lead by Mr. Naresh Chandra recommended changes like the constitution of nomination committee to appoint independent directors, division of the non-executive directors’ remuneration into fixed (maximum 30 percent) and variable (maximum 70 percent) component, audit committee to be composed of non-executive directors of which at least two-thirds proportion be independent, and separation of the board chairman from CEO’s position (CEO duality). Organisations
like the National Association of Software and Services Companies (NASSCOM), the Asian Corporate Governance Association (ACGA), and the Institute of Company Secretaries of India (ICSI) also issued reports suggesting improvements in the governance framework of Indian Companies.

To overhaul the corporate governance norms in India, the SEBI amended the equity listing agreement in the year 2010. Further, constitutional amendments were made to the Companies Act in the years 2013 and 2015. Constant efforts by the regulatory bodies have enhanced the level of corporate governance practices in the recent past. The efforts are directed to match the international standards and guidelines. Thus, it can be deduced that Indian lawmakers have followed a radical approach towards developing watertight corporate governance systems.

2.2.4 Corporate Governance Theories

Corporate governance is an amalgamation of numerous disciplines. It encompasses economic and non-economic functions of all types of corporations, individuals employed in it, and the stakeholders. The corporate governance definitions in Section 2.2.1 also illustrate that it is multi-disciplinary in nature. A review of literature revealed that the agency theory, stewardship theory, stakeholder theory, and resource dependency theory can validate the occurrences of fraud and illegality in companies (Donaldson and Davis, 1991; Vafeas, 1999; Beasley, 1996; McKendall et al., 1999; Dunn, 2004; Abdullah, 2006; Chen et al., 2006; Shan et al., 2013). Thus, the fundamental theories of corporate governance explaining corporate illegality are illustrated in Figure 2.1 and discussed hereafter.

2.2.4.1 Agency Theory

In the context of corporate finance, an agency relationship is formed when one or more person (principal) engages another person (agent) to perform and make decisions on his behalf through a contract. The theory was expounded by Alchian and Demsetz (1972) and developed by Jensen and Meckling (1976). The theory postulates that the actions of the management (agent) may not be aligned with the interests of the owners (principal). Their activities may benefit the firms, but the prime goal of managers is self-gain which may not make the shareholders better off ex-ante (Macey, 1991). Since there is a conflict between the interests of the shareholders and the
management, agency cost arises that must be incurred for the interests to run parallel and prevent abuse of authority.

Good governance requires each firm to establish such mechanisms that protect the shareholders from management’s self-interest. From the agency perspective, independence of the board, i.e., the inclusion of outside directors on the board which are not related to the management, helps in effective monitoring of situations where there is a conflict of interests. Powerful CEOs may have a detrimental effect on the firm performance. Thus, the splitting of power and control can be exercised by separation of the CEO and the chairman. This non-duality will enable the board of directors to monitor and curb the opportunistic behaviour of the executives.

**Figure 2.1: Important Theories of Corporate Governance Explaining Corporate Illegality**

Source: Researcher’s compilation

### 2.2.4.2 Stewardship Theory

Sociology and psychology form the basis of this theory which focuses on executive behaviour. The stewardship theory given by Davis et al. (1997) suggests that managers are good stewards of the organisation and their actions align with the interests of the owners and other stakeholders regardless of their personal motivations. According to the stewardship theory, management aims to achieve the organisational
goals and satisfy all the stakeholders rather than engaging in self-satisfying behaviour. It is assumed that performance of challenging tasks and the success of the firm is related to the maximisation of manager’s utilities. Thus, this theory asserts that steward’s behaviour is pro-organization and managers derive maximum satisfaction by accomplishing the company’s set goals. Advocates of this theory emphasise on structures that facilitate and enable the managers rather than controlling them (Davis et al., 1997). It is propagated that decision making under single leader helps in higher firm performance (Donaldson and Davis, 1991). Owing to this stream of thought, the stewardship theory takes a liberal view towards CEO duality and assumes optimum utilisation of the company resources under stewards. The appointment of specialist executive directors is preferred over non-executive directors under this theory (Clarke, 2004).

2.2.4.3 Stakeholder Theory

Developing on the fundamentals of management discipline, the stakeholder theory was propounded by Freeman (1984). The theory centres on the issues that concern all the stakeholders of the company unlike its traditional form (shareholder theory) in which only shareholders were given importance and the sole objective of the firm was to maximise its profits. The stakeholder theory recognises that customers, investors, employees, government bodies, and trade associations/union are all affected by the firm activities and consequently all of them are addressed as stakeholders. It recognises the accountability of the firm towards its stakeholders and is thus considered an improvisation of the agency theory as it highlights the different constituents of the firm.

2.2.4.4 Resource Dependency Theory

Directors serve as an important link between the organisation and the external environment. The directors are considered instrumental in attracting the important resources from the environment that benefit the company. This theory purports that the directors bring resources like information, expertise, and skills which are crucial for the existence of the company. The scarcity of resources in the environment and their relative importance gives way to interdependence amongst the organisations which result in directors occupying multiple directorships. If board busyness is
associated with this theory, it can be assumed that a director’s engagement with the external environment facilitates higher firm performance.

Williamson (1985) suggested that an increase in the firm resources reduces the transaction costs. Board size is also associated with resource dependency theory and it is asserted that increased board size adds to the pool of expertise and is positively related to company’s performance and curbing down domination of the CEO. However, a contradicting view provides evidence that multiple directorships are inconsistent with the shareholder interests leading to an increased likelihood of accounting fraud (Beasley, 1996; Shivdasani and Yermack, 1999). It results in deterioration of firm value due to over commitment of the directors which lowers their ability to effectively check the management activities on behalf of the stakeholders (Fich and Shivdasani, 2006).

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Sutherland (1949, p. 9) provided criminologists with the first scholarly definition of white-collar crime. He defined it as crime “committed by a person of respectability and high social status in the course of his occupation”. However, some criminologists have suggested that the term ‘white-collar crime’ not be used at all due to its striking inability to differentiate between the corporations themselves and their executive management personnel. A variety of terms have been suggested as substitutes or synonyms for white-collar crime, including ‘avocational crime’ (Geis, 1974a), ‘upperworld crime’ (Geis, 1974b), ‘economic crime’ (American Bar Association, 1976), ‘organizational crime’ (Schrager and Short, 1978), ‘corporate crime’ (Clinard and Quinney, 1986), ‘professional crime’ (Clinard and Quinney, 1986), ‘dubious behavior’ (Bromiley and Marcus, 1989), ‘occupational crime’ (Clinard and Quinney, 1986; Green, 1990), ‘organizational misconduct’ (Szwajkowski, 1986), ‘the criminal elite’ (Coleman, 1994), and ‘elite deviance’ (Simon, 1999). The expressions used also suggest that the crimes committed by the corporate executives might be for their own benefit or for that of the organisation. A few scholarly definitions of white-collar crime are presented in Table 2.4.
Table 2.4: Definitions of Corporate Illegality and Related Concepts

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ross (1907)</td>
<td>“Criminaloids are those who prosper by flagitious practices which may not yet come under the ban of public opinion.”</td>
</tr>
<tr>
<td>Sutherland (1939)</td>
<td>“White-collar crime is committed by a person of respectability and high social status in the course of his occupation.”</td>
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<tr>
<td>Edelhertz (1970)</td>
<td>“White-collar crime is an illegal act or series of illegal acts committed by nonphysical acts committed by nonphysical means and by concealment or guile, to obtain money or property, to avoid the payment or loss of money or property, or to obtain business or personal advantage.”</td>
</tr>
<tr>
<td>The Law Commission on ‘The Trial and Punishment of Social and Economic Offences’ (47th report) (1972)</td>
<td>“White-collar crime is a crime committed in the course of one’s occupation by a member of the upper class of the society.”</td>
</tr>
<tr>
<td>Schrager and Short (1978)</td>
<td>“Organizational crimes are illegal acts of omission or commission of an individual or a group of individuals in a legitimate formal organization in accordance with the operative goals of the organization, which have a serious physical or economic impact on the employees, consumers or the general public.”</td>
</tr>
<tr>
<td>Bureau of Justice Statistics, U.S. Department of Justice (1981)</td>
<td>“White-collar crime is a non-violent crime for financial gain committed by means of deception by persons whose occupational status is entrepreneurial, professional or semiprofessional and utilizing their special occupational skills and opportunities; also, non-violent crimes for financial gain utilizing deception and committed by anyone having special technical and professional knowledge of business and government, irrespective of the person’s occupation.”</td>
</tr>
<tr>
<td>Reiss and Biderman (1981)</td>
<td>“White-collar crime is the violator’s use of a significant position of power for illegal gain.”</td>
</tr>
<tr>
<td>Braithwaite (1982)</td>
<td>“Corporate crime is conduct of a corporation, or individuals acting on behalf of the corporation, that is proscribed by law.”</td>
</tr>
<tr>
<td>Finney and Lesieur (1982)</td>
<td>“Organizational crimes are offenses committed by officers on behalf of their organization.”</td>
</tr>
<tr>
<td>Szwajkowski (1985)</td>
<td>“Organizational illegality is legally prohibited action of organization members that is taken primarily on behalf of the organization.”</td>
</tr>
</tbody>
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Chapter 2  
Corporate Governance and Corporate Illegality

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Baucus (1994)</td>
<td>“Illegal corporate behavior comprises of acts violating administrative and civil law, resolved through various procedures such as fines, settlements, consent decrees, judgments by government agencies against the firm, and so forth.”</td>
</tr>
<tr>
<td>McKendall and Wagner III (1997)</td>
<td>“An illegal act primarily meant to benefit a firm by potentially increasing revenues or decreasing costs.”</td>
</tr>
</tbody>
</table>

Source: Researcher’s compilation

As shown in Figure 2.2, corporate illegality is a branch of white-collar crime, which includes both corporate illegality and occupational crime. Corporate illegality, i.e., illegal corporate behaviour and corporate crime, involves activities stipulated by laws to be unethical, unacceptable, and ‘impermissible’, whether the acts are intentional or unintentional. Szwajkowski (1985) explained corporate illegality as a legally prohibited action of organisational members taken on behalf of the organisation. It is defined as an illegal act primarily meant to benefit a firm by potentially increasing revenues or decreasing costs (Szwajkowski, 1985; McKendall and Wagner III, 1997). Corporate illegality consists of acts of omission or commission by any individual or group of individuals within a business organization that violate an administrative, civil, or criminal law, and for which the organization is the primary intended beneficiary (Clinard and Quinney, 1973; Schrager and Short, 1978; Shover, 1978; Baucus, 1994). Illegal behaviour of the firm can be attributed to the wrongful motives of the executives, provision of opportunity to exploit power, and their choice to exercise the opportunity (McKendall and Wagner III, 1997).

Baucus (1994) defined and distinguished between the terms illegal corporate behaviour and corporate crime. Illegal corporate behaviour, the broader category, is explained as an act of violating administrative and civil law, resolved through various procedures such as fines, settlements, consent decrees, judgments by government agencies against the firm, and so forth. It involves both intentional and unintentional wrongdoing (since it can occur through acts of commission or omission). Corporate crime, on the other hand, is a narrower concept which consists of actions that violate criminal law and where the courts declare that the firm is engaged in criminal activities. The managers are assumed to have knowledge of the act to be illegal and thus, can be considered an intentional act.
Corporate crime is an organisational crime that occurs in the context of complex and varied sets of structural relationships and interrelationships between boards of directors, executives, and managers on one hand and between the parent corporation, the corporate divisions, and subsidiaries on the other (Clinard et al., 1979). Victims of corporate crime not only suffer financial losses, but there is a tremendous physical damage and loss of trust and confidence in the company.

Corporate illegality is also different from occupational crime since occupational crime refers to personal violations that take place for self-benefit of an individual during the course of a legitimate occupation, while corporate illegal behaviour refers to crimes by business or officials, committed on behalf of the employing organisations (Payne, 2013). Thus, violation of mandatory regulations by the employees on behalf of the company to avert penalty or punishment for the organisation is a white-collar crime.

### 2.3.1 Theories Explaining White-Collar Crime

White-collar crimes are primarily non-violent crimes based on the concepts of criminology which can explain the behaviour of corporate actors and create a foundation for understanding the same by defending it with suitable responses. The theories related to white-collar crime explicate the individual motivations and societal factors contributing to corporate misconduct. This part of the chapter elucidates on the

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**Figure 2.2: Classification of White-Collar Crime**

Source: Researcher’s compilation
prospective causes of white-collar crime through micro-level theories (relating to human behaviour) and macro-level theories (concerning societal features).

2.3.1.1 Learning Theory

The learning theory is a social behavioural approach which emphasises that human behaviour is learned from its surroundings and humans commit crime because of their association with others who engage in crime. Sutherland (1939) developed the differential association theory explaining how individuals learn to commit crimes, why they commit crimes, and why the laws are incompetent in controlling them. The theory asserts that an individual’s probability of engaging in deviant behaviour increases when an individual can rationalise it to be favourable to violate laws. It is also suggested that communication with close people or groups helps in shaping these definitions. The nine propositions of the theory are inclined to elucidate the process through which individuals learn criminal behaviour from their peers.

The social learning theory is a general theory of crime, conceptualised by Akers (1973). It is a comprehensive explanation for deviance over Sutherland’s pioneering sociological theory of differential association which was narrower in scope. The theory is based on three mechanisms namely differential reinforcement, beliefs, and modelling. First, differential reinforcement relates to the positive or negative punishment one may go through for his or her behaviour. Secondly, the beliefs which are favourable to crime, approve of or justify crime, and hold values that encourage crime form the second premise of the theory. Lastly, modelling or imitating the behaviour of surrounding individuals may result in criminal act especially if reinforcements for such behaviour are acceptable. Thus, the theory brings forth that an individual’s social group may perpetrate criminal acts. The large scale white-collar crimes can be perceived to be a learning effect since their execution is not possible without the participation of multiple offenders.

2.3.1.2 Rational Choice Theory and Deterrence Theory

The rational choice theory purports that humans are selfish and tend to achieve their own individual happiness. Since individuals can’t attain all their goals, they make choices in relation to them and the ways to attain them. The theory contends that people who commit crimes weigh the rewards of accomplishing their acts against the
punishment and risk of detection for the same. Bucy et al. (2008) support the theory through their empirical study which shows that greed was the most common reason for white-collar crimes followed by motivators like money and financial gain. The general deterrence theory also postulates on the same line and states that the rate of crime can be reduced by the threat of punishment acting as a deterrent. Through rational calculations and comparing the payback with the punishment, a rational individual will base his decision of engaging in crime. Though deterrence theory can be attributed to the occupational crime its application to corporate crime indicates that greater certainty and greater severity of punishment is inversely proportional to likelihood of corporate crime (Robson, 2010).

2.3.1.3 Strain Theory

The classic strain theories linked the strain of committing crime with social class and economic status of individuals. This approach however could not be generalized to white-collar crime. According to the anomie theory, the strain experienced by corporate executives may be caused by cultural and environmental uncertainties which force them to use illegitimate means to fulfill their corporate goals. Agnew (1992) proposed the General Strain Theory which stated that criminal behaviour in individuals of all social strata operate through negative emotions arising from strain. Unlike organizational theories that form the basis of crime on corporate environment, this theory explains strain as a product of individual stress factors. The three cardinal categories of strain were classified as failure to receive positively valued goals, removal of positive stimuli from individual, and presence of negative stimuli. The theory has been tested in criminal and non-criminal population from all classes, age, gender, and crime types. Delinquent behaviour and white-collar crime have been reasoned through individual’s psychological reaction to its social surroundings and inability to gain monetary goals through legitimate means. Individual’s extreme desire for money has also been associated to deviance. The motivation to engage in crime is lead by the strain that executives feel when there is fear of falling, i.e., losing what they have worked hard to gain (Weisburd et al., 1991; Wheeler, 1992). Thus, under this theory stress in individuals at all levels of society has been associated with white-collar crime.
2.3.1.4 Neutralization Theory

Sykes and Matza (1957) proposed the neutralization theory to explain how juvenile criminals get involved in delinquent behaviour. The mental strength needed to commit a crime is sourced from neutralizations and occurs before the happening of a crime. The theory is an offshoot of Cressey’s (1953) notion in which he acknowledged the voicing of the trust-violators as the most important element of white-collar crime. Other reasons found for violating laws included individual’s financial problem and their belief that breach of trust may solve the problem. The improved theory described five mechanisms that juveniles use to rationalise their misconduct. It included ‘denial of injury’ whereby criminals justify by stating that no harm was caused to anyone by their acts. Second, ‘denial of victim’ is a scenario where the offender causes harm to another by convincing themselves that the victim deserves it. Neutralization of the third type ‘appeal to higher loyalties’ occurs when the criminal defends by saying his misconduct was for the benefit of a large group (profit making in case of the company). ‘Denial of responsibility’ is the fourth kind of neutralization where offenders validate their behaviour by refuting their responsibility for the misdeeds. Lastly, in ‘condemnation of condemners’ the neutralization of criminal argues that legal justice system is itself involved in wrongdoing and is thus held responsible for their engagement in criminal acts. Since the white-collar criminals are also rational beings it may be assumed that they also use such neutralizations to justify their acts.

2.3.1.5 Routine Activities Theory

Cohen and Felson (1979) propounded the theory evolving three concepts of crime from routine activities, i.e., motivated offenders, suitable targets, and absence of competent guardians. It posits that potential offenders or victims are exposed to the opportunities of crime by engaging in their daily routine activities. Performing occupational tasks regularly places the criminal in an opportunistic position for illegal behaviour. The first concept of motivated offender assumes that there is motivation or inclination towards wrongful gain of money, power, property, etc. Suitable target refers to the vulnerability of objects that may be victimized. Factors like ease of removal, associated risk, and its value is considered when opportunistic situation appears. Lastly, absence of capable guardians like lock or alarms may increase the chances of crime. In case of organizational crimes, employees holding a position of
trust are exposed to assets of employers and may develop ways to circumvent the guardians. The theory finds relevance in the area of white-collar crime since the occupational set up in organizations permits the convergence of the three concepts.

2.3.1.6 Social Conflict Theory

The conflict theory was propounded by Karl Marx who divided the society into two unequal classes in a perpetual conflict for limited resources. The theory advocated that the higher class enjoys greater privileges as compared to the lower class which causes economic inequality and social disorder leading to financial crimes in a capitalist economy. Sutherland (1939) and Gottschalk (2014) described a white-collar criminal as a member of the privileged socio-economic class who commits illegal acts for economic gains. The theory contends that white-collar criminals are most usually treated with leniency or are declared first time offenders during the trial. On other instances, harmful activities are excluded from criminal head and categorized as administrative violations. Such broadly and ill-defined corporate criminal offences help white-collar criminals escape punishment and penalties. In the view of Siegel (2011), financial crime occurs due to the class conflicts that subsist in the society. The social conflict theory asserts that the economically powerful professionals personify the upper class. The judicial system favours this class and so, such individuals from the elite class can influence the lawmakers to safeguard their interests.

2.3.2 Baucus and Near’s (1991) Model of Illegal Corporate Behavior Process

The model builds on three classes of variables antecedent to corporate illegality. These factors relate to organization’s external environment, internal processes, and situational issues. The environmental aspects, i.e., scarcity, dynamism, and heterogeneity are adapted from Aldrich’s (1979) environmental dimensions. The internal antecedents (performance, firm size, and slack) are the firm level factors that may cause illegal behaviour. The situational elements encompass both internal and environmental variables that are directly related to illegal events. A pictorial representation of the model is depicted in Figure 2.3.
(a) Environmental Antecedents

Numerous studies (e.g., March and Simon, 1958; Staw and Szwajkowski, 1975; Pfeffer and Salancik, 1978) have established a relationship between environmental scarcity and organisational behaviour. March and Simon (1958), and Staw and Szwajkowski (1975), and Pfeffer and Salancik (1978) observed that firms facing uncertainty in terms of resource scarcity might take deviant actions and engage in illegal activities to reduce uncertainty and acquire the limited resources. The dynamic conditions surrounding the organisation also induce illegal behaviour in the firm (Emery and Trist, 1965; Gross, 1978; Finney and Lesieur, 1982). To reduce the likelihood of wrongdoing, the managers across the firm may develop standard operating procedures (SOPs) but due to the ever-changing conditions, either the managers are unable to follow SOPs or do not follow them at all (Kriesberg, 1976).

Heterogeneity refers to the degrees of similarity/diversity of the organisations and individuals in a firm’s environment. Since operating in a steady environment is relatively smoother than in an unstable one, all organisations constantly try to diminish ambiguity and competition. For example, when heterogeneity is high, standard operating procedures cannot be developed (Pfeffer and Salancik, 1978;
Aldrich, 1979). Thus, a firm operating in a heterogeneous backdrop is more likely to engage in illegal behaviour than it would be in a homogeneous environment.

**(b) Internal Antecedents**

The most familiar antecedent hypothesised to corporate illegality is corporate performance (Gross, 1978; Clinard and Yeager, 1980; Finney and Lesieur, 1982). There is academic and industrial evidence which shows that poor performance of a firm compels its’ managers to take unethical decisions and behave in a fraudulent manner to achieve desired levels of performance (Clinard et al., 1979; Cochran and Nigh, 1987).

Illegal behaviour may occur as firms make an effort to manage the communication and coordination problems within the firm. The increase in the organisation’s size leads to restructuring of activities, increase in decentralisation, and decrease in personal and structural controls (Pugh et al., 1963; Pugh et. al., 1968; Finney and Lesieur, 1982; Vaughan, 1982). Thus, the firm is divided into specialised units where opportunities for wrongdoing may occur and the knowledge of illegal activities in such departments is less likely to spread beyond the unit involved.

Moreover, firms with fewer slack resources are prone to take on illegal behaviour than firms with it. Cyert and March (1963) noted that slack aids an organisation in stabilising and adapting to circumstances. Firms with limited resources have fewer strategic alternatives (Chakravarthy, 1982) and therefore look out to cut costs or utilise resources by illegal means.

**(c) Situational Antecedents**

Firm’s illegal activities are reiterated based on its’ history of regulatory violation. Organisational norms and managerial behaviour of repeated wrongdoing create a culture that may cause and promote corporate illegality (Clinard and Yeager, 1980; Finney and Lesieur, 1982). Cressey (1976), Clinard et al. (1979), Szwajkowski (1981), and Simpson (1986) reported that the level of illegality varies within industries due to differences in the legal surveillance and enforcement.

The model tested the potential antecedents that may cause different types of corporate illegality. The effect of environmental, internal, and situational factors was tested using longitudinal analysis.
2.3.3 Baucus’s (1994) Multivariate Model of Corporate Illegality

Baucus (1994) proposed a model which maintains that performance problems are not the sole trigger for decisions and actions that lead to illegality. Managers are assumed to be rational actors who engage in problem-solving and they may undertake such activities which may result in intentional or unintentional illegality. This model does not assume that corporate wrongdoing represents intended behaviour. The model (as in Figure 2.4) describes the characteristics of the environment and firm that create conditions of pressure or need, opportunity, or predisposition which may cause illegality.

(a) Conditions of Pressure or Need

According to Baucus (1994), the pressure or need for illegality arises when a firm faces uncertainty and unexpected demands or constraints. Escalated dynamism in the external environment and elements like market competitiveness, environmental heterogeneity, and scarcity can generate pressure to commit illegality. In an effort to control or adapt to uncertainty, the firms may engage in wrongdoing (Pfeffer and Salancik, 1978; Aldrich, 1979). Characteristics of the legal or regulatory environment are another reason for firms to behave illegally. In cases where the cost of complying with the laws is greater than the expected penalties for violation, corporate illegality can be expected. Managers in firms facing regulatory changes (e.g., increased penalties) engross themselves to create defensive strategies that deflect the managerial efforts from accomplishing the organisation’s primary objectives.

Here, the managers may view regulations as additional pressure to behave illegally rather than as a control mechanism to prevent wrongdoing. The top level management teams aiming to achieve higher firm performance pushes pressure at lower levels to engage in wrongdoing. In other circumstances, stakeholder’s demanding higher performance also creates a pressure on the management. To sustain firm’s reputation, the managers may delve into unintentional illegalities. In the short run, improving the financial performance can limit the alternative strategies available to managers (Chakravarthy, 1982). In such situations, the managers might feel the need to commit corporate crimes.

(b) Conditions of Opportunity

The opportunities for corporate illegality crop up when the environmental factors favour it or are deficient in preventing it (Yeager, 1986). Firm-specific characteristics,
Figure 2.4: Model of Corporate Illegality Process

**PRESSURE**
- Competitive Environment
  - Intense competition
  - Environmental heterogeneity
  - Environmental scarcity
- Legal and Regulatory Environment
  - High cost to conform to regulations
  - Frequent changes in law
  - Stricter interpretation & enforcement of laws
- Organizational Characteristics
  - Pressure for performance/output
  - Poor financial performance
  - Few slack resources

**OPPORTUNITY**
- Competitive Environment
  - Environmental turbulence
  - Environmental munificence
  - Low integrity of rivalry
- Legal and Regulatory Environment
  - Highly complex, ambiguous laws & transaction systems
  - Newly enacted legislations
  - Regulatory agencies highly dependent on firms
- Organizational Characteristics
  - Large size
  - Complexity
  - High levels of innovation

**PREDISPOSITION**
- Environmental Characteristics
  - Mature industry environment
  - Prevalence of illegality in industry
  - Long, established relationships with regulatory agencies
- Organizational characteristics
  - Highly committed employees
  - Corporate culture reinforcing wrongdoing
  - High levels of executive succession

**INDIVIDUAL CHARACTERISTICS**

**CORPORATE CRIME & INTENTIONAL ILLEGAL CORPORATE BEHAVIOR**

**UNINTENTIONAL ILLEGAL CORPORATE BEHAVIOR**

*Source: Adapted from Baucus (1994)*
structures, or procedures (e.g., size and complexity) may also create opportunities (Vaughan, 1982). Vaughan (1983) noted that even though both pressure and opportunity are essential for illegality to occur, opportunity can be exploited independent of organisational pressure. This is called unintentional illegality which emerges if managers are less diligent towards enforcing laws and policies, which in turn creates opportunities for others to carry out illegality.

Opportunities may arise when the organisation has to counter intense rivalry and industrial competition (Porter, 1980). The chances of wrongdoing also soar when low competition is coupled with abundant resources (munificence). In such a situation, managers deliberately exploit opportunities to acquire larger market share and gain competitive advantage. Organisation members have more leeway or opportunities to engage in illegal activities in a dynamic environment since few rules or procedures exist and organisation members make up rules as they go along.

Another area that creates opportunities for corporate crime is the regulatory framework of the firms or industry. The existence of complex and ambiguous laws creates prospects in which illegality may occur. Also, when managers are unable to interpret newly established regulations and there is ambiguity in their enforcement, an opportunity can be marked to indulge in wrongdoing.

There is evidence supporting a direct and positive relationship between organisational complexity with corporate illegality (Simpson, 1986; Cochran and Nigh, 1987; Dalton and Kesner, 1987; Baucus and Near, 1991). Larger firms are decentralised which creates a situation for less stringent planning and control mechanisms, easy concealment of illegality, and renders multiple settings where wrongdoing can happen (Vaughan, 1983). The curvilinear relationship between innovation and corporate illegality also supports opportunities. Thus, in firms where innovation level is high and control is decentralised, the employees may create illegal solutions to problems. Owing to the industrial pressures, organisations that lag behind in innovations also plunge into illegality.

(c) Conditions of Predisposition

“Predisposition recognizes that environmental and organizational factors can train, socialize, or in some way prejudice firm members towards activities that involve or result unintentionally in corporate illegality” (Baucus, 1994, p. 711). The model
recognises that environmental factors and specific firm conditions may incline the managers to act illegally. Predisposition is not just responsible for the onset of illegality but is also a major cause of repeated offending. It is noted that once employees engage in illegal activities and develop such deviant attitudes, the behaviour is inculcated in the organisational culture.

The characteristics of an industry (e.g., culture, norms, and values) influence the predisposition of managers towards illegality. National and regional culture also affects the behaviour of the management. It has been reported that old firms having cordial relation with the regulatory authorities are more likely to engage in wrongdoing. The lawmakers also adopt the industry practices over time. The culture followed by the top management teams and employees in an organisation creates predisposition towards opportunity abuse. Acceptance of employees’ questionable activities, approving, or participating in illegal activities by the top executives develops a corporate culture which endorses corporate crimes.

Thus, the model propagates that illegal activity by the management neither is always intentional nor solely led by poor firm performance. The environmental and firm related pressure factors together with opportunity and predisposition variables create a setting for illegal activities.

2.3.4 Consequences of Illegality

(a) Consequences for Shareholders and Bondholders

The public announcement about violation of laws and illegality affects the shareholders and bondholders the most. The market value of company shares and the credit rating of bonds are adversely affected by such news. This fluctuation in company’s value of capital also affects the banks associated with the violator company. Recovery of money becomes difficult for banks that lend money or invest in companies against their overestimated cash flows and collaterals. In such a scenario even bank’s shareholders lose money due to decline in its own share prices. The public confidence in board of directors to act as a guardian of shareholder’s wealth and controller of management is also hampered in such a situation. According to Zahra et al. (2005) shareholder activism has amplified and all stakeholder groups have tuned up vigilance in response to the economic losses incurred in management
frauds. For example, financial misreporting in Enron Corporation resulted in its’ accountancy firm, i.e., Arthur Andersen, being nailed for concealing company’s fraud.

(b) Consequences for Society and Community

Substantial financial losses are incurred by the communities that host companies accused of illegality. Zahra et al. (2005) state that some of the concerns of the community include unemployment, depleted stock portfolios, decreased philanthropy for arts and schools, and losses in secondary businesses (like restaurants and fuel stations). The company encounters a perpetual problem with gaining public confidence. Financial institutions may get reluctant in advancing credit to such organizations. Moreover, fraudulent companies are most likely to be expelled from trade associations and strategic alliances.

(c) Consequences for Employees

The lower level employees in an organization are often unaware of the management’s illegal activities, yet suffer its consequences. It may tarnish the employee’s reputation, make them lose their job, create hindrance in getting placed at a new job, and part with their retirement benefits promised by the company. Owing to economic crisis, the company may resort to retrenching and laying-off staff. Further, there are possibilities of trimming down investment on training of employees which may hamper their professional growth.

(d) Consequences for Manager’s Reputations

The reputation of individuals and organization involved in illegal activities is irreparably tainted with incidences of fraud and illegality. The innocent executives of the company are bracketed together with the fraudsters. Legislature has prescribed fines and sentences for regulatory non-compliance as a result of which white-collar criminals are found to be penalized and jailed for their indulgence in illegal activities. Beasley (1996) reported that senior executives in such cases are forced to resign or terminated.

2.3.5 Typology

Clinard et al. (1979) formulated a typology that categorized corporate illegality into seven classes. They are administrative violations, environmental violations, financial violations, labour violations, manufacturing violations, unfair trade practices, and
other violations. These violations were studied in the American context. The scope of the classification is wide enough to cover corporate wrongdoing in other parts of the world as well and thus, the typology can be generalized.

(a) Administrative Violations

These violations primarily deal with statutory legal or regulatory non-compliance by the organization, prescribed by an agency or a court. Failure to abide by the agency laws or court enforcements falls into this category. Inability, failure, or denial to produce information or report and register the required information with the agency is integrated into ‘paperwork violation’. Trademark, copyright, and patent infringements are also administrative violations.

(b) Environmental Violations

Environmental law infringement is a type of white-collar crime. Any capital outlay required for construction of pollution check which is neglected by a corporation in relation to air or water pollution and environmental permits are included in environmental violation. Detrimental effects on plant and animal life, water, air and soil quality, emission of hazardous gasses, and improper disposal of wastes are a concern for the lawmakers. Companies fail to abide by the laws or sometimes even avoid compliance due to additional overhead costs associated with it. Such violators are subject to jail, fines, or penalties if convicted.

(c) Financial Violations

Financial violations include the infringement of regulations stipulated by bodies governing the securities market and revenue departments. Disclosure violations under this group relate to illegal monetary payouts like bribe, political donations, and violation of foreign currency laws. Violations related to financial securities and frauds are also clubbed under this category. Tax violation includes cases where penalty was charged by the government over and above the deficit taxes or interest payments. Lastly, accounting practices contravention involves internal control violations, bogus entries, and improper estimation of costs.

(d) Labour Violations

The state and national governments in all countries enact laws to reduce ambiguity in rules concerning labour working conditions and their rights and obligations. The labour violations involve health and safety hazards at workplace, policy of
discrimination, unfair labour practices, and violation of minimum wage and work hour rules. Some of the major issues addressed by the regulators are terms and conditions of employment contract, timely and suitable payment of wages, pension funds, maternity benefits, maintenance of records and registers, child labour, etc. Trade unions and collective bargaining have also come up as a mechanism for workforce redressal in case of conflict with the employers.

(e) Manufacturing Violations

Violations in the manufacturing area cover the safety laws for consumer products, motor vehicles, food, and drugs. Production and distributions of hazardous consumer goods which are unsafe for usage are punishable under law. Such products may have electric shock hazards, fire hazards, motor vehicle defects, and deficiencies which are associated with safety standards and non-compliance with such standards usually amount to civil penalties. Some of the reasons for convictions in food and drugs sector are breach of compliance references for packaging and labeling, false and misleading advertisements, testing of regulated merchandise, and production without statutory license and registration.

(f) Unfair Trade Practices

Unfair trade practices largely cover actions of the businesses that are detrimental to interests of any of its stakeholders (e.g., creating monopoly, price discrimination, antitrust violations, insider trading). Major categories of the violation are false representation regarding product features (quantity, quality, grade, performance, guarantee etc.), false offer of bargain price, dubious offering of gifts or prices, non-compliance with statutory standards, and hoarding and destruction of goods. Unfair trade practices also relate to fraudulent transaction of securities in the financial markets that involve misrepresentation and concealment of material facts or bear intention to deceive. These activities are punishable as restrictive trade practices may amount to penalties or jail term.

2.3.6 Statutory Framework for Corporate Illegality in India

The Government of India with Ministry of Corporate Affairs and several regulatory bodies have emphasised on prevention and detection of corporate irregularities and fraudulent activities through various statues. The Indian Penal Code (1860), the
Indian Contract Act (1872), the Companies Act (2013), and the Securities Exchange Board of India (SEBI) Act (1992) are the important statutes accentuating the laws to check, curb, and detect illegalities in companies.

The Indian Penal Code (IPC) (1860) is a comprehensive criminal law statute which came into force during British rule in India. Besides covering offences relating to state, armed forces, elections, public servants, public tranquillity, marriage and the like, it contains laws for corporate crimes. Chapter II of the IPC contains definition of terms like dishonestly, fraudulently, counterfeit, document, electronic record, and illegal which apply to corporate crimes also. Furthermore, Chapter XVIII stipulates conditions and punishment for criminal breach of contracts, forgery (of documents or e-documents), cheating (by personation, causing intentional wrongful loss, inducing dishonest delivery of property), falsification of accounts, and tampering or using counterfeit property marks. Thus, the IPC covers all offences an individual is legally bound to do and provides for legal intervention if the performance of the same is omitted.

Based on the principles of English Common Law, the Indian Contract Act (1872) relates to the essentials of a contract as well as the enforcement of contractual rights and duties of the parties involved. It encompasses general principles of contract (sections 01-75), rules for sales of goods (sections 72-123), special contracts, viz., indemnity, guarantee, bailment, and pledge (sections 124-238), and partnership laws (sections 239-266). The statute defines fraud in section 17 and specifies that fraudulent act must be done with the intent to deceive the contracting parties or its’ agent. The fraudulent acts which amount to fraud include concealment of material facts, false promises, and incorrect suggestions. The violation of the provisions of the act leads to civil liabilities.

The Indian companies are governed, regulated, and registered under the Companies Act (1956). The Companies Act lays down the stipulations for the registration, incorporation, and functioning of corporations and its members, instituted within the territorial boundary of India. The legislative act was amended in 2013 to revise and include new laws on corporate governance in India. The new act focuses on comprehensive inclusion of all aspects of corporate illegalities and liabilities related to infringement of the law. Besides elaborating on offences included in
corporate fraud and prescribing penalties and punishment, the provisions of the Act stipulate the establishment of Serious Fraud Investigation Organization (SFIO) by the Central Government to probe into organisational frauds.

The SEBI Act (1992) makes the SEBI a statutory body enshrined with the primary objective of protecting investor interests and safeguarding them against dubious activities by the companies. The SEBI monitors the growth and development of companies that engage in trading in the Indian securities market. The SEBI Act is divided into seven chapters, each dealing with matters concerning the constitution of the board, its powers, and issues connected thereto. Chapter IV lays special emphasis on the supervisory functions of the board relating to the activities of securities market intermediaries and organisations. The SEBI’s authority with respect to regulation, issuing directions, investigation, inspection of books of accounts, and their seizure is contained therewith. Chapter VA deals with prohibition of fraudulent and manipulative activities. The SEBI explicitly forbids participation of any person in sale or purchase of deceptive securities, commit fraud in the course of business, defraud using any material information which is not publically available, undertake insider trading, or hold securities in contravention of the regulations of the said Act. The adjudicating authorities and various fines and penalties for violating the statutory provisions are contained in Chapter VIA of the Act. Furthermore, the SEBI from time to time issues the rules and regulations that help in smooth functioning of the securities markets and also chalks out the various illegalities that the companies may delve into while trading on the various stock exchanges in the Indian securities market. In addition, the SEBI has issued forty-six regulations (e.g., Prohibition of Insider Trading Regulations, Disclosure and Investor Protection and Securities Contracts Regulations, Depositories and Participants Regulations, Disclosure and Investor Protection Guidelines, Merchant Banker Regulations, Issue of Capital and Disclosure Requirements Regulations, Prohibition of Fraudulent and Unfair Trade Practices Regulations etc.) that are suitably updated to match the needs of the securities markets and stock exchanges for controlling corporate frauds and illegal activities. A list of the important provisions contained in the Indian statutory bodies is tabulated in Table 2.5.
### Chapter 2: Corporate Governance and Corporate Illegality

**Table 2.5: Important Provisions Regulating Corporate Illegality in India**

<table>
<thead>
<tr>
<th>Competent Authority</th>
<th>Section</th>
<th>Violation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Companies Act (2013)</td>
<td>7(5)&amp;7(6)</td>
<td>Furnishing of false information at the time of incorporation of company by promoters, first directors or any other person.</td>
</tr>
<tr>
<td></td>
<td>8(11)</td>
<td>Managing the affairs of the non-profit company fraudulently.</td>
</tr>
<tr>
<td></td>
<td>34</td>
<td>Misrepresenting any material information in prospectus.</td>
</tr>
<tr>
<td></td>
<td>36</td>
<td>Inducing any person fraudulently to invest money.</td>
</tr>
<tr>
<td></td>
<td>38(1)</td>
<td>Making of applications for acquisition of any securities in fictitious names.</td>
</tr>
<tr>
<td></td>
<td>46(5)</td>
<td>Issue of duplicate shares of company with intent to defraud or deceive.</td>
</tr>
<tr>
<td></td>
<td>56(7)</td>
<td>Transfer of any shares by depository or depository participant with an intent to defraud, deceive any person.</td>
</tr>
<tr>
<td></td>
<td>66(10)</td>
<td>Concealment of name or misrepresenting the amount of claim knowingly of any creditor.</td>
</tr>
<tr>
<td></td>
<td>75(1)</td>
<td>Failure to repay deposit with intent to defraud depositor.</td>
</tr>
<tr>
<td></td>
<td>143(12) to 143(15)</td>
<td>Powers and duties of auditors and auditing standards (Fraud reporting).</td>
</tr>
<tr>
<td></td>
<td>211</td>
<td>Establishment of Serious Fraud Investigation Office.</td>
</tr>
<tr>
<td></td>
<td>212</td>
<td>Investigation into affairs of company by Serious Fraud Investigation Office.</td>
</tr>
<tr>
<td></td>
<td>213 (proviso)</td>
<td>Conducting business to defraud its creditors, members or any other person.</td>
</tr>
<tr>
<td></td>
<td>229</td>
<td>Penalty for furnishing of false statement, mutilation, destruction of documents.</td>
</tr>
<tr>
<td></td>
<td>241</td>
<td>Application to Tribunal for relief in cases of oppression, etc.</td>
</tr>
<tr>
<td></td>
<td>447</td>
<td>Punishment for fraud.</td>
</tr>
<tr>
<td></td>
<td>448</td>
<td>Punishment for false statement.</td>
</tr>
<tr>
<td></td>
<td>449</td>
<td>Punishment for false evidence.</td>
</tr>
<tr>
<td></td>
<td>450</td>
<td>Punishment where no specific penalty or punishment is provided.</td>
</tr>
<tr>
<td></td>
<td>451</td>
<td>Punishment in case of repeated default.</td>
</tr>
<tr>
<td></td>
<td>454</td>
<td>Adjudication for penalties.</td>
</tr>
<tr>
<td>The SEBI Act (1992)</td>
<td>11C</td>
<td>Investigation (into practices detrimental to investors or securities market).</td>
</tr>
<tr>
<td></td>
<td>12A</td>
<td>Prohibition of manipulative and deceptive devices, insider trading and substantial acquisition of securities or control.</td>
</tr>
<tr>
<td></td>
<td>15A to 15JA</td>
<td>Penalties and Adjudication.</td>
</tr>
</tbody>
</table>

*Contd...*


<table>
<thead>
<tr>
<th>Competent Authority</th>
<th>Section</th>
<th>Violation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Indian Penal Code (1860)</td>
<td>120B</td>
<td>Punishment of criminal conspiracy.</td>
</tr>
<tr>
<td></td>
<td>201</td>
<td>Causing disappearance of evidence of offence, or giving false information to screen offender.</td>
</tr>
<tr>
<td></td>
<td>408</td>
<td>Criminal breach of trust by clerk or servant.</td>
</tr>
<tr>
<td></td>
<td>409</td>
<td>Criminal breach of trust by public servant, or by banker, merchant or agent.</td>
</tr>
<tr>
<td></td>
<td>419</td>
<td>Punishment for cheating by personation.</td>
</tr>
<tr>
<td></td>
<td>420</td>
<td>Cheating and dishonestly inducing delivery of property.</td>
</tr>
<tr>
<td></td>
<td>467</td>
<td>Forgery of valuable security, will, etc.</td>
</tr>
<tr>
<td></td>
<td>468</td>
<td>Forgery for purpose of cheating.</td>
</tr>
<tr>
<td></td>
<td>471</td>
<td>Using as genuine a forged document.</td>
</tr>
<tr>
<td></td>
<td>477A</td>
<td>Falsification of accounts.</td>
</tr>
</tbody>
</table>

Source: Researcher’s compilation

2.3.7 The Corporate Illegality Crisis in India

The phenomenon of corporate frauds is a global concern and has notably zoomed in India since 2001. Table 2.6 shows the most prominent corporate frauds in India and the humongous economic losses suffered as a consequence of it. The escalating frequency and scale of corporate illegality clearly exhibit the loopholes in the corporate governance system of Indian companies. The failure of oversight mechanisms like the audit committee, independent directors, code of conduct, and the whistleblower systems pose a serious threat to the righteous functioning of a company. Probing into the failures of the corporate world, the Central Bureau of Investigation (CBI) revealed that deceptive documentation, multiple funding, overvaluation of guarantee, and syphoning off funds are the major areas of fraud experienced by the banking companies.

Many of the Indian corporate failures are a consequence of fraud by the board of directors or their weak diligence. The Central government has taken initiatives to limit such economic crimes by establishing investigative agencies like the Serious Frauds Investigation Office (SFIO), the Central Bureau of Investigation (CBI), the Central Vigilance Commission, and the Central Economic Intelligence Bureau.

A number of surveys have made an attempt to describe and quantify the magnitude of corporate frauds in India and its repercussions. An examination of frauds by KPMG revealed that in India 88 percent of fraud details are not made publically available and the average loss per fraud amounts to U.S. $0.7 million in the
years 2007 to 2011 (KPMG, 2011). The Reserve Bank of India (RBI) has reported 29,653 cases of fraud only in the banking industry during 2012-13 (Grant Thornton and ASSOCHAM, 2015). Further, a survey by the Grant Thornton and ASSOCHAM India (2014) revealed that 40 percent of the respondents believed that the incidence of illegality has gone up in the last two years, where real estate and financial services are the most vulnerable sectors and public sector enterprises being the most usual victim. The Association of Certified Fraud Examiners’ (ACFE) Report (2014) showed that 83.50 percent of fraud cases involve asset misappropriation which equals a median loss of about U.S. $125,000 million. Thus, it is evident that probing into the current situation of corporate wrongdoings is essential to control its pervasiveness.

### Table 2.6: Biggest Indian Corporate Scams

<table>
<thead>
<tr>
<th>Year</th>
<th>Scam/Company</th>
<th>Chief Accused</th>
<th>Economic Loss (Approx.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>National Spot Exchange Limited</td>
<td>Jignesh Shah, Founder</td>
<td>INR 5,600 crore</td>
</tr>
<tr>
<td>2013</td>
<td>Saradha Chit Fund</td>
<td>Sudipta Sen, Chairman</td>
<td>INR 2,400 crore</td>
</tr>
<tr>
<td>2011</td>
<td>Sahara Group</td>
<td>Subrata Roy, Chairman</td>
<td>INR 20,000 crore</td>
</tr>
<tr>
<td>2011</td>
<td>Speak Asia</td>
<td>Ram Sumiran Pal, Promoter</td>
<td>INR 2,200 crore</td>
</tr>
<tr>
<td>2009</td>
<td>Satyam Computer Ltd.</td>
<td>B Ramalinga Raju, Chairman</td>
<td>INR 7,200 crore</td>
</tr>
<tr>
<td>2001</td>
<td>Ketan Parekh Securities Scam</td>
<td>Ketan Parekh</td>
<td>INR 1,250 crore</td>
</tr>
<tr>
<td>1992</td>
<td>Harshad Mehta Scam</td>
<td>Harshad Mehta</td>
<td>INR 5,000 crore</td>
</tr>
</tbody>
</table>

*Source: Researcher’s compilation*

### 2.4. SUMMARY

Corporate governance mechanisms enable monitoring of the board of directors and the management. The primary objective of having an effective governance system is to ensure that power in the executives is not abused and interests of the stakeholders are protected. Laws set by the regulatory agencies are centred at developing mechanisms to curb corporate wrongdoing. The theories and models of corporate governance and illegality give an insight into the causes of illegality and the motivations that drive the executives to engage in illegal activities.

The aim of this chapter was to build a theoretical background and develop understanding of the research problem. The next chapter gives an in-depth review of the literature that associates the field of corporate governance and corporate illegality.
REFERENCES


Blue Ribbon Committee. (1999). *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*. 


Chapter 2 Corporate Governance and Corporate Illegality


