Company Law

DMGT201/DCOM106

Edited by:
Gopika Juneja

LOVELY PROFESSIONAL UNIVERSITY

COMPANY LAW

Edited By

Gopika Juneja

Printed by
EXCEL BOOKS PRIVATE LIMITED
A-45, Naraina, Phase-I,
New Delhi-110028
for
Lovely Professional University
Phagwara

SYLLABUS

Company Law

Objectives: The objective of the course is to understand and evaluate the legal framework of Corporate Environment in India and to gain elementary knowledge of Indian Corporate Law.

Sr. No.	Topics
1.	Definition of company, characteristics of company, lifting the corporate veil, company distinguished from partnership, kinds of companies, incorporation of company, promoter and their legal position.
2.	**Memorandum of Association:** contents, alteration, Doctrine of ultra vires.
3.	**Articles of Association:** contents, alteration, Doctrine of Indoor Management, Constructive notice of memorandum and articles, Articles and memorandum- their relation and distinction, legal effect of Memorandum and Articles.
4.	**Prospectus:** Definition, contents, shelf prospectus, information memorandum, red herring prospectus, abridged prospectus, Misstatements in prospectus and their consequences, statement in lieu of prospectus, underwriting commission and brokerage,
5.	**Membership in a company:** Members and shareholders, modes of becoming member, cessation of membership, rights and liabilities of members.
6.	**Shares and share capital:** kinds of share capital, alteration and reduction of capital, reorganization of capital, voting rights.
7.	**Corporate Governance:** Directors-Qualification; appointment and remuneration; disclosure; service contracts; removal; retirement and disqualification; powers and fiduciary duties; Role and duties of directors in relation to good corporate governance
8.	**Company meetings and proceedings:** general meetings of shareholders, requisites of a valid meeting, proxies, voting and poll, resolutions.
9.	Borrowing power, debentures and charges: ultra vires borrowings, Prevention of oppression and mismanagement: Principal of majority rule, remedial actions for prevention of oppression and mismanagement.
10.	**Winding up:** Meaning, Modes, and Consequences of winding up.

CONTENT

Unit 1: Nature of the Companies Act, 1956

Notes

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Objectives

After studying this unit, you will be able to:

- Define application and scheme of the Company Act;
- Explain Company Law administration;
- Describe other specific definitions related to Company Act.

Introduction

The subject of company law is codified in the Companies Act, 1956. The basic concepts of company law are incorporated in the Act. The Act is a formidable document, containing a large number of Sections and Schedules. It provides a broad legal framework for the operation of companies registered under the Act.

Notes

1.1 Extent, Application and Scheme of the Act

1.1.1 Extent of the Act

The Act extends to the whole of India except:

1. As regards the State of Nagaland, it applies, subject to such modifications, if any, as the Central Government may, by notification in the Official Gazette, specify [s.1 (3)];
2. As regards Goa, Daman and Diu, some of the provisions of the Act shall not apply or shall apply only with such exceptions and modifications or adaptations to any existing company registered under the Act and for such a period or periods as may be specified by notification by the Central Government in the Official Gazette (s.620B); and
3. As regards Jammu and Kashmir, some of the provisions of the Act as the Central Government may, by notification in the Official Gazette, direct, shall not apply or shall apply only with such exceptions and modifications or adaptations to any existing company or any company registered under the Act as may be specified, after the commencement of the Central Laws (Extension to Jammu and Kashmir) Act, 1968 (i.e., 15 August, 1968) (s.620C).

1.1.2 Application of the Act

The Act applies to the following companies:

1. Companies formed and registered under the Companies Act, 1956.
2. Companies formed and registered under the previous company laws, i.e., the existing companies (s.561).
3. Companies registered but not formed under any previous company laws to the extent and in the manner declared in Part IX (dealing with 'Companies authorized to register under the Act') of the Act (s.562).
4. Unlimited companies registered as limited companies in pursuance of any previous company laws (s.563).
5. Unregistered companies for the purpose of winding up under Part X (dealing with 'Winding up of Unregistered Companies,) of the Act (Ss.582, 583 and 589).
6. Foreign Companies (s.592 to 602).
7. Insurance companies, banking companies, electricity companies and any other company governed by any special Act for the time being in force, except as far as the provisions of the Companies Act, 1956 are inconsistent with the provisions of the Insurance Act, 1938; Banking Regulation Act, 1949; Indian Electricity Act, 1910; or the Electricity Supply Act, 1948; or any Special Act respectively.

   The provisions of the Companies Act, 1956 apply to these special classes of companies to the extent that such provisions are not inconsistent with those of the Special Acts governing them [clauses (a) to (d) of s.616].
8. Such corporate body incorporated by any Act for the time being in force as the Central Government may, by notification in the Official Gazette, specify on its behalf subject to such exceptions, modifications or adaptations as may be specified therein [clause (e) of s.616].

Notes

9. Government Companies (s.617).
10. Nidhis or Mutual Benefit Societies declared as such by the Central Government by notification in the Official Gazette [s.620A(2)].
11. Producer Companies (s.581A to 581ZT).

1.1.3 Non-applicability of the Act

The Companies Act, 1956 is not applicable to certain associations. These are:

1. Companies established under Special Acts of Parliament, such as Life Insurance Corporation of India, Indian Airlines Corporation, (s.616).
2. Partnership firms which are governed by the Indian Partnership Act, 1932.
3. Co-operative Societies which are governed by the Co-operative Societies Act, 1912.
4. Trusts which are governed by the Indian Trusts Act, 1882.
5. Societies registered under the Societies Registration Act, 1860.

1.1.4 Scheme of the Act

The scheme of the Act may be considered broadly under five heads, corresponding to the different parts it has. They are:

1. ***Formation of Company (Parts II to IV):*** The provisions of the Act relating to the formation of a company include: (a) Incorporation of a company. (b) Memorandum and articles of association. (c) Prospectus. (d) Issue of shares and debentures. (e) Certificate to commence business.
2. ***Management and Administration of Company (Part VI):*** Under this head, the following provisions are included: (a) Registered office and name of the company; (b) Members and debenture holders; (c) Meetings and proceedings; (d) Managerial personnel; (e) Managerial remuneration; (f) Accounts; (g) Audit; (h) Investigation; (i) Directors; (j) Managing directors; (k) Managers; (l) Arbitration, compromises, arrangements and reconstructions; (m) Prevention of mismanagement and oppression.
3. ***Winding up of Company (Part VII):*** The Act contains the following provisions as regards to the winding up of companies, viz., (a) Modes of winding up; (b) Winding up by the court; (c) Voluntary Winding up; (d) Winding up subject to the supervision of the court.
4. ***Miscellaneous Provisions (Parts V and VIII to XIII):*** These include: (a) Registration of charges; (b) Application of the Act to companies formed under previous company laws; (c) Winding up of unregistered companies; (d) Foreign companies; (e) Registration offices and officers and fees; (f) General. The Act is then followed by 15 schedules which, deal with various matters provided in the Act.
5. ***Producer Companies (Part IX A).***

Self Assessment

Fill in the blanks:

1. .... is codified in the Companies Act, 1956.
2. Companies formed and registered under the ....

Notes

3. Companies registered but not formed under any previous company laws to the extent and in the manner declared in ....
4. Companies Act, 1956 is not applicable to................................
5. The Central Government is the supreme authority responsible for the administration of ....

1.2 Company Law Administration

The present set up dealing with Company Law Administration, directly or indirectly, at various stages and providing for various administrative authorities is as follows:

1. The Central Government
2. The Company Law Board
3. National Advisory Committee on Accounting Standards
4. Securities and Exchange Board of India
5. Official Liquidator
6. Advisory Committee
7. Courts.

1.2.1 The Central Government (s.637)

The Central Government is the supreme authority responsible for the administration of company law. It acts through the Department of Company Affairs in the Ministry of Law, Justice and Company Affairs. It is, however, not possible for the Central Government to directly look after the day-to-day administration of company law. It has, therefore, delegated its powers to the Company Law Board which acts as the executive arm of the Department of Company Affairs. The Company Law Board exercises powers which have been conferred on it by the Companies Act and those powers which are delegated to it by the Central Government.

Section 637 empowers the Central Government to delegate any of its powers and functions, by notification in the Official Gazette (except the power to appoint Public Trustee under s. 153A) to some other authority as may be specified in the notification.

A copy of every notification shall, as soon as, after it is issued, be placed before both the Houses of Parliament.

Now, for all practical purposes, the day-to-day administration of company law is carried out by the Company Law Board.

1.2.2 Constitution of Board of Company Law Administration

Section 10 E provides as follows:

1. It empowers the Central Government to constitute the Board of Company Law Administration (CLB).
2. The Company Law Board shall exercise and discharge such powers and functions as may be conferred on it by or under the Companies Act, 1956 or any other law. Further, it shall also exercise and discharge such other powers and functions of the Central Government under this Act or any other law as may be conferred on it by the Central Government, by notification in the Official Gazette under the provisions of the Companies Act, 1956 or that other law.

3. The CLB shall consist of such number of members, not exceeding nine, as the Central Government deems fit, to be appointed by that Government by notification in the Official Gazette.
4. The members of the CLB shall possess such qualifications and experience as may be prescribed.
5. One of the members of the Board shall be appointed by the Central Government to be the Chairman of the CLB.
6. No act done by the CLB shall be called in question on the ground only of any defect in the constitution of, or the existence of any vacancy in the CLB.
7. The CLB may, by order in writing, form one or more Benches from among its members and authorise each such Bench to exercise and discharge such of the Board's powers and functions as may be specified in the order. Every order made or act done by a Bench in exercise of such powers or discharge of such functions shall be deemed to be the order or act, as the case may be, of the Board.
8. The CLB shall in the exercise of its powers and the discharge of its functions under the Act or any other law be guided by the principles of natural justice and shall act at its discretion.
9. The CLB shall have power to regulate its own procedure.

Appeals against the Orders of the CLB

Section 10 F provides that any person aggrieved by any decision or order of CLB may file an appeal to the high court within 60 days from the date of communication of the decision or order of CLB to him on any question of law arising out of the order.

This period of 60 days may be extended by a further period not exceeding 60 days if the high court is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period of 60 days.

1.2.3 National Advisory Committee on Accounting Standards

Section 210 A provides that the Central Government may, by notification in the Official Gazette, constitute National Advisory Committee on Accounting Standards, to advise the Central Government on the formation and laying down of accounting policies and accounting standards, for adoption by companies or class of companies under the Companies Act, 1956.

1.2.4 The Securities and Exchange Board of India

Section 2(45B) provides that the Central Government may, by notification in the Official Gazette, establish the Securities and Exchange Board of India (in short - SEBI) for the protection of investors in securities.

Powers of SEBI

Section 55A provides that the provisions contained in sections 55 to 58, 59 to 84, 108, 109, 110, 112, 113, 116 to 122, 206, 206 A and 207 shall be administered by SEBI, so far as they relate to issue and transfer of securities and non-payment of dividend in case of:

(i) Listed public companies;

(ii) Those public companies which intend to get their securities listed on any recognised stock exchange in India.

Section 209A provides that the books of account and other books and papers of every company shall be open to inspection during business hours, *inter alia,* by the officers of SEBI as may be authorised by it. However, an inspection may be made without giving any previous notice to the company or any officer thereof. Further, an inspection can be made in respect of matters covered under sections referred to in s.55A.

Further, under s.621, a court may take cognizance of offence relating to the issue and transfer of securities and non-payment of a dividend, on a complaint in writing, by a person authorised by SEBI.

Task Discuss the application of companies act in respect of J&K state.

1.2.5 Official Liquidator

For the purpose of winding up of companies by the court, there shall be an official liquidator, who may be:

- appointed from a panel of professional firms of chartered accountants, advocates, company secretaries, cost and works accountants which the Central Government constitutes for the court.
- a body corporate, consisting of such professionals as may be approved by the Central Government.
- a whole time or a part time officer, appointed by the Central Government.

1.2.6 Advisory Committee

Section 410 provides that for the purpose of advising the Central Government and the Company Law Board on the matters arising out of the administration of the Companies Act, 1956, as may be referred to it by the Central Government or the Company Law Board, the Central Government may constitute this Committee consisting of not more than 5 persons with suitable qualifications. The Central Government is, however, not bound to constitute an Advisory Committee.

Moreover, even if an Advisory Committee is constituted neither the Central Government nor the Company Law Board is bound to accept its advice.

1.2.7 Courts

According to section 2, the 'Court' means:

(a) With respect to any matter relating to a company (other than any offence against the Act) the Court having jurisdiction under this Act with respect to that matter relating to that company, as provided in s.10;

(b) With respect to any offence against this Act, the Court of a Magistrate of the First Class or, as the case may be, a Presidency Magistrate, having jurisdiction to try such offence.

Jurisdiction of Courts

Notes

As regards to the jurisdiction of Courts, section 10 provides as follows:

1. The court having jurisdiction under this Act shall be:
   (a) The High Court having jurisdiction in relation to the place at which the registered office of the company concerned is situated, except to the extent to which jurisdiction has been conferred on any District Court or District Court subordinate to that High Court in pursuance of (2) below; and
   (b) Where jurisdiction has been so conferred, the District Court in regard to matters falling within the scope of the jurisdiction conferred, in respect of companies having their registered offices in the district.
2. The Central Government may, by notification in the Official Gazette and subject to such restrictions, limitations and conditions as it thinks fit, empower any District Court to exercise all or any of the jurisdiction conferred by this Act upon the court, not being the jurisdiction conferred by this Act upon the court:
   (a) In respect of companies generally, by Sections 237, 391, 394, 395 and 397 to 407, both inclusive;
   (b) In respect of companies with a paid up share capital of not less than 1 lakh of rupees, by Part VII (Sections 425 to 560) and the other provisions of this Act relating to the winding up of companies.
3. For the purposes of jurisdiction to wind up companies, the expression 'registered office' means the place which has longest been the registered office of the company during the six months immediately preceding the presentation of the petition for winding up.

Self Assessment

6. What is the correct sequence of the following assignments?

   (i) Internal control (ii) Test check

   (iii) Internal check (iv) Statutory audit

   Select the correct answer using the codes given below:

   Codes

   (a) (i), (ii), (iii), (iv) (b) (iii), (i), (iv), (ii)

   (c) (iii), (i), (ii), (iv) (d) (iv), (iii), (ii), (i)

7. Which of the following conditions must be satisfied in a claim for loss by fire?

   (i) There must be actual fire.

   (ii) Fire must be accidental.

   (iii) Cause of fire must be ascertainable.

   (iv) The goods must have been destroyed, not damaged by fire.

   Select the correct answer using the codes given below:

   Codes

   (a) (i) and (ii) (b) (i) and (iii)

   (c) (ii) and (iii) (d) (iii) and (iv)

1.3 Some Important Definitions

Some important definitions related to companies act are:

- ***Officer:*** Section 2(30) provides that the term 'Officer' includes any director, manager or secretary or any person in accordance with whose directions or instructions the board of directors or any one or more of the directors is or are accustomed to act.
- ***Relative:*** Section 2(41) provides that the term 'relative' means, with reference to any person, any one who is related to such person in any of the ways specified in s.6, and no others.

  Section 6 provides that a person shall be deemed to be a relative of another, if, and only if:

  (i) They are members of a Hindu undivided family; or

  (ii) They are husband and wife; or

  (iii) The one is related to the other in the manner indicated in Schedule 1A.

  Schedule 1A provides the following list of relatives:

  (i) Father, Father's father, Father's mother.

  (ii) Mother (including step-mother), Mother's mother, Mother's father.

  (iii) Son (Including step son), Son's wife, Son's son, Son's son's wife, Son's daughter, Son's daughter's husband.

  (iv) Daughter (including step-daughter), Daughter's husband, Daughter's son, Daughter's son's wife, Daughter's daughter, Daughter's daughter's husband.

  (v) Brother (including step brother), Brother's wife.
- ***Public Financial Institutions (S.4 A):*** The following financial institutions shall be regarded, for the purposes of the Act, as public financial institutions, namely: (i) The Industrial Credit and Investment Corporation of India Limited (ICICI), (ii) The Industrial Finance Corporation of India (IFCI), (iii) The Industrial Development Bank of India (IDBI), (iv) The Life Insurance Corporation of India (LIC), (v) The Unit Trust of India (UTI).

  Also, s.4A empowers the Central Government to specify other institutions, as it may think fit, to be a public financial institution by issuing a notification in the Official Gazette. However, no institution shall be so specified unless (i) it has been established or constituted by or under any Central Act; or (ii) not less than 51 per cent of the paid up share capital of such an institution is held or controlled by the Central Government.

  The Central Government has specified many other institutions to be public financial institutions. Some of these are: (i) The Infrastructure Development Finance Company Ltd., (ii) National Housing Board, (iii) Rural Electrification Corporation Ltd., (iv) Indian Railways Finance Corporation Ltd., (v) National Insurance Company Ltd., (vi) Power Finance Corporation Ltd., (vii) Small Industries Development Bank of India, etc.

  Section 4A is relevant in the context of Sections 94A and 224A.

Task "No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which the Company Law Board is empowered to determine". Discuss

- ***Officer Who is in Default:*** Section 5 provides that for the purpose of any provision in this Act which enacts that an officer of the company who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise, the expression 'officer who is in default' means all the following officers of the company, namely:

  (i) The managing director or managing directors;

  (ii) The whole time director or directors;

  (iii) The manager;

  (iv) The secretary;

  (v) Any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act;

  (vi) Any person charged by the board of directors with the responsibility of complying with any provision, provided the person so charged has given his consent in this behalf to the board of directors;

  (vii) Where any company does not have any of the officers specified in clauses (a) to (c), any director or directors who may be specified by the board of directors in this behalf or where no director is so specified, all the directors.

  (viii) Where the board of directors exercises any power under clause (f) or clause (g), it shall, within 30 days of the exercise of such powers, file with the Registrar a return in the prescribed form.

Self Assessment

8. The provisions of the Act relating to the formation of a company are discussed in parts .... of the act.

   (i) II to IV (ii) III to IV

   (iii) Parts I to II (iv) Parts IV to V

9. Property of the company belongs to ....

   (i) Company (ii) Shareholders

   (iii) Members (iv) Promoters

10. In the case of company, audit is ....

    (i) Compulsory (ii) Optional

    (iii) Situational (iv) None of the above

11. The companies which are formed under special Act are called as ....

    (i) Chartered Companies (ii) Statutory Companies

    (iii) Registered Companies (iv) None of these

Notes

Case Study

Companies under politics

The Enron Development Corporation of USA, which is one of the largest integrated natural gas companies in the world, started construction in Maharashtra, in April 1995, on the 695, MW gas fired plant. But the new government of Maharashtra - the Shiv Sena - BJP combine ordered a review of the project. The BJP had opposed the deal on various counts when it was being struck between Enron and then the government of Maharashtra headed by Congress party. Some of the counts on which the project was criticised were: (i) the social and environmental aspects of the project, (ii) the alleged bribes paid by Enron, (iii) the high cost of the project, (iv) the lack of transparency, and (v) the absence of competitive bidding. The Congress leaders alleged that cancelling the project was a politically-motivated decision. Also, it is pertinent to refer to the ruling by the Bombay High Court in 1994, when it threw out a petition filed against the project by one of the leaders of BJP. In a strongly worded verdict the court had said, "The proposal was deliberated at length for two and a half years, draft agreements were prepared from time to time, and it was ultimately the eighth or ninth draft which was finalised. Nothing was done secretly. There was total transparency at every stage of negotiation. There is nothing to show that anybody was being favoured for any specific reason."

Also the Government of India had taken a series of decisions concerning inviting private sector participation in the power sector and announcing a list of incentives. Firstly, the first few private sector projects were to be given the status of pioneer projects what later came to be known as "fast track" ones, and were to be given every facility by the government. Secondly, for the first few projects, the government would not go in for public tendering. Naturally, Enron cannot be blamed for government policies.

Question

Describe various reasons behind the increment in cost of Enron plant in Maharashtra. (*Hint:* Due to the political reasons)

Self Assessment

State whether the following statements are true or false:

12. SEBI is a regulatory body to regulate the functioning of stock exchanges.
13. Courts have been replaced by Company Law Board under the Companies Act, 1956.
14. The administration of the Companies Act, 1956 is vested in the Company Law Board.
15. Any person aggrieved by the decision or order of the Company Law Board may file an appeal in the Supreme Court.
16. No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which the Company Law Board is empowered to determine.

1.4 Summary

- The Companies Act, 1956, has been in force for the last 55 years.
- The Act confers a variety of powers on the Central Government and the Company Law Board to monitor, regulate and control the affairs of the companies.

Notes

- To ensure better management of companies, the Central Government accord approval for the appointment and reappointment of persons as Managing Directors, Whole-time Directors or Managers of a public limited or private limited company which is a subsidiary of a public limited company, under Section 269 read with Section 388 of the Companies Act.
- In 1988, the Government dispensed with the requirement of the approval for appointment of managerial personnel in respect of cases which fulfill the conditions as prescribed in Schedule XIII of the Act.
- This Schedule can be modified to suit the changing needs of the time and circumstances in keeping with this policy of regulation by exception.

1.5 Keywords

CLB: Section 10 E enables the Central Government to constitute the Board of Company Law Administration (CLB).

Officer: Section 2(30) provides that the term 'Officer' includes any director, manager or secretary or any person in accordance with whose directions or instructions the board of directors or any one or more of the directors is or are accustomed to act.

SEBI: Section 2(45B) provides that the Central Government may, by notification in the Official Gazette, establish the Securities and Exchange Board of India (in short - SEBI) for the protection of investors in securities.

The Central Government: The Central Government is the supreme authority responsible for the administration of company law.

1.6 Review Questions

1. What is the extent of the Companies Act, 1956?
2. Enumerate the companies to which the Companies Act, 1956 is applicable.
3. Enumerate the associations to which the Companies Act, 1956 is not applicable.
4. Describe the scheme of the Companies Act, 1956.
5. Outline the set up of Company Law Administration.
6. What are the different authorities by which the administration of the Companies Act, 1956 is carried out?
7. Write an explanatory note on Company Law Board.
8. Discuss about "Societies registered under the Societies Registration Act, 1860."
9. What do you mean by Official Liquidator.
10. Write short notes on:
    (i) Public Financial Institutions
    (ii) SEBI
    (iii) Advisory Committee
    (iv) Meaning of (a) officer, (b) relative, (c) officer who is in default.

Notes

Answers: Self Assessment

1. Company law
2. Companies Act, 1956
3. Part IX
4. Partnership firms which are governed by the Indian Partnership Act, 1932.
5. Company law
6. (c)
7. (a)
8. Parts II to IV
9. Company
10. Optional
11. Statutory Companies
12. True
13. False
14. True
15. False
16. True

1.7 Further Readings

Books

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Unit 2: Meaning and Nature of a Company

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Objectives

After studying this unit, you will be able to:

- Define a company;
- Describe various characteristics of a company;
- Explain the corporate veil lifting process.

Introduction

A company, in its ordinary, non-technical sense, means a body of individuals associated for a common objective, which may be to carry on business for gain or to engage in some human activity for the benefit of the society. Accordingly, the word 'company' is employed to represent associations formed to carry on some business for profit or to promote art, science, education or to fulfill some charitable purpose. This body of individuals may be incorporated or unincorporated.

Notes

2.1 Definition of a Company

The Companies Act, 1956 defines the word 'company' as a company formed and registered under the Act or an existing company formed and registered under any of the previous company laws (s.3). This definition does not bring out the meaning and nature of the company into a clear perspective. Also s.12 permits the formation of different types of companies. These may be (i) companies limited by shares, (ii) companies limited by guarantee and (iii) unlimited companies. The vast majority of companies in India are with limited liability by shares. Therefore, it is advisable to define the term 'company' keeping in mind this type of company. However, a brief description of other types of companies will be given later in unit 3.

Lord Lindley has described the company as "an association of many persons who contribute money or money's worth to a common stock and employ it in some trade or business; and who share the profit and loss (as the case may be) arising therefrom". The common stock so contributed is denoted in money and is 'the capital' of the company. The persons who contribute to it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his 'share'. The member may sell his share in the company, thus, withdrawing himself and making someone else a member to whom he transfers shares. Thus, shares in a company are transferable. As a natural consequence of transferability of shares, the company has what is commonly known as perpetual succession. With the withdrawal or death of a member of a company, the latter does not come to an end. The life of the company is independent of the lives of the members of the company. Members may come and members may go, the company continues until it is dissolved.

Gower, L.C.B. in his book entitled *The Principles of Modern Company Law* gives an interesting example. He says, 'During the war all the members of one private company, while in general meeting, were killed by a hydrogen bomb. But the company survived, not even a hydrogen bomb could have destroyed it'.

Section 34(2) gives the effect of registration of a company by identifying the features it acquires as a consequence thereof. The section provides that:

"From the date of incorporation mentioned in the certificate of incorporation, such of the subscribers of the memorandum and other persons, as may from time to time be members of the company, shall be a body corporate by the name contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company and having perpetual succession and a common seal, but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is mentioned in the Act.

Self Assessment

Fill in the blanks:

1. An existing company formed and registered under any of the previous company laws ....
2. The persons who contribute to it, or to whom it belongs, are ....
3. Members may come and members may go, the company continues until it is ....
4. .... gives the effect of registration of a company by identifying the features it acquires as a consequence thereof.

2.2 Characteristics of Company

Notes

On the basis of the above observations, we may spell out the following characteristic features of a company.

2.2.1 Incorporated Association

A company must be incorporated or registered under the Companies Act. Minimum numbers required for the purpose is 7, in case of a public company and 2, in case of a private company (s.12). It may also be mentioned that as per s.11, an association of more than 10 persons, in case of banking business and 20 in case of any other business, if not registered as a company under the Companies Act, or under any other law for the time being in force, becomes an illegal association.

2.2.2 Artificial Person

A company is created with the sanction of law and is not itself a human being, it is therefore, called artificial; and since it is clothed with certain rights and obligations, it is called a person. A company is accordingly, an artificial person.

2.2.3 Separate Legal Entity

Unlike partnership, company is distinct from the persons who constitute it. Section 34 (2) says that on registration, the association of persons becomes a body corporate by the name contained in the memorandum. Lord Macnaghten in the famous case of Salomon v. Salomon & Co. Ltd. (1897) AC 22 observed that:

A company is at law a different person altogether from the subscribers…..; and though it may be that after incorporation the business is precisely the same as it was before and the same persons are managers and the same hands receive the profits, the company is at law not the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.

The facts of the famous Salomon's case were as follows:

Salomon carried on business as a leather merchant. He sold his business for a sum of £30,000 to a company formed by him along with his wife, a daughter and four sons. The purchase consideration was satisfied by allotment of 20,000 shares of £1 each and issue of debentures worth £10,000 secured by floating charge on the company's assets in favour of Mr Salomon. All the other shareholders subscribed for one share of £1 each. Mr Salomon was also the managing director of the company. The company almost immediately ran into difficulties and eventually became insolvent and winding up commenced. At the time of winding up, the total assets of the company amounted to £6,050; its liabilities were £10,000 secured by the debentures issued to Mr Salomon and £8,000 owing to unsecured trade creditors. The unsecured sundry creditors claimed the whole of the company's assets, viz. £6,050 on the ground that the company was a mere alias or agent for Salomon.

Held: The contention of the trade creditors could not be maintained because the company being in law a person quite distinct from its members, could not be regarded as an 'alias' or agent or trustee for Salomon. Also the company's assets must be applied in payment of the debentures as a secured creditor is entitled to payment out of the assets on which his debt is secured in priority to unsecured creditors.

Notes

In Lee v. Lee Air Farming Limited (1960) 3 All ER 429 PC, a company was formed for the purpose of manufacturing aerial top-dressing. Lee, a qualified pilot, held all but one of the shares in the company and by the articles was appointed governing director of the company and chief pilot. Lee was killed while piloting the company's aircraft and his widow claimed compensation for his death under the Workmen Compensation Act. The company opposed the claim on the ground that Lee was not a 'worker' as the same person could not be employer and the employee.

Held: There was a valid contract of service between Lee and the company; and Lee was, therefore, a worker. Mrs. Lee's contention was upheld.

In Bacha F. Guzdar v. The Commissioner of Income-Tax, Bombay [AIR (1955) SC. 74], the facts of the case were as follows:

The plaintiff (Mrs. Guzdar) received certain amounts as dividend in respect of shares held by her in a tea company. Under the Indian Income-tax Act, agricultural income is exempted from payment of income-tax. As income of a tea company is partly agricultural, only 40 per cent of the company's income is treated as income from manufacture and sale and, therefore, liable to tax. The plaintiff claimed that the dividend income in her hands should be treated as agricultural income up to 60 per cent, as in the case of a tea company, on the ground that dividends received by shareholders represented the income of the company.

Held: By the Supreme Court, that though the income in the hands of the company was partly agricultural yet the same income when received by Mrs. Guzdar as dividend could not be regarded as agricultural income.

Task A husband and wife who were the only two members of a private ltd., company were killed in a motor accident. Does the company also die with them?

2.2.4 Limited Liability

The company being a separate person, its members are not as such liable for its debts. Hence, in the case of a company limited by shares, the liability of members is limited to the nominal value of shares held by them. Thus, if the shares are fully paid up, their liability will be nil. However, companies may be formed with unlimited liability of members or members may guarantee a particular amount. In such cases, liability of the members shall not be limited to the nominal or face value of the shares held by them. In case of unlimited liability companies, members shall continue to be liable till each paise has been paid off. In case of companies limited by guarantee, the liability of each member shall be determined by the guarantee amount, i.e., he shall be liable to contribute up to the amount guaranteed by him.

Unlimited Liability of a Member of a Limited Liability Company

In the following cases, a shareholder or member shall lose the privilege of limited liability:

1. Where members of the company are reduced below the statutory minimum, viz., 7 in case of a public company and 2 in case of a private company and the company carries on the business for more than 6 months while the members are so reduced, every person who is a member during the time that it so carries on business after those 6 months and is aware of the fact that it is operating with fewer than the requisite number shall be personally liable for the whole of the debts contracted during that time (s.45).

2. Where in the course of winding up, it appears that any business of the company has been carried on with intent to defraud creditors; the Court may declare the persons who were knowingly parties to the transaction personally liable without limitation of liability for all or any of the debts or other liabilities of the company (s.542).

2.2.5 Separate Property

Shareholders are not, in the eyes of the law, part owners of the undertaking. In India, this principle of separate property was best laid down by the Supreme Court in Bacha F. Guzdar v. The Commissioner of Income Tax, Bombay (Supra). The Supreme Court held that "a shareholder is not the part owner of the company or its property, he is only given certain rights by law, e.g., to vote or attend meetings, to receive dividends" Similarly, in R. F. Perumal v. H. John, it was observed that "no member can claim himself to be owner of the company's property during its existence or on its winding up. In still another case, it was observed that " even where a shareholder held almost entire share capital, he did not even have an insurable interest in the property of the company". In Macaure v. Northern Assurance Co. Ltd., the facts were as follows:

'Macaure' held all except one share of a timber company. He had also advanced substantial amount to the company. He insured the company's timber in his personal name. On timber being destroyed by fire, his claim was rejected for want of insurable interest. The Court applying principle of separate legal entity held that the insurance company was not liable.

2.2.6 Transferability of Shares

Since business is separate from its members in a company form of organisation, it facilitates the transfer of member's interests. The shares of a company are transferable in the manner provided in the Articles of the company (s.82). However, in a private company, certain restrictions are placed on such transfer of shares but the right to transfer is not taken away absolutely.

2.2.7 Perpetual Existence

A company being an artificial person cannot be incapacitated by illness and it does not have an allotted span of life. The death, insolvency or retirement of its members leaves the company unaffected. Members may come and go but the company can go forever. The saying "King is dead, long live the King" very aptly applies to the company form of organisation.

2.2.8 Common Seal

A company being an artificial person is not bestowed with a body of natural being. Therefore, it has to work through its directors, officers and other employees. But, it can be held bound by only those documents which bear its signature. Common seal is the official signature of a company.

Seal of company when to be used – The articles of association of the company provide for putting the seal of the company on documents. Apart from those documents, the company seal is to be put on power of attorney, deed of lease, share certificates, debentures, debenture trust deed, deed of mortgage, promissory notes, negotiable instruments (except cheques), agreement of hypothecation, loan agreements with banks and financial institutions, contract of employment, guarantees issued by the company and all formal documents and documents executed on stamp papers.

Notes

Use of Seal Outside India (s.50)

Where a company has any business or transaction in a place outside India, a facsimile (exact reproduction) of the common seal may be kept there. The seal should also contain the name of the place where the seal would be used. For such use, there must be power in the articles. A person must be properly authorised to use the seal, who shall sign his name and also put the name of the place and the fact that he has been authorised to do so by the specified resolution.

As per s.48, a company may, by writing under its common seal, empower any person, either generally or in respect of any specified matters, as its attorney, to execute deeds on its behalf in any place either in or outside India [s.48(1)].

It further provides that a deed signed by such an attorney on behalf of the company and under his seal where sealing required, shall bind the company and have the same effect as if it were under its common seal[s.48(2)].

2.2.9 Company may sue and be sued in its own name

Another fallout of separate legal entity is that the company, if aggrieved by some wrong done to it may sue or be sued in its own name. In Rajendra Nath Dutta v. Shibendra Nath Mukherjee (1982) (52 Comp. Cas. 293 Cal.), a lease deed was executed by the directors of the company without the seal of the company and later a suit was filed by the directors and not the company to avoid the lease on the ground that a new term had been fraudulently included in the lease deed by the defendants. Held that a director or managing director could not file a suit, unless it was by the company in order to avoid any deed which admittedly was executed by one of the directors and admittedly also the company accepted the rent. The case as made out in the plaint was not made out by the company but by some of the directors of the company and the company was not even a plaintiff. If the company was aggrieved, it was the company which was to file the suit and not the directors. Therefore, the suit was not maintainable.

Self Assessment

5. Consider the following statements:

   A statutory auditor of a public limited company claims that he has the following legal rights in relation to his duties:

   (i) Right to refuse to make a report

   (ii) Right of access to books of accounts and registers

   (iii) Right to seek explanation from directors and officers -

   (iv) Right to make statement in the general meeting

   Of the above statements:

   (a) (i), (ii) and (iii) are correct

   (b) (i), (ii) and (iv) are correct

   (c) (i), (iii) and (iv) are correct

   (d) (ii), (iii) and (iv) are correct

Notes

6. Match List-I with List-II and select the correct answer using the codes given below in the lists:

List-I (Company Issue)		List-II (Company Document)	
A.	Affirmation of compliance with the registration formalities	1.	Certificate of incorporation
B.	Classes of shares into which shake capital is divided	2.	Statutory declaration
C.	Rules for forfeiture of shares	3.	Memorandum of Association
D.	Name and address of the company auditor	4.	Articles of association
		5.	Prospectus

	A	B	C	D
(a)	1	4	3	5
(b)	5	4	3	1
(c)	2	3	4	5
(d)	4	1	5	2

2.3 Lifting of the Corporate Veil

A company is distinct from its members. It is a separate legal entity. There is thus, a veil between a company and its members keeping them both separate from each other. However, sometimes it becomes necessary to lift this veil, disregard the distinct corporate entity of the company and find out the realities of the company. The court may investigate the real affairs, ownership, etc., of the company. This is called lifting or piercing the corporate veil. In other words, the Court investigates into the true state of affairs of the company. It has been observed that though a corporation is a distinct entity, yet in reality, it is an association of persons who are in fact the beneficial owners of all the corporate property.

The corporate veil is therefore lifted by the court, when it ignores the company and concerns itself directly with the members or managers. It is largely in the discretion of the Courts and will depend upon the underlying social, economic and moral factors as they operate in and through the corporation.

The corporate veil may be lifted in the following instances:

- To investigate the relationships between the holding company and subsidiary company;
- To investigate the number and names of members of the company;
- To investigate the true ownership of shares and controlling power over the company;
- To investigate lawful objects of the company;
- To investigate mismanagement and oppression by the majority;
- To investigate the character of the company where it is trading with an alien enemy or persons managing the affairs of the company are under the control of enemies or been residing in enemy country;
- To investigate into the affairs where there exists a tendency to create monopoly;

Notes

- To investigate the company affairs where it is used for tax evasion or to circumvent tax obligation;
- To investigate if the company is acting as an agent for its shareholders;
- To investigate the affairs where it is formed for fraudulent purposes, to defeat and circumvent the law or to defraud its creditors or to avoid valid obligations.

Bombay High Court in (2004) 121 Comp. Cas 314 has held that the corporate veil may be lifted to the extent permitted under the statute and no more.

The advantages of incorporation are allowed to be enjoyed only by those who want to make an honest use of the 'company'. In case of a dishonest and fraudulent use of the facility of incorporation, the law lifts the corporate veil and identifies the persons (members) who are behind the scene and are responsible for the perpetration of fraud.

Following are some such cases:

- ***For the Protection of Revenue*:** The Court may not recognize the separate existence of a company where the only purpose for which it appears to have been formed is the tax-evasion or circumvention of tax obligation. D was a rich man having dividend and interest income. He wanted to avoid surtax. For this purpose, he formed four private companies, in all of which he was the majority shareholder. The companies made investments and whenever interest and dividend incomes were received by the companies, D applied to the companies for loans which were immediately granted and never repaid. In a legal proceeding, the corporate veils of all the companies were lifted and the incomes of the companies treated as if they were of 'D' [In re Dinshaw Maneckjee Petit (1927) Bom. 371].
- ***Where the company is acting as agent of the shareholders:*** In such circumstances, the shareholders will be held liable for its acts. There may be an express agreement to this effect or such agreement may be implied from the facts of a particular case.
- ***Where a company has been formed by certain persons to avoid their own valid contractual obligation:*** In such conditions, the court may proceed on the assumption as if no company existed.

Example: A sold his business to B and agreed not to compete with him for a given number of years within reasonable local limits. A, desirous of re-entering business, in violation of the contractual obligation, formed a private company with majority shareholdings. B filed a suit against 'A' and the private company and the court granted an injunction restraining 'A' and his company with going ahead in the competing business (Gilford Motor Co. v. Horne (1933) 1 Ch. 935).

- ***Where a company has been formed for some fraudulent purpose or is a 'sham':*** The court will lift the corporate veil in such circumstances to identify the perpetrator of the fraud. In Delhi Development Authority v. Skipper Construction Company (P) Ltd. [1996] 4 SCALE 202, the skipper construction company failed to pay the full purchase price of a plot to DDA. Instead construction was started and space sold to various persons. The two sons of the directors who had business in their own names claimed that they had separated from the father and the companies they were running had nothing to do with the properties of their parents. But no satisfactory proof in support of their claim could be produced. Held, that the transfer of shareholding between the father and the sons must also be treated as a sham. The fact that the director and members of his family had created several corporate bodies did not prevent the court from treating all of them as one entity belonging to and controlled by the director and his family.

- ***Where a company formed is against public interest or public policy:*** Where for the purpose of determining the character of the members, the Court may lift the corporate veil.

Example: C company was floated in London for marketing tyres manufactured in Germany. The majority of C's shares were held by the German nationals residing in Germany. During World War I, C company filed a suit against D company for the recovery of trade debt. The D company contended that C company was an alien enemy company (Germany being at war with England at that time) and that the payment of the debt would be a trading with the enemy. The Court agreed with the contention of the defendants [Daimler Co. Ltd. v. Continental Tyre and Rubber Co., (1916) 2AC 307].

- ***Where device of incorporation is used for some illegal or improper purpose:*** [PNB Finance Ltd. v. Shital Prasad Jain (1983) 54 Comp. Cas 66 (Delhi)]. S, the financial advisor of a financing public limited company was given a loan of ₹ 15 lakhs by the company to purchase immovable properties in Delhi. A pronote with regard to the same was also executed by S. S diverted the amount of the loan to three public limited companies floated by him and his son. These companies, in turn, applied the amount in purchasing immovable properties at New Delhi. The Delhi High Court refrained the defendants from in any manner alienating, transferring, disposing of or encumbering the properties in question.

- ***Where the number of members falls below the statutory minimum***: (i.e., seven in the case of a public company and two in the case of a private company) and the company continues to carry on business for more than six months while the number is so reduced. In such a case, every person who is a member of the company during the time that it so carries on business after those six months and has knowledge of that fact, shall be severally liable to the creditors for the payment of the company's debts contracted during that period. Such a member can be sued severally (i.e., directly) by the creditors of the company. Both the privileges of limited liability and that of the separate legal entity are lost. The creditors are permitted to look behind the company to the shareholders for the satisfaction of their claims (s.45).

- ***Where prospectus includes a fraudulent misrepresentation***: In case of a prospectus containing fraudulent misrepresentation as to a material fact, Ss. 62 and 63 make the promoters, directors, etc., personally liable not only in damages but they may even be prosecuted in terms of fine up to ₹ 50,000 or imprisonment up to 2 years or both.

- ***Where a negotiable instrument is signed by an officer of a company on behalf of the company without mentioning the name of the company:*** Thereon, he is personally liable to the holder of the instrument, unless the company has already made the payment on the instrument [s.147 (4) (c)].

- ***Holding and Subsidiary Companies:*** (Ss. 212-213). In the eyes of law, the holding company and its subsidiaries are separate legal entities. However, in the following cases, a subsidiary company may lose its separate identity to a certain extent:

  - Where at the end of its financial year, a company has subsidiaries, it may lay before its members in general meeting not only its own accounts, but also a set of group accounts showing the profit or loss earned or suffered by the holding company and its subsidiaries collectively and their collective state of affairs at the end of the year;

  - The Central Government, where it feels desirable, may direct the holding and subsidiary companies to synchronize their financial years;

  - The Court may, on the facts of a case, treat a subsidiary company as merely a branch or department of one large undertaking owned by the holding company.

Notes

- ***Investigation into related companies:*** Section 239 provides that if it is necessary for the satisfactory completion of the investigation into the affairs of a company, the Inspector appointed to investigate may look into the affairs of another related company in the same management or group.
- ***For investigation of ownership of a company:*** The separate legal entity may be disregarded under s.247. This Section authorises the Central Government to appoint one or more Inspectors to investigate and report on the membership of any company for the purpose of determining the true persons who are financially interested in the company and who control or materially influence its policy.
- ***Business intended to defraud creditors:*** Where in the course of winding up of a company, it appears that any business of the company has been carried on, with intent to defraud creditors of the company, or any other persons, or for any fraudulent purpose, the court on the application of the Liquidator, or any creditor or contributory of the company, may, if it thinks proper, declare that any persons who are knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct (s.542).

Self Assessment

7. The term 'company' is defined under which section of the Act?

   (a) Sec 3 (1) (b) Sec 4 (2)

   (c) Sec 2 (4) (d) Sec 1 (3)

8. Which company shares can be freely transferable

   (a) Private Company (b) Public Company

   (c) Both a and b (d) None of the above

9. The liability of members if company is limited by guarantee.

   (a) Unpaid value of shares (b) Guarantee amount

   (c) Unlimited liability (d) None of the above

10. The liability of members if company is limited by shares

    (a) Unpaid value of shares (b) Guarantee amount

    (c) Unlimited liability (d) None of the above

Task Savoy Ltd. had eight members at the time of incorporation. Within two months, two of the members transferred their shares to one of the existing members. By the end of the year, the company went into liquidation. All the shares are fully paid-up. The creditors of the company sought to recover their dues from the company. The liquidator demanded money from the shareholders, who refused to accept any liability; their shares being fully paid-up. Explain the legal position.

2.4 Company Distinguished from Partnership

Notes

Section 4 of the Indian Partnership Act, 1932 defines a partnership as 'the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'. Persons who enter into a partnership are individually called 'Partners' and collectively a 'Firm', and the name under which the business is carried on is called the 'Firm's Name'.

The essential characteristics of a partnership organisation are:

1. A partnership is an association of two or more than two persons. However, a limit is placed by s.11 of the Companies Act, 1956 on the maximum number of partners – at ten in case of banking business and twenty in case of any other business.
2. A partnership must be the result of an agreement between two or more persons.
3. The agreement must be to carry on some business.
4. The agreement must be to share profits of the firm.
5. The business must be carried on by all or any of them acting for all. The partnership is based upon the idea of mutual agency. Every partner assumes a dual role – that of a principal and an agent.
6. The liability of each partner of the firm is unlimited in respect of the firm's debts.
7. A partnership firm has no independent legal existence apart from the persons who constitute it.
8. A partnership agreement is based on mutual confidence and trust of the partners.
9. No partner can transfer his share in a partnership to an outsider without the consent of all the other partners.
10. No change can be made in the nature of the partnership business without the consent of all the partners.

A partnership firm may be distinguished from a company in the following ways:

1. ***Legal Status:*** A partnership firm has no existence apart from its members. A company is a separate legal entity distinct from its members.
2. ***Mutual Agency:*** A partnership is founded on the idea of mutual agency – every partner is an agent of the rest of the partners. A member of a company is not an agent of the other members.
3. ***Liability of Members:*** The liability of a partner is unlimited, i.e., even his own personal assets are liable for the debts of the firm. The liability of a member of a limited company is limited to the extent of the amount remaining unpaid on shares held by him or the amount of guarantee, as mentioned in the memorandum of association of the company.
4. ***Transfer of Interest:*** A partner cannot transfer his interest in the partnership without the consent of all other partners. A member, subject to the restrictions contained in the articles, can freely transfer his shares in the company.
5. ***Duration of Existence:*** Unless there is a contract to the contrary, the death, retirement, or insolvency of a partner results in the dissolution of the firm. In contrast, a company enjoys a perpetual succession. Death or retirement or insolvency of a member of a company does not affect the existence of the company.

Notes

6. ***Minimum Membership:*** The minimum number of persons required to form a partnership is two. The minimum number required to form a private company is two and in the case of a public company the minimum number is seven.

7. ***Maximum Membership:*** A partnership cannot be formed by more than twenty persons. The number is limited to ten in the case of a banking business. In the case of a public company, there is no limit to the maximum number of members. However, a private company cannot have more than fifty members.

8. ***Audit:*** The audit of the accounts of a firm is not compulsory, whereas the audit of accounts of a company is mandatory.

9. ***Use of the Words 'Limited' and 'Private Limited' not Allowed:*** Section 631 provides that if any person or persons trade or carry on business under any name or title of which the words, "Limited" or "Private Limited" are the last words, that person or each of these persons shall, unless duly incorporated as a public or a private company, as the case may be, be punishable with fine which may extend to ₹ 500 for every day upon which that name has been used.

Self Assessment

State whether the following statements are true or false:

11. The corporate veil can be lifted where the main object of forming a company is tax evasion.
12. The corporate veil can be lifted where it has been formed by the promoters to avoid their contractual obligation.
13. An illegal association means a company formed to pursue illegal objects.
14. The corporate veil can be lifted where the company is formed against public policy.
15. A holding company and its subsidiary company are not separate legal entities.

Case Study

Company's Responsibilities in different prospective

The Carbolic Smoke Ball Company made a product called the "smoke ball". It claimed to be a cure for influenza and a number of other diseases. The smoke ball was a rubber ball with a tube attached. It was filled with carbolic acid (phenol). The tube was then inserted into the user's nose. It was squeezed at the bottom to release the vapours into the nose of the user. This would cause the nose to run, and hopefully flush out the cold. In fact the inflammation caused by the device would have probably increased susceptibility to catching influenza.

The Company published advertisements in the Pall Mall Gazette and other newspapers on November 13, 1891, claiming that it would pay £100 to anyone who got sick with influenza after using its product according to the instructions set out in the advertisement.

£100 reward will be paid by the Carbolic Smoke Ball Company to any person who contracts the increasing epidemic influenza colds, or any disease caused by taking cold, after having used the ball three times daily for two weeks, according to the printed directions supplied with each ball.

Contd...

£1000 is deposited with the Alliance Bank, Regent Street, shewing our sincerity in the matter.

During the last epidemic of influenza many thousand carbolic smoke balls were sold as preventives against this disease, and in no ascertained case was the disease contracted by those using the carbolic smoke ball.

One carbolic smoke ball will last a family several months, making it the cheapest remedy in the world at the price, 10s. post free. The ball can be refilled at a cost of 5s. Address: "Carbolic Smoke Ball Company, "27, Princes Street, Hanover Square, London."

Mrs. Louisa Elizabeth Carlill saw the advertisement, bought one of the balls and used three times daily for nearly two months until she contracted the flu on January 17, 1892. She claimed £100 from the Carbolic Smoke Ball Company. They ignored two letters from her husband, who had trained as a solicitor. On a third request for her reward, they replied with an anonymous letter that if it is used properly the company had complete confidence in the smoke ball's efficacy, but "to protect themselves against all fraudulent claims" they would need her to come to their office to use the ball each day and checked by the secretary.

Mrs. Carlill brought a claim to court. The barristers representing her argued that the advertisement and her reliance on it was a contract between her and the company, and so they ought to pay. The company argued it was not a serious contract.

Question:

Do you agree to what the company says? Justify. (***Hint:*** summarize this case in your words).

Practical Exercise

1. Akash and Suman have been carrying on business in partnership as building contractors in a small town for some years. They carry out most of the work themselves and only occasionally employ labour. They have no plans to enlarge the area of their operations. It has been suggested to them that they ought to trade as a company registered under the Companies Act, 1956. They ask your advice on: what are the alleged advantages of trading as a company as compared to partnership? Are there any disadvantages of trading as a company?

2. Two joint Hindu families carry on a business together as joint owners. The first family consists of three brothers and their respective sons, being twelve in number. The second family consists of the father, four major sons and two minor sons. Is the business illegal? (***Hint:*** The business is not illegal. The minors are not to be counted. There are only twenty major persons – the maximum number of members fixed for an association for carrying on a non-banking business without being incorporated s.11)

3. The directors of a public limited company accepted a bill of exchange on behalf of their company. But the word 'Ltd.,' was omitted from the name of the company at the time of acceptance of the bill of exchange. Who can be held liable for the payment of the bill? (***Hint:*** The directors can be held personally liable, if the company refuses to pay.)

2.5 Summary

- The Companies Act empowers the Central Government to inspect the books of accounts of a company, to direct special audit, to order investigation into the affairs of a company and to launch prosecution for violation of the Companies Act, 1956.

Notes

- Books of accounts and other documents of the companies are inspected by the officers of the Directorate of Inspection and Investigation authorised for this purpose under Section 209A of the Companies Act and the Registrars of Companies.
- These inspections are designed to find out whether the companies conduct their affairs in accordance with the provisions of the Companies Act, to see whether any unfair practices prejudicial to the public interest are being resorted to by any company or a group of companies and to examine whether there is any mismanagement which may adversely affect interest of the shareholders, creditors, employees and others.
- Wherever inspection reports disclose any information that may be of interest to other Departments or agencies like the Ministry of Commerce, Central Board of Direct Taxes, Enforcement Directorate, State Government or Provident Fund Authorities, such information is passed on to them and suitable corrective action is initiated.
- When contraventions of the provisions of the Companies Act are detected, action is taken for filing prosecution for such violations of the provisions of the Companies Act.

2.6 Keywords

Audit: The audit of the accounts of a firm is not compulsory, whereas the audit of accounts of a company is mandatory.

Company: The Companies Act, 1956 defines the word 'company' as a company formed and registered under the Act or an existing company formed and registered under any of the previous company laws (s.3).

Mutual Agency: A partnership is founded on the idea of mutual agency – every partner is an agent of the rest of the partners.

Partnership: Partnership as 'the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'.

2.7 Review Questions

1. What are the statutory exceptions to the decision in Salomon's case?
2. "The legal personality of a company is distinct from its members individually and collectively". Comment and point out the circumstances when the separate entity of a company is disregarded by the courts.
3. Explain the meaning of 'Perpetual Succession' and 'Common Seal' in the case of a company.
4. Enumerate the advantages that a business organisation enjoys through incorporation under the Companies Act, 1956.
5. What do you understand by the concept of corporate personality?
6. Explain clearly the meaning of 'lifting of the corporate veil' of a company. Under what circumstances may the court lift the veil of a company?
7. Explain the merits and demerits of incorporation of a company.
8. What is the significance of the concept of limited liability?
9. What do you understand by 'Corporate Veil'? When is this said to be lifted?
10. Distinguish between a company and a partnership firm.

Answers: Self Assessment

1. (s.3)
2. members
3. dissolved
4. Section 34(2).
5. (d)
6. (c)
7. (a)
8. (a)
9. (b)
10. (a)
11. True
12. True
13. False
14. True
15. False

2.8 Further Readings

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www.webopedia.com

Unit 3: Kinds of Companies

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe various types of company classifications;
- Explain private and public company;
- Define holding and subsidiary type of companies;
- Elaborate upon foreign company;
- Explain one man company.

Notes

Introduction

In the case of a body corporate which is incorporated in a country outside India, a subsidiary or holding company of the body corporate under the law of such country shall be deemed to be a subsidiary or holding company of the body corporate within the meaning and for the purposes of this Act also, whether the requirements of this section (S.4) are fulfilled or not.

A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, shall be deemed for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India.

3.1 Classification on the Basis of Incorporation

Companies can be classified into three categories according to the mode of incorporation. If a company is incorporated by a charter granted by the monarch, it is called a Chartered Company and is regulated by that charter. For example, the East India Company came into being by the grant of a Royal Charter. Such types of companies do not exist in India. A company which is created by a special Act of the Legislature is called a Statutory Company and is governed by the provisions of that Act. The State Bank of India and the Industrial Finance Corporation of India are two examples of statutory companies. A company brought into existence by registration of certain documents under the Companies Act, 1956 is called a Registered Company.

3.2 Classification on the Basis of Liability

The liability of members of a registered company may be limited or unlimited (s.12). It may be limited by shares, or by guarantee or by both (i.e., shares and guarantee).

3.2.1 Companies Limited by Shares

A company limited by shares is a registered company having the liability of its members limited by its memorandum of association to the amount, if any, unpaid on the shares respectively held by them. The amount remaining unpaid on the shares can be called up at any time—during the lifetime of the company or at the time of winding up. However, a shareholder cannot be called upon to pay more than the amount remaining unpaid on his shares. His personal assets cannot be called upon for the payment of the liabilities of the company, if nothing remains to be paid on the shares purchased by him. Such a company is also known as a 'Share Company.'

3.2.2 Companies Limited by Guarantee

A company limited by guarantee is one having the liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound up. Such a company is also known as 'guarantee company'. The liability of the members of a guarantee company is limited by a stipulated sum mentioned in the memorandum. The guaranteed amount can be called up by the company from the members only at the time of winding up if the liabilities of the company exceed its assets.

A pure 'guarantee company' does not have a share capital. The working funds, if required, are raised from source like fees, donations, subsidy, endowments, grants, subscriptions and the like. Such a company is generally formed for the purpose of promotion of art, science, culture, charity, sport, commerce or for some similar purpose.

Notes

3.2.3 Hybrid Companies

A company limited by shares as well as by guarantee is a hybrid form of company which combines elements of the guarantee and the share company. Such a company raises its initial capital from its shareholders, while the normal working funds are provided form other sources such as fees, charges, subscription, etc. Every member of such a company is subject to a two-fold liability, i.e., the guarantee which may become effective in the winding up of the company and the liability to pay up to the nominal amount of his share which may become effective during the lifetime of the company or at the time of winding up.

3.2.4 Companies with Unlimited Liabilities

An unlimited company is a company not having any limit on the liability of its members. The members of such a company are liable, in the event of its being wound up, to the full extent of their fortunes to meet the obligations of the company. However, the members are not liable to the company's creditors. The company, being a separate legal entity from the persons who constitute it, is liable to its creditors. If the creditors cannot obtain payment from the company, they may petition the court for the winding up of the company. The Liquidator will then call upon the members to contribute to the assets of the company without limitation of their liability for the payment of the debts of the company.

Self Assessment

Fill in the blanks:

1. If a company is incorporated by a charter granted by the monarch, it is called a ....
2. The State Bank of India and the Industrial Finance Corporation of India are two examples of .... companies.
3. A company limited by guarantee is known as ....
4. A pure 'guarantee company' does not have a ....

3.3 Classification on the Basis of Number of Members

From the point of view of the general public and on the basis of number of members, a company may be classified as:

1. Private company
2. Public company

3.3.1 Private Company

A private company can be formed by merely two persons by subscribing their names to the Memorandum of Association. It means a company which has a minimum paid-up capital of one lakh rupees or such higher paid up capital as may be prescribed; and by its Articles:

1. Restricts the rights of its members to transfer shares;
2. Limits the number of its members to fifty, excluding its employee-members or past employee-members; provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purpose of this definition, be treated as a single member;

3. Prohibits an invitation to the public to subscribe to its shares and debentures; and

4. Prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.

3.3.2 Public Company

A public company means a company:

1. Which is not a private company;

2. Has a minimum paid-up capital of ₹ 5 lakhs or such higher paid-up capital as may be prescribed;

3. Is a private company which is a subsidiary of a company which is not a private company.

Section 12 prescribes the minimum number of members as seven who have to subscribe their names to the memorandum of association but there is no restriction with regard to the maximum number of members of a public company. A public company may or may not invite public to subscribe to its share capital. In case, it decides to invite public to subscribe to its share capital, then it has to issue a prospectus. In case, it decides not to invite public to subscribe to its share capital and arranges the capital privately then it need not issue a prospectus; it has simply to submit a statement in lieu of prospectus with the Registrar of Companies at least three days before it can make allotment of shares. The articles of such a company do not contain provisions restricting the right of members to transfer their shares. Under the Securities (Contracts) Regulation Act, 1956, shares and debentures of public companies only are capable of being dealt in on a stock exchange.

Task Amit and Sunny have been carrying on business in partnership as building contractors in a small town for some years. They carry on most of the work themselves and only occasionally employ labour. They have no plans to enlarge the area of their operations. It has been suggested to them that they ought to trade as a private company limited by shares. They ask your advice. What are the alleged advantages of trading as a private company limited by shares? Are there any disadvantages in so trading?

Distinction between Private and Public Company

Following are the main points of distinction between a private and a public company:

- In the case of a private company, minimum number of persons to form a company is two while it is seven in the case of a public company.
- In case of a private company the maximum number of members must not exceed fifty whereas there is no such restriction on the maximum number of members in case of a public company.
- In private company, the right to transfer shares is restricted, whereas in case of public company the shares are freely transferable.
- A private company cannot issue a prospectus, while a public company may, through prospectus, invite the general public to subscribe for its shares or debentures.
- A private company can commence business immediately after receiving the certificate of incorporation, while a public company can commence business only when it receives a certificate to commence business from the Registrar.

Notes

- A private company need not hold a statutory meeting but a public company must hold a statutory meeting and file a statutory report with the Registrar.
- The directors of a private company are not required to file with the Registrar written consent to act as directors or sign the memorandum of association or enter into a contract for their qualification shares. But the directors of a public company must file with the Registrar their written consent to act as directors, must sign the memorandum and must enter into a contract for their qualification shares.
- Directors of a private company may be appointed by a single resolution, but it is not so in case of a public company.
- Directors of a private company are not required to retire by rotation, but in case of a public company, at least two-third of the directors must retire by rotation.
- The number of directors in a private company may be increased to any extent without the permission of the Central Government, but in case of a public company if the number of directors is to be more than twelve, then the approval of the Central Government is necessary.
- Two members have to be personally present to form the quorum in a private company but in a public company this number is five members.
- In a private company, there are no restrictions on managerial remuneration.
- In addition to the above, a private company enjoys some special privileges. A public company enjoys no such privileges.
- A private company cannot issue share warrants.

Special Privileges and Exemptions available to a Private Company

A private company enjoys certain special privileges which are not available to a public company. It is so because in a private company the money is raised from few people and generally they belong to the same family or group or are close friends. Therefore, not much public interest is involved therein. But in case of public companies where the money is raised from general public and the number is quite large, it is necessary to safeguard their interests, hence, several restrictions are imposed on public companies.

Following are the special privileges available to a private company:

- A private company can be formed with only two members [s.12 (1)].
- A private company can proceed to allot shares without waiting for the minimum subscription (s.69). The reason is that a private company is not required to offer shares to the public.
- A private company is not required to issue a prospectus. Therefore, it can allot shares without issuing a prospectus or delivering to the Registrar a statement in lieu of prospectus [s.70 (3)].
- A private company need not offer further issue of shares to the existing shareholders, i.e., a private company is free to allot new issue to outsiders [s.81(3)].
- A private company can issue any kind of shares and allow disproportionate voting rights since Ss. 85 to 89 of the Act are not applicable to it. [s.90(2)].
- A private company can commence business immediately after its incorporation [s.149 (7)].
- It need not have an index of members [s.151 (1)].

Notes

- A private company is not required to hold a statutory meeting or to file a statutory report with the Registrar of Companies [s.165 (10)].
- Only two members, who are personally present at the meeting, shall form the quorum unless the articles provide for a larger number [s.174 (1)].
- In case of a private company, poll can be demanded by one person present in person or by proxy, if not more than seven persons are present; if the number present is more than seven, two members present in person or by proxy can demand a poll [s.179 (1) (b)].
- A private company need have a minimum of two directors only [s.252 (2)].
- All the directors may be appointed by a single resolution.
- The directors of a private company need not file their written consent to act as directors or to take up their qualification share (Ss.264 & 266).
- The directors of a private company need not retire by rotation (s.255).
- Section 266 dealing with restrictions on appointment or advertisement of directors is not applicable to a private company [s.266 (5) (b)].
- Where a new director is to be appointed, a special notice of fourteen days is required. This provision is not applicable to a private company, unless it is a subsidiary of a public company [s.257 (2)].
- Directors of a private company can vote on a contract in which they are interested (s.300).
- A private company is exempted from restrictions regarding managerial remuneration.

Loss of Privileges by a Private Company

Section 43 provides that if a private company contravenes any of the three conditions included in its Articles as per s.3(1) (iii), then it will be treated as if it is a public company and it will then result in loss of privileges and exemptions to which it is normally entitled to.

The provision to s.43 states that if the contravention of any of the three restrictions contained in the articles was accidental, or if the Central Government is satisfied that it is just and equitable to grant relief, it may relieve the company from these consequences on the application by the company or any other interested person.

Conversion of a Private Company into a Public Company

Section 44 provides for conversion of a private company into a public company. The procedure is:

- The company in general meeting must pass a special resolution altering its articles in such a manner that they no longer include the provisions of s.3(1) (iii) which are required to be included in the articles of a private company. On the date of the passing of the resolution, the company ceases to be a private company and becomes a public company.
- Within thirty days of the passing of the special resolution altering the articles, the company shall file with the Registrar (i) a printed or type-written copy of the special resolution and (ii) a prospectus or a statement in lieu of prospectus.

  If default is made in filing the resolution and the prospectus or the statement in lieu of prospectus, the company and every officer in default shall be liable to a fine up to ₹5,000 for every day of default.

Notes

- If the number of members is below seven, steps should be taken to increase it to at least seven whilst the number of directors should be increased to at least three, if there are only two directors.
- The word 'Private' is to be deleted before the word 'Limited' in the name.

Conversion of Public Company into a Private Company

There is no direct or express provision in the Act for the conversion of a public company into a private company except a reference in the proviso to s.31(1). A public company having a share capital and membership within the limits imposed upon private companies by s.3(1) (iii), may become a private company by following the procedure as given below:

- The company in general meeting has to pass special resolution for altering the articles so as to include therein the necessary restrictions, limitations and prohibitions and to delete any provision inconsistent with the restrictions. For instance, a private company has to put certain restrictions on the right of members to transfer their shares.
- The word 'Private' should be added before 'Limited'.
- The approval of the Central Government to the alteration in the articles for converting a public company into a private company should be obtained.
- Within one month of the date of the receipt of the order of approval, a printed copy of the altered articles must be filed with the Registrar.
- With thirty days of the passing of the special resolution, a printed or type-written copy thereof should be filed with the Registrar.

Self Assessment

5. Match List-I with List-II and select the correct answer using the codes given below the lists:

	List-I		List-II
A.	Duties of auditors	1.	Access to Books of company
B.	Rights of auditors	2.	Penalty for non-compliance with sections 227 to 229
C.	Liabilities of auditors	3.	Company in general meeting
D.	Removal of auditors	4.	To make a report

	A	B	C	D
(a)	4	1	2	3
(b)	2	3	1	4
(c)	1	4	3	2
(d)	3	2	4	1

6. Match List-I with List-II and select the correct answer using the codes given below the lists:

	List-I		List-II
A.	A pure 'guarantee company'	1.	A company limited by shares
B.	Share company	2.	A company limited by guarantee
C.	Hybrid companies	3.	Company limited by share or guarantee
D.	Wrong statement	4.	Company limited by share and guarantee

	A	B	C	D
(a)	4	1	2	3
(b)	2	1	4	3
(c)	1	4	3	2
(d)	3	2	4	1

3.4 Classification on the Basis of Control

On the basic of control, companies can be divided into:

1. Holding companies
2. Subsidiary companies

3.4.1 Holding and Subsidiary Companies

Where a company has control over another company, it is known as the Holding Company. The company over which control is exercised is called the Subsidiary Company. A company is deemed to be under the control of another if:

- That other controls the composition of its Board of Directors.
- The other company holds more than half in nominal value of its equity share capital (where a company had preference shareholders, before commencement of this Act, enjoying voting rights with that of equity shareholders, for the purpose of control, holding company should enjoy more than half of the total voting power).
- It is a subsidiary of a third company which itself is a subsidiary of the controlling company. For example, where company 'B' is a subsidiary of company 'A' and company 'C' is a subsidiary of company 'B', then company 'C' shall be a subsidiary of company 'A'. If company 'D' is a subsidiary of company 'C', then company 'D' shall also be a subsidiary of company 'B' and consequently also of company 'A'.

Thus, in order to be holding company, a company must either control the composition of the Board of Directors or hold more than half of the nominal value of the equity share capital of another company.

> *Task* In a private limited company it is discovered that there are, in fact, fifty four members. On an enquiry, it is ascertained that six of the members have been employees of the company in the recent past and that they acquired their shares while they were still employees of the company. Is it necessary to convert the company into a public limited company? [***Hint:*** There is no need for conversion. Employee members and ex-employee members are excluded from the number of fifty - the maximum members of a private company. See s.3(1) (iii);].

Company Controlling Composition of Board of Directors

The composition of the Board of Directors of a company shall be deemed to be controlled if the latter has the power, without the consent or concurrence of the other person, to appoint or remove the holders of all or majority of the directorships.

Notes

A company shall be deemed to have the power to appoint a person as a director in other company in the following cases:

- Where a person cannot be appointed thereto without the exercise in his favour by the company of such a power of appointment.
- Where a person's appointment or directorship follows necessarily from his appointment as director, or manager of, or to any other office or employment in the company.
- Where a directorship is held by an individual nominated by the company or a subsidiary thereof.

In determining whether one company is a subsidiary of another, following shall be disregarded:

- Any shares held or power exercisable by the other company in a fiduciary capacity shall be treated as not held or exercisable by it.
- Any shares held or power exercisable in a company by any person under provisions of its debentures or of a trust-deed for securing any issue of such debentures shall be disregarded.
- Any shares held or power exercisable by, or by a nominee for a company or its subsidiary, other than as in clause (2) above, shall be treated as not held or exercisable by it if the ordinary business of that other company is lending money and the shares are held or power is exercisable only by way of security in the ordinary course of business.

However, shares held or power exercisable by any person as a nominee of that other company shall be treated as held or exercisable by the said company. Thus, the shares held or power exercisable by a subsidiary shall be treated as 'held' or 'exercisable' by the holding company. For example, 'B' and 'C', are subsidiaries of company 'A', and both of them hold together more than half of the equity share capital of company 'D' then 'D' shall be deemed to be a subsidiary of 'A' although it has not made any direct investment nor 'B' or 'C' singly hold more than 50% shares, in the company 'D'.

Self Assessment

7. Minimum number of members in case of public company is

   (a) 1 (b) 2

   (c) 5 (d) 7

8. Minimum number of members in case of private company is

   (a) 1 (b) 2

   (c) 3 (d) 4

9. Maximum number of members in case of private company is

   (a) 50 (b) 100

   (c) 150 (d) 200

10. Maximum number of members in case of public company is

   (a) 0 (b) Unlimited

   (c) 50 (d) 100

3.5 Classification on the Basis of Ownership

On the basis of ownership, a company may be:

1. Government company
2. Non-government company

3.5.1 Government Company

Section 617 defines a Government Company as "any company in which not less than 51% of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments [and includes a company which is a subsidiary of a Government Company"].

Government Companies are as much governed by the provisions of the Companies Act as any other company; but by virtue of s.620, the Central Government may direct that any of the provisions of the Act will not apply to them or shall apply only with such exceptions, modifications and adaptations as may be notified by the Government. However, the Central Government cannot exempt the Government Companies from the provisions of Ss.619 and 619-A which specifically deal with such companies.

Section 619 provides that the auditor of a Government Company shall be appointed or re-appointed by the Central Government on the advice of the Comptroller and Auditor-General of India. The ceilings on the number of audits to be undertaken by an auditor under s.224 are equally applicable to audit of Government Companies. The Comptroller and Auditor General of India have the power to direct the manner in which the accounts are to be audited and to give instructions to the auditor in regard to any matter relating to the performance of his functions. He is also empowered to get a supplementary test audit of accounts conducted by persons authorised by him. The auditor of the Government Company has to submit a copy of his audit report to the controller and auditor general who has the right to comment upon, or supplement the audit report in such manner as he thinks fit. Such comments or supplementary audit report must be placed before the annual general meeting of the company at the same time and in the same manner as the auditor's report.

Section 619-A provides that the Central Government must place before both Houses of the Parliament, an annual report on the working and affairs of each Government Company to be prepared within three months of its annual general meetings, together with a copy of the audit report and any comments upon or supplement to, such audit report, made by the controller and auditor general of India. Where a State Government is a participant in a Government Company, this report has, likewise, to be placed before the State Legislature.

Section 619-B provides that the provisions of s.619 as stated above also apply to a company in which the Central Government or any State Government or any Government Corporation hold either singly or jointly not less than 51% of the paid-up share capital.

3.5.2 Foreign Company

Foreign Company is a company incorporated in a country outside India and has a place of business in India.

However, where not less than 50% of the paid-up share capital (whether equity or preference or partly equity and partly preference) of a company incorporated outside India and having an established place of business in India, is held by one or more citizens of India or by one or more Indian bodies corporate, such company shall comply with such of the provisions of the Act as may be prescribed with regard to the business carried on by it in India.

Notes

Section 592 requires that every foreign company which establishes a place of business in India, must, within 30 days of the establishment of such place of business, file with the Registrar of Companies at New Delhi and also the Registrar of Companies of the State in which such place of business is situated: (a) A certified copy of the memorandum and articles of the company and if they are not in English, then a certified translation thereof; (b) the full address of the registered office of the company; (c) a list of the directors of the company and its secretary with full particulars of their nationality, address and business or occupation; (d) the names and addresses of one or more persons resident in India who are authorised to accept service of process or notice or other documents to be served on the company; and (e) the address of the principal place of business in India.

Section 593 provides that in case of any alteration in any of the above particulars, the company has to file with the Registrar of Companies a return of such alteration within the prescribed time.

Section 594 makes the application of the provisions regarding books of account to be kept by a company under s.209 to a foreign company so far as it concerns its business in India. The books of account must be kept at the principal office in India and three copies of balance sheet, profit and loss account and other documents must be delivered to the Registrar with a list in triplicate of all places of business in India.

Section 595 requires a foreign company to exhibit conspicuously on the outside of every office or place of business in India the name of the company and 'limited' or 'private limited,' if it is a limited company and the country in which it is incorporated in English as well as in the local languages in general use in the locality in which the office is situated. Also the prospectus issued in India must contain this information.

Section 596 provides the procedure for service of any process, notice or other documents on a foreign company and it shall be deemed to have been served, if addressed to any person whose name has been delivered to the Registrar of Companies under s.592.

Section 597 provides that the foreign company must also deliver the documents under s.592 to the Registrar of Companies, New Delhi.

Section 598 provides penalty for default in complying with any of the foregoing requirements. The company and every officer of the company who is in default shall be punishable with fine up to ₹ 10,000 and in the case of a continuing default with an additional fine up to ₹ 1000 for every day during which the default continues.

Section 599 provides that the foreign company which fails to comply with the foregoing provisions is prohibited from enforcing any contract by way of a suit, set-off or counter-claim, although it will be liable to be sued in respect of any contract it may have entered into.

Section 600 makes the application of the following Sections to a foreign company: Sections 124-145; 118; 209; 159-160; 209A; 601-608.

Section 584 provides for the winding up of a foreign company. Where a foreign company, which has been carrying on business in India, ceases to carry on such business in India, it may be wound up as an unregistered company under Part X (Ss.582-590), notwithstanding the fact that the company has been dissolved or ceased to exist under laws of the country in which it was incorporated.

Task A group of promoters propose to establish a company for charitable purposes without the addition of the word 'Limited' as part of its name. Discuss briefly the procedure to be followed in addition to the normal procedure for incorporation of a company.

Notes

3.6 One Man Company

A member may hold virtually the entire share capital of a company. Such a company is known as a 'one-man company'. This can happen both in a private company and a public company. The other member/members of the company may be holding just one share each. Such other members may be just dummies for the purpose of fulfilling the requirements of law as regards minimum membership [Salomon v. Salomon & Co. Ltd.].

3.7 Incorporation of Company

Section 12 provides for incorporation of companies which need not have a share capital. A guarantee company is an example of a company without a share capital. However, with the introduction of the requirement of minimum paid up share capital for a public company and a private company, the concept of companies without a share capital has become redundant since 2000. However, a company registered under section 25 is not required to have minimum paid up share requirement. [s. 3(6)]

3.8 Illegal Association

Any company association or partnership carrying on banking business with more than ten members or carrying on any other business with more than twenty members that has for its object the acquisition of gain, without being registered under the Companies act, shall be considered an illegal association.

Exceptions:

- Joint family carrying on a business as such is not illegal association.
- Stock exchange is not considered an illegal association since it is not formed for the purposes of carrying on any business.

Disabilities of an Illegal Association:

- It cannot enter into any contract, nor can it sue any member or outsider.
- It cannot contract any debts.
- It has no legal existence. However, it can get registered any time and become legal.
- Every member shall be personally liable to unlimited extent for all liabilities incurred in such business.
- Every member shall be punishable with fine which may extend to ₹10,000.
- It cannot be wound up under the Act.
- Its members have no remedy against each other for contribution or apportionment in respect of partnership dealings and transactions.

Self Assessment

State whether the following statements are true or false:

11. A subsidiary company does not control the composition of the board of directors of its holding company.
12. A subsidiary company does not hold any shares in its holding company.

Notes

13. A one-mean company is one in which a single person holds virtually all shares of the company.
14. An association of persons may be incorporated having its objects of promoting commerce, arts, science, religion or charity.
15. A partnership firm can be a member of s.25 company.

Case Study

Customer Contract

"I didn't receive the products. The supplier said the goods were detained in the Customs Office because Customs didn't find the original invoice attached to the goods. The supplier explained that it's his company's policy was to issue original invoices only when quantities are above 5 units. He told me to pay for another 2 units for another $150 USD, but I have refused. I paid by Western Union. He registered on your website as a US company, but actually it is Chinese Company.

All his information is fraudulent. His is a fraudulent company!"

If you think their price is very attractive and want to deal with them, it is very necessary for you to verify that they are legitimate company and their contact information is correct. In this case, the fraudster is pretending to be a US company, but all his registered information is false. This can be judged easily by calling his company telephone number or by searching the company name on related state government websites.

Western Union is a dangerous payment method, it can be picked up anywhere in the recipient's country, with no way of tracing the person who picked it up. The criminal remains anonymous. So it is a commonly used payment method for con-artists. So try to avoid adopting this payment method and consider other more secure payment methods like escrow.

Questions:

1. What would you understand if the seller requests you to send payment to another country instead of his registered country showed on the website? (***Hint:*** Refer First Para of case)
2. Analyze the ways in which a person can find out the whether the company is fraudulent. (***Hint:*** Take full knowledge about the product and company if you use virtual mode of transaction)

3.9 Summary

- No company, association or partnership consisting of more than twenty persons shall be formed for the purpose of carrying on any other business that has for its object the acquisition of again by the company, association or partnership, or by the individual members thereof, unless it is registered as a company under this Act, or is formed in pursuance of some other Indian law.
- This section shall not apply to a joint family as such carrying on a business; and where a business is carried on by two or more joint families, in computing the number of persons for the purposes of sub-sections (1) and (2), minor members of such families shall be excluded.

Notes

- Every member of a company, association or partnership carrying on business in contravention of this section shall be personally liable for all liabilities incurred in such business.
- Every person who is a member of a company, association or partnership formed in contravention of this section shall be punishable with fine which may extend to one thousand rupees.
- Any seven or more persons, or where the company to be formed will be a private company, any two or more persons, associated for any lawful purpose may, by subscribing their names to a memorandum of association and otherwise complying with the requirements of this Act in respect of registration, form an incorporated company, with or without limited liability.

3.10 Keywords

Company Limited by Shares: A company limited by shares is a registered company having the liability of its members limited by its memorandum of association to the amount, if any, unpaid on the shares respectively held by them.

Government Company: Section 617 defines a Government Company as any company in which not less than 51% of the paid-up share capital is held by the Central Government, or by any State Government.

One Man Company: A member may hold virtually the entire share capital of a company. Such a company is known as a 'one-man company'.

Private Company: A private company can be formed by merely two persons by subscribing their names to the Memorandum of Association.

Subsidiary Company: A company over which control is exercised by that other company is called the Subsidiary Company.

3.11 Review Questions

1. State the various classes of companies that can be formed under the Act. Explain the characteristics of each.
2. Define a 'Private Company'. State the special privileges and exemptions enjoyed by a private company.
3. Define a public company. Distinguish between a private company and a public company.
4. What is your opinion on: "There are five members in a public company"?
5. What does a private company have to do in order to become a public company?
6. "A company can be incorporated under the Companies Act without the suffix 'limited' or 'private limited', as the case may be". Discuss.
7. "A Government Company is governed by the same legal provisions as any other company registered under the Companies Act." Discuss.
8. Explain there may be a company without a share capital.
9. Describe a one-man company is perfectly a valid company.
10. Write explanatory notes on:
    (i) Government Company

Notes

(ii) Holding and subsidiary companies

(iii) Foreign Company

(iv) Non-profit company/section 25 company

(v) Guarantee Company

(vi) Investment Company

11. Explain the consequences and remedy, if any, in respect of the following situations:

    (i) A private company has contravened the provisions of s.3(i)(iii) (i.e. definition of a private company) of the Companies Act, 1956;

    (ii) The number of members of a company registered as a public company is reduced to five.

Answers: Self Assessment

1.	Chartered Company	2.	Statutory
3.	Guarantee Company	4.	Share Capital
5.	(a)	6.	(b)
7.	(d)	8.	(b)
9.	(a)	10.	(b)
11.	True	12.	True
13.	False	14.	True
15.	True		

3.12 Further Readings

Books

Aggarwal, Rohini (2003), "Student's Guide to Mercantile and Commercial Laws," Taxmann's, New Delhi.

Avtar Singh, *Company Law*, Eastern Publishers.

Begrail, Ashok K, *Company Law*, Vikas Publishing House, Delhi.

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Unit 4: Formation of Company

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the process of formation of a company;
- Describe pre-incorporation of company;
- Elaborate upon provisional contracts.

Introduction

A declaration by an advocate of the Supreme Court or of a High Court, an attorney or a pleader entitled to appear before a High Court or ["a secretary or a chartered accountant, in whole-time practice in India"] who is engaged in the formation of a company, or by a person named in the articles as a director, manager or secretary of the company, that all the requirements of this Act and the rules there under have been complied with in respect of registration and matters precedent and incidental thereto, shall be filed with the Registrar; and the Registrar may accept such a declaration as sufficient evidence of such compliance.

4.1 Formation of Company

The whole process of formation of a company may be roughly divided, for convenience, into three parts i.e., Promotion, Registration and Floatation.

Notes

4.1.1 Promotion

Promotion is a term of wide import denoting the preliminary steps taken for the purpose of registration and floatation of the company. The persons who assume the task of promotion are called promoters. The promoter may be an individual, syndicate, association, partnership or company.

Who is a Promoter?

This term has not been defined under the Act, although the term is used expressly in Ss. 62, 69, 76, 478 and 519.

Perhaps, the true test of whether a person is a promoter is whether he has a desire that the company be formed and is prepared to take some steps, which may or may not involve other persons, to implement it. However, persons assisting the promoters by acting in a professional capacity do not thereby become promoters themselves. The solicitor; who drafts the Articles, or the accountant who values assets of a business to be purchased, are merely giving professional assistance to the promoters. If, however, he goes further than this, e.g., by introducing his client to a person who may be interested in purchasing shares in the proposed company, he would be regarded as promoter.

Duties and Liabilities of Promoters

Promoters have been described to be in fiduciary relationship (relationship of trust and confidence) with the company. This relationship of trust and confidence requires the promoter to make a full disclosure of all material facts relating to the formation of the company. He should not make any secret profit at the expense of the company he promotes, without the knowledge and consent of the company and if he does so, the company can compel him to account for it.

A promoter is not forbidden to make profit but to make secret profit. In Gluckstein v. Barnes, a Syndicate of persons was formed to buy a property called 'Olympia' and re-sell this Olympia to a company to be formed for the purpose. The Syndicate first bought the debentures of the old Olympia Company at a discount. Then they bought the company itself for £ 1,40,000. Out of this money provided by themselves the debentures were repaid in full and a profit of £ 20,000 made thereon. They promoted a new company and sold Olympia to it for £ 1,80,000. The profit £ 40,000 was revealed in the prospectus but not the profit of £ 20,000.

Held: Profit of £ 20,000 was a secret profit and the promoters of the company were bound to pay it to the company because the disclosure of this profit by themselves in the capacity of vendors to themselves in the capacity of directors of the purchasing company was not sufficient.

Disclosure to be made to whom? In Erlanger v. New Sombrera Phosphate Co., it was held that the disclosure should be made to an independent and competent Board of Directors. This duty is not discharged if he makes the disclosure to the Board of Directors who are mere nominees of his own or are in his pay.

Where it is not possible to constitute an independent Board of Directors, the disclosure should be made to the whole body of persons who are invited to become shareholders and this can be done through the prospectus. Thus, the promoters have to ensure that 'the real truth is disclosed to those who are induced by the promoters to join the company.'

Liabilities of a Promoter for Non-Disclosure

In case a promoter fails to make full disclosure at the time the contract was made, the company may either:

- Rescind the contract and recover the purchase price where he sold his own property to the company, or
- Recover the profit made, even though rescission is not claimed or is impossible, or
- Claim damages for breach of his fiduciary duty. The measure of damages will be the difference between the market value of the property and the contract price.

Liabilities of a Promoter under the Companies Act

- Promoter is liable to the original allottee of shares for the mis-statements contained in the prospectus. It is clear that his liability does not extend to subsequent allottees. He may also be imprisoned for a term which may extend to 2 years or may be punished with fine up to ₹50,000 for such untrue statements in the prospectus (Ss.62 and 63).
- In the course of winding up of the company, on an application made by official Liquidator, the court may make a promoter liable for misfeasance or breach of trust (s.543). The court may also order for the public examination of the promoter (Ss.478 and 519).

Where there are more than one promoter, they are jointly and severally liable and if one of them is sued and pays damages, he is entitled to claim contribution from other or others. However, the death of a promoter does not relieve his estate from liability arising out of abuse of his fiduciary position.

4.1.2 Registration (Ss.12, 33)

Section 12 states that, "any seven or more persons or where the company to be formed will be a private company, two or more persons, associated for any lawful purpose may, by subscribing their names to a memorandum of association and otherwise complying with the requirements of this Act in respect of registration form an incorporated company, with or without limited liability." Thus, the promoters will have to get together at least seven persons in the case of a public company, or two persons in the case of a private company to subscribe to the memorandum of association.

Section 33 states that the following three documents are required to be presented to the Registrar of Companies of the State in which the registered office of the company is to be situated, for the purpose of registration of a company:

1. The memorandum of the company;
2. The articles, if any;
3. The agreement, if any, which the company proposes to enter into with any individual for appointment as its managing or wholetime director or manager.

The documents in (1) and (2) above are required to be signed by seven persons in the case of a public company and by two persons in the case of a private company. As we shall see later, certain types of companies need not frame their own Articles of Association; in that case "Regulations for Management of a Company Limited by shares" (given in Table A of Schedule I to the Act, 1956) may be adopted.

Notes

Task Shyam forges all the seven signatures on a memorandum of association, and he obtains a certificate of incorporation. After some time, the registrar comes to know and wants to revoke the certificate. Can he do so?

Section 33 also requires a declaration to be filed with the Registrar along with the Memorandum and the Articles. This is known as "Statutory Declaration of Compliance." It can be made by an advocate of Supreme Court or of a High Court, an attorney or pleader entitled to appear before a High Court, or a Company Secretary or a Chartered Accountant in wholetime practice in India, who is engaged in the formation of the company, or by a person named in the articles as a director, manager or secretary of the company. The declaration must certify that all requirements of the Act and Rules made there under in respect of registration have been complied with.

Section 266 requires that if the first directors are appointed by the articles then the following must be complied with before the registration of articles with the Registrar:

- Written consent of those directors to act, signed by themselves, or by an agent duly authorised in writing; and
- An undertaking in writing signed by each such director to take from the company and pay for his qualification shares (if any), unless he has taken his qualification shares and paid or agreed to pay for them, or signed the Memorandum for a number of shares not less than the qualification shares.

Section 266 is applicable only to a public company having a share capital.

4.1.3 Floatation

When a company has been registered and has received its certificate of incorporation, it is ready for 'floatation'; that is to say, it can go ahead with raising capital sufficient to commence business and to carry it on satisfactorily.

We have seen earlier under 'classification of companies' that a private company is prohibited from inviting public to subscribe to its share capital. Therefore, when a private company is formed, the necessary capital is obtained from friends and relatives by private arrangement.

In the case of a public company also, the promoters may not invite public to subscribe to its share capital and may arrange the capital privately as in the case of a private company. In such a case, the intention of the promoters is to take advantages of incorporation not available to a private company, e.g., to have unlimited number of members, to confer unrestricted right to transfer shares on the members, etc. However, by far, large numbers of public companies raise their capital in the very first instance by inviting public to subscribe to its share capital.

Section 70 makes it obligatory for every public company to take either of the following two steps: (i) Issue a prospectus in case public is to be invited to subscribe to its capital, or (ii) Submit a 'statement in lieu of prospectus' in case capital has been arranged privately. It must be done at least 3 days before allotment.

Self Assessment

Fill in the blanks:

1. .... is a term of wide import denoting the preliminary steps taken for the purpose of registration and floatation of the company.

Notes

2. Promoters have been described to be in .... with the company.
3. A .... is not forbidden to make profit but to make secret profit.
4. Promoter is liable to the original .... of shares for the mis-statements contained in the prospectus.

4.2 Availability of Company Name

Section 20 states that a company cannot be registered by a name, which in the opinion of the Central Government is undesirable. Therefore, it is advisable that promoters find out the availability of the proposed name of the company from the Registrar of Companies. For the purpose, three names in order of priority should be filed.

The following two documents, though not required to be filed for the purpose of registration, are usually delivered along with the aforesaid documents.

1. The address of the registered office of the company (s.146).
2. Particulars regarding directors, manager and secretary, if any (s.303).

These two documents are required to be submitted within thirty days of registration of the company.

4.3 Certificate of Incorporation/Consequences of Incorporation

When the aforesaid documents have been filed with the Registrar and the necessary fees paid, the Registrar will, if he is satisfied, enter the name of the company on the Register of Companies maintained by him (s.33) and then will issue a Certificate of Incorporation under his signature in token of registration of the company on the date noted on it (s.34). This certificate serves the same purpose in the case of a company which a birth certificate does in the case of a natural person.

On registration, the company comes into existence as a legal person distinct from its members who constitute it from the earliest moment of the day of incorporation stated in the certificate of incorporation, with rights and liabilities similar to a natural person, competent to enter into contracts (s.34).

The certificate of incorporation is conclusive evidence that all the requirements of the Companies Act in respect of registration and of matters precedent and incidental thereto have been complied with. Accordingly, if memorandum is found to be materially altered after signature but before registration (Peel's case), or is signed by only one person for all the seven subscribers or the signatories be all infants (Moosa Goolam Ariff v. Ebrahim Gulam Ariff), the certificate would be nevertheless conclusive and would not affect the status and existence of the company as a legal person although such irregularities might give rise to claim between the subscribers.

This provision prevents the reopening of matters prior and contemporaneous to the registration and essential to it and it places the existence of the company as a legal person beyond doubt.

In the case of Moosa v. Ebrahim, the memorandum was signed by two adult persons and by a guardian of the other five members, who were minors. The Registrar, however, registered the company and issued a certificate of incorporation. The court held the certificate to be conclusive for all purposes.

In another case of Jubilee Cotton Mills Ltd. v. Lewis, the Registrar issued a certificate of incorporation on January 8th, but dated it January 6th, which was the date he received the documents. On January 6th, the company made an allotment of share to Lewis. Held, that the certificate was conclusive evidence of incorporation on January 6th and that the allotment was not void on the ground that it was made before the company was incorporated.

However, if a company has been incorporated with illegal objects, the illegal objects would not become legal by the issue of the certificate.

Section 36 states that, on registration, memorandum and articles of the company bind the company and its members to the same extent as if they respectively had been signed by the company and by the members and contained covenants on its and their part to observe all the provisions contained in the Memorandum and Articles.

Self Assessment

5. The companies which are formed under special charter granted by the king or queen of England are called.
   (a) Statutory companies (b) Registered companies
   (c) Chartered companies (d) None of these
6. The companies which are formed under special Act. Those companies are called as
   (a) Chartered companies (b) Statutory companies
   (c) Registered companies (d) None of these
7. The companies which are formed under companies Act. 1956. They will be called as
   (a) Chartered companies (b) Statutory companies
   (c) Registered companies (d) None of these
8. If the guarantee Co. is having no share capital, the liability of shareholders will be
   (a) To the extent of guarantee (b) Unpaid value of shares
   (c) Unlimited (d) None of the above

4.4 Pre-incorporation or Preliminary Contracts

We have mentioned earlier that a company is an artificial person and is capable of entering into contracts. The promoters may enter into contracts with third parties on behalf of the proposed company before obtaining the certificate of incorporation or after obtaining the certificate of incorporation but before obtaining the certificate to commence business. Thus, in the case of a public company following are the three situations when contracts may be entered into:

1. Contracts before incorporation
2. Contracts after incorporation but before obtaining the certificate to commence business
3. Contracts after obtaining the certificate to commence business.

However, in the case of a private company, as it is not required to obtain the certificate to commence business, there are only two situations, i.e., (i) contracts before incorporation; and (ii) contracts after incorporation.

Those contracts which are entered into by promoters for the intended company before registration of the company are known as pre-incorporation or preliminary contracts. Very often a company is formed to purchase an existing business or other property. In such circumstances, the promoters enter into contracts with the owners of the business or property to be acquired by the proposed company.

A pre-incorporation contract never binds a company since a person cannot contract before his (or its) existence and a company before incorporation has no legal existence. However, S.15(h) and 19 (e) of the Specific Relief Act, 1963 has provided some relief in this regard. It provides that when promoters of a company have, before its incorporation entered into a contract for the purpose of the company and such a contract is warranted by the terms of its incorporation, the contract may be specifically enforced by or against the company. It is, however, necessary that the company in such a case must have accepted the contract after its incorporation and communicated such acceptance to the other party to the contract. Contracts like preparation and printing of the Memorandum, Articles, etc., renting premises, hiring secretarial staff are envisaged under the Act.

Liability of promoters vis-à-vis pre-incorporation contracts. An important question that needs to be tackled is what is the position of a promoter vis-à-vis preliminary contracts? If the company does not execute a fresh contract after incorporation and the contract is not one warranted for the purpose of incorporation of the company, what will be the legal position of the promoter who brings about such a contract?

In Phonogram Ltd. v. Lane (1982) Q.B. 938, it was observed that although a contract made before a company's incorporation cannot bind the company, it is not wholly devoid of legal effect, even if all the persons who negotiated the contract are aware that the company has not yet been incorporated.

The contract takes effect as a personal contract with the persons who purport to contract on the company's behalf [Kelner v. Baxter (1866) LR 2 CP 174]. Promoters shall be liable to pay damages for failure to perform the promises made in the company's name. This shall be so even where the contract expressly provides that only the company's paid up capital shall be answerable for performance [Scot v. Lord Ebury (1867) LR 2 CP 255].

Task The registrar of companies issued a certificate of incorporation on 8 January, 2006. However, by mistake, the certificate was dated 5 January, 2006. An allotment of shares had been made on 7 January, 2006. Can the allotment be declared void on the ground that it was made before the company was incorporated?

4.5 Provisional Contracts

Those contracts which are entered into by a public company after obtaining the certificate of incorporation but before getting the certificate to commence business are known as provisional contracts [s.149(4)]. Such contracts are not binding on the company until the company is entitled to commence business and on that date they shall become binding, without any need for ratification.

If the company is unable to obtain the certificate to commence business, the provisional contracts will never become binding on it, and no one can sue in respect of them.

As it shall be explained later, a company can do only such acts as by its memorandum it is expressly or impliedly authorised to do. Any transaction which is not so authorised is *ultra vires* (beyond the powers) and is null and void *ab initio*. Neither the company, nor the other party to the contract can enforce it.

Notes

4.6 Form of Contracts made by Companies

Section 46 provides that a company can, in general, contract in the same form as an individual. Thus, a contract which, if made between private persons, is required to be in writing, may be made on behalf of the company also in writing. It should be signed by a person acting under the express or implied authority of the company. Such contracts may also be varied or discharged in the same manner. Also, a contract which would be valid if made between private persons although made orally or by parol on behalf of the company by any person acting under express or implied authority. Such contracts could also be varied or discharged in the same manner.

Some contracts are required to be under seal and, therefore, s.147 requires every company incorporated under the Act to have a common seal upon which its name should be engraved in legible characters.

Under s.50, a company may obtain power through its articles to have an official seal, for use outside India. This is in addition to a common seal.

Self Assessment

State whether the following statements are true or false:

9. A promoter stands in a fiduciary relationship with the company he promotes.
10. The validity of a certificate of incorporation cannot be disputed on any grounds whatsoever.
11. After the grant of certificate of incorporation, if all the subscribers to the memorandum die, the certificate of incorporation automatically gets cancelled.
12. Unlike a private company, a public company cannot commence business immediately after incorporation.
13. A certificate of incorporation is conclusive evidence that all the requirements of the Companies Act, as regards registration have been complied with.

Case Study

Company Differences

It would have been business as usual at multinational drug-maker Pfizer's annual shareholder meeting, but for a dissenting LIC representative who opposed two enabling proposals to increase the salary of the managing director and the commission of two Indian non-executive directors, respectively.

LIC totally holds 14.38 per cent in Pfizer, and the LIC representative told that he was communicating the decision taken by the corporation. He was, however, unable to give reasons behind the decision. Market observers indicated that LIC could push for a poll on the proposal, given its equity holding.

One of the enabling resolutions was regarding Pfizer's Managing Director in India, Mr. Kewal Handa's salary, proposing that it be increased from its 2007-level of ₹ 1.80 crore to a maximum of ₹ 2.50 crore a year.

The other enabling resolution was with reference to resident non-executive directors Mr. R. A. Shah and Mr. Pradip Shah, seeking to raise their commission, at the rate of one per cent of the company's profit, up to ₹ 50 lakh a year.

Contd...

The company explained that the commission for non-executive directors was upped to ₹ 20 lakh a year in 2004, effective for a five-year period starting December 2003.

Shareholders should be part of the good and bad times of the company, said a shareholder who has been holding a Pfizer share since the beginning, when the multinational sent letters to shareholders inviting them into their fold.

He, along with some other shareholders, were expressing their unhappiness over the dividend. The dividend for the year ended 2008 was ₹ 12.50 per share, as compared with the previous year's ₹ 27.50 per share. However, Pfizer's Chairman, Mr. R.A. Shah, clarified that there were no motives behind the company's actions and dividends were generous when the circumstances warranted it.

On Pfizer Inc's recently announced plan to raise stake in its Indian subsidiary to 75 per cent, from the present 41 per cent, he said, that there was no intention to delist, "at this time".

Unlike info-tech companies, he said, the applicable milestone for Pfizer for reverse book building was 75 per cent. Creeping acquisition and buy-back was allowed only till 75 per cent, he clarified. Also, he said, Pfizer was also evaluating the possibility of merging Duchem (that has pharma and animal health businesses) with itself.

Detailing Pfizer's plans to expand its domestic reach, Mr. Handa said that they would increase the product portfolio and value offerings from the company. The company was planning to increase its field force by 300 people, including 100 for just retail sales.

Question

Discuss LIC's role in Pfizer. (***Hint:*** Summarize the LIC responsibilities in Pfizer)

4.7 Summary

- The formation of a company, shall state the matters specified in Part I of Schedule II and set out the reports specified in Part II of that Schedule; and the said Parts I and II shall have effect subject to the provisions contained in Part III of that Schedule.
- A condition requiring or binding an applicant for shares in or debentures of a company to waive compliance with any of the requirements of this section, or purporting to affect him with notice of any contract, document or matter not specifically referred to in the prospectus, shall be void.
- Expert to be unconnected with formation or management of company.

4.8 Keywords

Floatation: When a company has been registered and has received its certificate of incorporation, it is ready for 'floatation'; that is to say, it can go ahead with raising capital sufficient to commence business and to carry it on satisfactorily.

Pre-incorporation contract: A pre-incorporation contract never binds a company since a person cannot contract before his (or its) existence and a company before incorporation has no legal existence.

Promoters: Promoters have been described to be in fiduciary relationship (relationship of trust and confidence) with the company.

Promotion: 'Promotion' is a term of wide import denoting the preliminary steps taken for the purpose of registration and floatation of the company.

Notes

4.9 Review Questions

1. Who is a promoter of a company? Discuss, citing legal cases, his legal position in relation to the company he promotes.
2. What are the liabilities of promoters under the Companies Act, 1956?
3. Describe the various stages of incorporation of a public company limited by shares.
4. What documents are required to be filed for incorporation?
5. Discuss the nature and purpose of such documents.
6. What are the conditions; precedent to be complied with by a company for obtaining a certificate to commence business? Are these conditions applicable to all classes of companies?
7. Explain certificate of incorporation in detail.
8. Certificate of commencement of business in the case of a public limited company. Discuss.
9. "Promoters have been described to be in fiduciary relationship (relationship of trust and confidence) with the company". Discuss.
10. "A pre-incorporation contract never binds a company since a person cannot contract before his (or its) existence and a company before incorporation has no legal existence". Discuss.

Answers: Self Assessment

1.	Promotion	2.	fiduciary relationship
3.	promoter	4.	allottee
5.	(c)	6.	(b)
7.	(c)	8.	(a)
9.	True	10.	True
11.	False	12.	True
13.	True		

4.10 Further Readings

Books

Aggarwal, Rohini (2003), "Student's Guide to Mercantile and Commercial Laws," Taxmann's, New Delhi.

Avtar Singh, *Company Law*, Eastern Publishers.

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Notes

Unit 5: Memorandum of Association

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define memorandum;
- Describe its form and contents;
- Explain the alteration of memorandum;
- Elaborate upon doctrine of ultra vires.

Introduction

'Memorandum' means "the memorandum of association of a company as originally framed or as altered from time to time in pursuance of any previous companies law or of this Act"–S. 2(28). Any seven or more persons, or where the company to be formed will be a private company, any two or more persons, associated for any lawful purpose may, by subscribing their names to a memorandum of association and otherwise complying with the requirements of this Act in respect of registration, form an incorporated company, with or without limited liability.

5.1 Memorandum of Association – Meaning and Purpose

The Memorandum of Association of a company is its charter which contains the fundamental conditions upon which alone the company can be incorporated. It tells us the objects of the company's formation and the utmost possible scope of its operations beyond which its actions cannot go. Thus, it defines as well as confines the powers of the company. If anything is done beyond these powers, that will be *ultra vires* (beyond powers of) the company and so void.

The memorandum serves a two-fold purpose viz., it enables shareholders, creditors and all those who deal with the company to know what its powers are and what is the range of its activities. Thus, the intending shareholder can find out the field in, or the purpose for which his money is going to be used by the company and what risk he is taking in making the investment. Also, any one dealing with the company, say, a supplier of goods or money will know whether the transaction he intends to make with the company is within the objects of the company and not *ultra vires* its objects.

5.2 Form and Contents

Section 14 requires that the memorandum of a company shall be in such one of the Forms in Tables B, C, D and E in Schedule I to the Act, as may be applicable in the case of the company, or in Forms as near thereto as circumstances admit. Section 15 requires the memorandum to be printed, divided into paragraphs, numbered consecutively, and signed by at least seven persons (two in the case of a private company) in the presence of at least one witness, who will attest the signature. Each of the members must take at least one share and write opposite his name the number of shares he takes. Section 13 requires the memorandum of a limited company to contain:

1. The name of the company, with 'limited' as the last word of the name in the case of a public company and 'private limited' as the last words in the case of a private company;
2. The name of the state, in which the registered officer of the company is to be situated;
3. The objects of the company, stating separately 'main objects' and 'other objects';
4. The declaration that the liability of the members is limited;
5. The amount of the authorised share capital, divided into shares of fixed amounts.

These contents of the memorandum are called compulsory clauses.

5.2.1 Use of Certain Keywords as Part of the Name

The Department of Company Affairs has clarified that if a company used any of the following keywords in its name, it must have a minimum authorised capital mentioned against the keywords:

Notes

Key words	Required Authorised Capital (₹)
1. Corporation	5 crores
2. International, Globe, Universal Continental, Inter-continental, Asiatic, Asia, being the first word of the name.	1 crore
3. If any of the words in (2) above stated is used within the name (with or without brackets)	50 lakhs
4. Hindustan, India, Bharat, being the first word of the name	50 lakhs
5. If any of the words at (4) above is used within the name (with or without brackets)	5 lakhs
6. Industries/Udyog	1 crore
7. Enterprises, Products, Business, Manufacturing	10 lakhs

5.2.2 Publication of Name (s.147)

Every company shall,

(i) paint or affix its name and the address of its registered office and keep the same painted or affixed, on the outside of every office or place of business in a conspicuous position in letters easily legible and in the language in general use in the locality.

Department of Company Affairs has clarified that exhibition of its name in English alone, without at the same time showing it in the local language will not be sufficient compliance with the requirements of the Section.

The words 'outside of every office' do not mean outside the premises in which the office is situated [Dr. H.L. Batliwala Sons & Co. Ltd. v. Emperor (1941) 11 Comp. Cas. 154 (Bom)]. Where office is situated within a compound, the display outside the office room though inside the building is sufficient.

(ii) have its name engraven in legible characters on its seal.

(iii) have its name and address of its registered office mentioned in legible characters in all business letters, bill heads, negotiable instruments, invoices, receipts, etc., of the company.

Penalty: If a company does not paint or affix its name and the address of its registered office in the prescribed manner, the company and every officer of the company who is in default shall be punishable with fine.

Also, every officer of a company or any person on its behalf who signs or authorises to be signed on behalf of the company any bill of exchange, hundi, promissory note or cheque, etc., wherein the name of the company is not mentioned in the prescribed manner, shall be personally liable to the holder of such bill of exchange, hundi, promisory note, cheque, etc., for the amount thereof unless it is paid the company. Personal Liability will, however, be not incurred in the following cases:

- The holder of a negotiable instrument, on which the company's name has been incorrectly stated, will not be able to enforce the personal liability under s.147(4) against the officer concerned if the error was due to the holder's own act [Durham Fancy Goods Ltd. v. Michael Jackson (Fancy Goods) Ltd. and Another (1968) 2 Q.B. 839].
- The word 'Limited' is abbreviated to 'Ltd.' (P. Stacey & Co. v. Wallis (1912) 28 T.L.R. 219.

- There is an accidental omission of the word 'limited' [Dermatine Co. v. Ashworth (1905) 21 T.L.R. 510]. In this case, a bill of exchange was accepted on behalf of a limited company. The rubber stamp of the company was longer than the paper. As a result, the word 'limited' did not appear on the instrument. Held, the directors who accepted the bill of exchange were not personally liable because omission was neither deliberate nor of negligent origin. It was an obvious error of most trifling kind and the mischief aimed at by the Act did not here exist.

5.2.3 The Registered Office Clause [s.13(1) (b)]

This clause states the name of the State in which the registered office of the company will be situated. Every company must have registered office which establishes its domicile and it is also the address at which company's statutory books must normally be kept and to which notices and all other communications can be sent. The notice of the exact situation (address) of the registered office may be given to the Registrar within thirty days from the date of incorporation (s.146).

As in the case of publication of the company's name, s.147 also makes similar provisions regarding publication of the Registered Office of the company.

5.2.4 The Objects Clause [s.13 (1) (d)]

The objects clause defines the objects of the company and indicates the sphere of its activities. A company cannot do anything beyond or outside its objects and any act done beyond them will be *ultra vires* and void and cannot be ratified even by the assent of the whole body of shareholders. However, a company may do anything which is incidental to and consequential upon the objects specified and such act will not be *ultra vires.* Thus, a trading company has an implied power to borrow money, draw and accept bills of exchange.

Task Advise Asiatic Government Security Life Assurance Co. Ltd. whether it can seek injunction against the New Asiatic Insurance Co. Ltd. which was subsequently formed, restraining it from having in its name the word 'Asiatic' on the ground that it has caused confusion and can deceive the public. [***Hint:*** Yes, it can seek injunction against the New Asiatic Insurance Co. Ltd. The two companies are in insurance business, the impression may be created that both of them are inter-related and the word 'Asiatic' is quite an imaginary word and does not mean anything. Mere addition of the word 'New' is not likely to give an otherwise impression. See s.20.]

Section 13, read along with Tables 'B', 'C', 'D' and 'E', in the act requires the company to divide its objects clause into three parts:

1. Main objects of the company to be pursued by the company on its incorporation;
2. Objects incidental or ancillary to the attainment of the main objects; and
3. Other objects of the company not included in (a) and (b) above.

A company, may on receipt of certificate to commence business, pursue any business given in the 'main objects'. In the case of companies (other than trading companies) with objects not confined to one State, the Memorandum must give the name of the State/(s) to whose' territories the objects extend'. No business given in 'other objects' can, however, be commenced unless prior approval of shareholders with regard thereto is obtained by way of special resolution passed in general meeting [s.149 (2A)]. Where special resolution is not passed, the Central Government, may on an application made by the Board of directors, allow a company to

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commence business in the 'other objects', provided the votes cast in favour of the resolution exceed the votes cast against the resolution, if any [s.149(2B)].

The objects of the company must not be illegal, immoral or opposed to public policy or in contravention of the Act. For example, s.77 prohibits a company to purchase its own shares.

5.2.5 The Liability Clause [s.13 (2)]

This clause states the nature of liability of the members. In case of a company with limited liability, it must state that liability of members is limited, whether it be by shares or by guarantee. This means that in case of a company limited by shares, a member can be called upon at any time to pay to the company the amount unpaid on the shares held by him. In case of companies limited by guarantee, this clause will state the amount which every member undertakes to contribute to the assets of the company in the event of its winding up.

In the case of an unlimited company, this clause need not be given in the memorandum. In fact, the absence of this clause in the memorandum means that the liability of its members is unlimited.

As per s.45, under certain circumstances the liability of members of a limited company becomes unlimited.

5.2.6 The Capital Clause [s.13 (4)(c)]

This clause states the amount of share capital with which the company is registered and the mode of its division into shares of fixed value, i.e., the number of shares into which the capital is divided and the amount of each share. If there are both equity and preference shares, then the division of the capital is to be shown under these two heads.

5.2.7 The Association Clause [s.13(4)(c)]

At the end of the memorandum of every company there is an association or subscription clause or a declaration of association which reads something like this:

"We, the several persons whose names and addresses and occupations are subscribed, are desirous of being formed into a company in pursuance of this memorandum of association and we respectively agree to take the number of shares in the capital of the company set opposite our respective names".

Then follow the names, addresses, descriptions, occupations of the subscribers and the number of shares each subscriber has taken and his signature attested by a witness.

Self Assessment

Fill in the blanks:

1. The memorandum serves a .... purpose.
2. .... requires that the memorandum of a company shall be in such one of the Forms in Tables B, C, D and E in Schedule I to the Act.
3. As in the case of publication of the company's name, ... also makes similar provisions regarding publication of the Registered Office of the company.
4. .... states the nature of liability of the members.
5. In the case of an ...., liability clause need not be given in the memorandum.

5.3 Alteration of Memorandum

Notes

Section 16 provides that the company cannot alter the conditions contained in memorandum except in the cases and in the mode and to the extent express provision has been made in the Act. These provisions are explained herein below.

5.3.1 Change of Name

Section 21 provides that the name of a company may be changed at any time by passing a special resolution at a general meeting of the company and with the written approval of the Central Government. However, no approval of the Central Government is necessary if the change of the name involves only the addition or deletion of the word 'private' (i.e., when public company is converted into a private company or vice versa).

If through inadvertence or otherwise, a company has been registered with a name which is identical with or too closely resembles with the name of an existing company, the company may change its name by passing an ordinary resolution and by obtaining the approval of the Central Government in writing (s.22).

The change of name must be communicated to the Registrar of Companies within 30 days of the change. The Registrar shall then enter the new name on the register in the place of the old name and shall issue a fresh certificate of incorporation with necessary alterations [s.23(1)]. The change of name becomes effective on the issue of fresh certificate of incorporation. The Registrar will also make the necessary alteration in the memorandum of association of the company [s.23(2)].

However, change of name shall not affect any rights or obligations of the company or render defective any legal proceeding which might have been continued or commenced by or against the company by its former name may be continued by or against the company by its new name [s.23(3).]

Within 30 days of the passing of the special resolution, a printed or a type written copy of the resolution should be sent to the Registrar of Companies.

5.3.2 Change of Registered Office

The procedure depends on whether the change is within the jurisdiction of same registrar of companies (s. 146) or whether the shifting is to the jurisdiction of another registrar of companies in the same state (s. 146 and s. 17A). This may include:

- ***Change of registered office from one premises to another premises in the same city, town or village:*** The company may do so anytime. A resolution passed by the Board of directors shall be sufficient. However, notice of the change should, within 30 days after the date of the change, be given to the Registrar who shall record the same (s.146).
- ***Change of registered office from one town or city or village to another town or city or village in the same state:*** In this case, the procedure is:
  - A special resolution is required to be passed at a general meeting of the shareholders;
  - A confirmation of regional director is to be obtained;
  - A copy of special resolution and confirmation by regional director is to be filed with the within 30 days;
  - Within 30 days of the removal of the registered office, notice of the new location has to be given to the Registrar who shall record the same. (s.146).

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- Change of registered office from one state to another state: Section 17 provides for the shift of the registered office from one State to another and such shift involves alteration of memorandum. The change of registered office from one locality to another in the same city or from one city to another in the same State does not involve alteration of memorandum.

The shift of the registered office from one State to another can be done by a special resolution which is required to be confirmed by the Central Government. The Central Government, before confirming the resolution, will satisfy itself that sufficient notice has been given to every creditor and all other persons whose interests are likely to be affected by the alteration, including the Registrar of Companies and the Government of the State in which the registered office is situated. Also, the Central Government will give an opportunity to members and creditors of the company, the Registrar and other persons interested in the company to be heard. The Central Government may confirm the resolution on such terms and conditions as it thinks fit.

It was made clear in Zuari Agro Chemicals Ltd. v. F. S. Wadia and Others (1974) 44 Comp. Cas. 465 that the Company Law Board (now Central government) will not substitute its own wisdom or judgement for the collective wisdom or judgement of the company expressed in special resolution. But the *bonafides* of the company's application for change can be screened.

Task A company is engaged in jute business. The members unanimously pass a resolution to start business in rubber. The proposed alteration in the objects clause is submitted to the Company Law Board for its approval. Advise the Board if the same could be approved or not. [***Hint:*** It should give the approval. The new business is not inconsistent with the existing business. See s.17(1)]

Loss of Revenues of State, Whether Relevant Consideration

In Orient Paper Mills Ltd. v. State, AIR (1957) Ori. 232, it was observed that a State whose interests are affected by the change has a *locus standi* to oppose shift of registered office of a company. Accordingly, the Orissa High Court declined to confirm change of registered office from Orissa to West Bengal, *inter alia*, on the ground that in a Federal constitution every State has the right to protect its revenue and, therefore, the interest of the State must be taken into account.

But in Minerva Mills Ltd. v. Govt. of Maharashtra (1975) 45 Comp. Cas 1(Bom.), Justice Ray of the Bombay High Court held that the Company Law Board (now Central government) cannot refuse confirmation on the ground that the change would cause loss of revenue to a State or would have adverse effects on the general economics of the State. The question of loss of revenue to one State would have to be considered in the prospectus of total revenues for the Republic of India and no parochial considerations should be allowed to turn the scale in regard to change of registered office from one State to another within India.

Similar view was expressed in Rank Film Distributors of India Ltd. v. Registrar of Companies, West Bengal [AIR (1969) Cal. 32]., i.e. that State has no statutory right under s. 17 to oppose the shifting of the registered office from one State to another.

A printed or a typewritten copy of the special resolution both under s. 146 and s. 17 should be sent to the Registrar within 30 days of its passing.

A certified copy of the Central Government order of the Central Government should be filed within three months thereof with the Registrar of each State – the old and the new State. If it is not filed within the prescribed time, then the alteration shall, at the expiry of such period, become void and inoperative.

A notice of the new location of the registered office must be given to the Registrar of the State to which the office has been shifted, within thirty days after the change of the office (s.146).

A company is in a position to shift its registered office from one State to another for certain purposes only. These are discussed in the following paragraph (under 'Alteration of objects' – the grounds being common).

5.3.3 Alteration of Objects Clause

Section 17 empowers a company by a special resolution to alter the objects or to change the place of its registered office from one State to another if the alteration is sought on any of the following grounds:

1. ***To carry on its business more economically and more efficiently:*** In Dalmia Cement (Bharat) Ltd., In re (1964) 34 Comp. Cas. 729 (Mad.), the Court observed that whether a company can carry on its business more economically or more efficiently is a matter for the judgement of the directors. If the directors consider that under the existing circumstances, it will be convenient and advantageous to combine the new objects with the existing objects and if it appears that such a conclusion may be fairly arrived at, the Court (now Central government) will not go behind it and hold an enquiry as to whether the opinion of the directors is well founded or is justified.

   The true legal position, observed the Delhi High Court, is that the business must remain substantially the same and the additions, alterations and changes should only be steps-in-aid to improve the efficiency of the company [Delhi Bharat Grain Merchants Assn. Ltd., In re (1974) 44 comp. Cas. 214 (Delhi)].

   In Re, Scientific Poultry Breeders Association (1933) 3 Comp. Cas. 89 (CA), a company's memorandum prohibited payment of remuneration to the members of its governing body. It wanted for efficient management, amendment in the memorandum to enable it to pay remuneration to its governing body members which was allowed.

2. ***To attain its main purpose by new or improved means:*** For the companies registered after 10th October, 1965, there is no difficulty in ascertaining the main purpose because the Memorandum would state it. But for the companies registered earlier, one has to look not only to the memorandum but also to what has actually been done.

3. ***To enlarge or change the local area of its operation:*** In India Mechanical Gold Extracting Company, In Re (1891) 3 Ch. 538, the company's business was confined to the 'Empire of India'. It wanted to enlarge its operations by dropping these words. It was allowed to do so on the condition that the word 'Indian' was also dropped from its name.

4. ***To carry on some business which under existing circumstances may be conveniently or advantageously combined with the business of the company:*** In fact, most of the amendments sought in objects clause are based on this ground. This clause enables a company to diversify. The working of the clause makes its scope very wide in as much as any activity which may either conveniently or advantageously be combined with the existing business may be allowed.

5. ***To restrict or abandon any of the objects specified in the memorandum:*** Even for deleting any portion of the object clause, the procedure laid down in s.17 has to be followed.

6. ***To sell or dispose of the whole or any part of the undertaking:*** Where a company wishes to adopt a cut-back or retrenchment strategy, i.e., where it feels that it has either grown too

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big or diversified in various directions that managing becomes difficult or uneconomical, it may alter its objects to sell or dispose of any of its undertakings.

7. ***To amalgamate with any other company or body of persons.***

Procedure for Alteration of Objects

A printed or a typewritten copy of the special resolution is required to be filed with the Registrar within thirty days of the passing thereof.

Also a petition is to be filed with the Central Government for confirmation of the special resolution. The Central Government, being satisfied that the notice of the resolution was given to all persons whose interests are likely to be affected by the alteration, including the Registrar and the State Government and having heard them, may confirm the alteration either wholly or in part.

A certified copy of the order of the Central Government together with a printed copy of the altered memorandum must be filed within three months of the date of the order, with the Registrar. The Registrar will register the documents and issue, within one month a certificate which will be conclusive evidence that everything required has been done (s.18). If the required documents are not filed within the prescribed time, the alteration and the order of the Central Government confirming the alteration, shall, at the expiry of such period, become void and inoperative (s.19).

5.3.4 Alteration of Liability Clause (s.38)

The liability of a member of a company cannot be increased unless the member agrees in writing. The consent of the member may, however, be given either before or after the alteration. Increase in liability may be by way of subscribing for more shares than the number held by him at the date on which the alteration is made or in any other manner.

In case where the company is a club or any other similar association and the alteration in the memorandum requires the member to pay recurring or periodical subscription or charges at a higher rate, although he does not agree in writing to be bound by the alteration, it shall be binding on him.

In case of unlimited liability company, the liability may be made limited. The alteration will, however, not affect any debts, liabilities, obligations or contracts entered into by or with the company before the conversion.

5.3.5 Alteration of Capital Clause (S.94)

This clause deals with alteration of share capital and has been discussed in unit 9.

Task The directors of a company borrow ₹ 50,000 from A on a transaction which is *ultra vires* the company. Discuss the rights of A against the company and its directors. [***Hint:*** A can hold directors personally liable. The company can be held liable only if the money has been used to pay *ultra vires* debts of the company or in case any assets have been purchased for the company, these may be attached.

Self Assessment

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6. Match List-I with List-II and select the correct answer using the codes given below in the lists:

	List-I (Company Issue)		List-II (Company Documents)
A.	Affirmation of compliance with the registration formalities	1.	Certificate of incorporation
B.	Classes of shares into which shake capital is divided	2.	Statutory declaration
C.	Rules for forfeiture of shares	3.	Memorandum of Association
D.	Name and address of the company auditor	4.	Articles of association
		5.	Prospectus

Codes:

	A	B	C	D
(a)	1	4	3	5
(b)	5	4	3	1
(c)	2	3	4	5
(d)	4	1	5	2

7. Which of the following statements are correct?
   (i) Minutes are not required to be read at a sub general meeting.
   (ii) Confirmation of Minutes is not an item of agenda in general meeting.
   (iii) The chairman may disallow any matter which in his opinion is detrimental to the interests of the company from being included in the minutes.
   (iv) Members cannot obtain copies of minutes through they can inspect them during business hours.

   Select the correct answer using the codes given below:

   (a) (ii) and (iii) (b) (i), (ii) and (iii)
   (c) (i), (iii) and (iv) (d) (ii) and (iv)

5.4 Doctrine of Ultra Vires

Ultra vires means beyond powers, i.e., any act done by the company beyond its legal powers and authority.

It has been observed that the company has an Independent legal existence and is a separate body corporate distinct from its members. The company can, therefore, perform acts on its own. The acts which the company performs are authorized by:

- Objects specified in the Memorandum of Association of the company with which it is registered. Objects include incidental objects also, and
- The Companies Act.

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Any act done by the company which is neither authorized by its objects nor by the Companies Act is *ultra vires* the powers and authority of the company. An act which is *ultra vires* the company is void and cannot bind the company. Since the act is void, it cannot be ratified by the shareholders either.

In a leading case on the point, it was held that a contract *ultra vires* the company was void and not even the subsequent assent of the whole body of the shareholders could ratify it. An *ultra vires* contract being void *ab initio* cannot become *intra vires* by reasons of estoppel, lapse of time, ratification, acquiescence, or delay. In this case, the objects of the company provided to make and sell, or lend or hire railway carriage and wagons and all kinds of railways plants, to carry on the business of mechanical engineers and general contractors, etc. The company contracted with Riche to finance the construction of railway line in Belgium. On repudiation of contract by the company, Riche claimed damages contending that the contract fell within the scope of the words "general contractors" and further contended that the contract was ratified by a majority of shareholders. It was observed in the case that the Memorandum of Association had two fold effects – an affirmative that it states the ambit and extent of powers of the company and negative that nothing shall be done beyond that ambit. It is specific and the term 'general contractors', therefore, cannot be so widely interpreted. The contract of the company to finance the construction of railway line was *ultra vires* the objects of the company. Since the act was *ultra vires*, the power and scope of objects of Memorandum could not be ratified either.

The directors though authorized to make payments towards any charitable or any benevolent object, the payment was held to be *ultra vires*. It was held that the directors could spend for the promotion of only such charitable objects as would be useful for the attainment of the company's objects. Earlier it has been held in Eastern Countries Rly that "no company can devote any part of its funds to an object which is neither essential; nor incidental to the fulfillment of its object howsoever beneficial that object might be".

Act Ultra vires the Powers of Directors and Ultra vires the Articles but Intra vires the Memorandum: The directors of the company may act beyond the powers and authority assigned to them. The directors derive their powers through:

1. Articles of Association
2. Specific authority through resolutions.
3. Companies Act.

An act *ultra vires* the powers of directors but not *ultra vires* the company can be ratified by the share holders. Similarly an act *ultra vires* the articles of company but within the powers of the Memorandum (*intra vires* the memorandum) can be ratified by altering the articles. In short, an act *ultra vires* the company is void and cannot be ratified. An act *ultra vires* the powers of directors and *ultra vires* the articles but *intra vires* the Memorandum can be ratified as such an act is only irregular.

The aggrieved party has the following relief:

- Directors can be made liable to outsiders for breach of an implied warranty of authority.
- Any member of the company can get an injunction restraining the company from performing an *ultra vires* act or from proceeding with it.
- If a director makes an *ultra vires* payment, he can be compelled to refund the money to the company.

It has been mentioned earlier that a company cannot go beyond its objects mentioned in its memorandum. The company's activities are confined strictly to the objects mentioned in its memorandum and if they go beyond these objects, then such acts will be *ultra vires.* The object of

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declaring such act as *ultra vires* is to protect the interests of shareholders and all others who deal with the company. Some points worth noting as regards doctrine of *ultra vires* are:

- A company exists only for the objects which are expressly stated in its objects clause or which are incidental to or consequential upon these specified objects.
- Any act done outside the express or implied objects is *ultra vires*.
- The *ultra vires* acts are null and *void ab initio.* The company is not bound by these acts; and neither the company nor the other contracting party can sue upon it.

Example: (1) A company with the objects, namely (i) to make and sell or lend on hire railway carriages and wagons and all kinds of railway plant, fittings, machinery and rolling stock; (ii) to carry on the business of mechanical engineers and general contractors; (iii) to purchase, lease, work and sell, mines, minerals, land and buildings; (iv) to purchase and sell as merchants timber, coal, metals or other materials. The company contracted to finance the construction of a railway bridge in Belgium and there was evidence that the agreement had been ratified by all the members. Later, the company repudiated the agreement and was sued for breach of contract. In its defence, the company repudiated its lack of capacity to enter into a contract which was outside the scope of its objects clause. The other party brought an action for damages for breach of contract. His contentions were that the contract in question came well within the meaning of the words 'general contractors' and, was, therefore, within the powers of the company and secondly, that the contract was ratified by the majority of the shareholders.

Held: That the term 'general contractors' must be taken to indicate the making generally, of such contracts as were connected with the business of mechanical engineers. If the term 'general contractors' was so interpreted it would authorise the making of contracts of any and every description, such as, for instance, of fire and marine insurance and the memorandum in place of specifying the particular kind of business, would virtually point to the carrying on of business of any kind whatsoever and would, therefore, be altogether not meaningful. Hence, the contract was entirely beyond the objects in the memorandum of association. [Ashbury Railway Carriage and Iron Co. v. Riche (1875) LR 7 HL 653].

(2) The objects clause of a company included making of costumes, gowns and similar things within the clothing trade. However, it extended its activities to the manufacture of veneered panels and became indebted to three parties (a) builders of the veneered panels factory, (b) suppliers of veneers and (c) fuel merchants. In the meantime the company went into liquidation and rejected the claim of the three creditors. The creditors filed suits for the recovery of money.

Held: the contention of the liquidator was correct as all the three contracts were clearly *ultra vires*.

- In case a company is about to undertake an *ultra vires* act, the members of a company (even a single member) can get an order of injunction from the court restraining the company from going ahead with the *ultra vires* act.
- If the directors have exceeded their authority and done something then such matter can be ratified by the general body of the shareholders, provided the company has the capacity to do so by its memorandum of association.

Example: Company has the power to borrow money, but the Articles of the company provide that in case the directors borrow more than ₹ 50,000, they should get prior approval by the company in general meeting. However, the directors can issue debentures to the extent of ₹ 75,000 without getting the approval from the shareholders.

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The company in general meeting may ratify the act of directors as it is *intra vires* the company, though *ultra vires* the powers of the directors of the company:

- Any property acquired by a company under an *ultra vires* transaction may be protected by the company against damage by third persons.
- Directors and other officers can be held liable to compensate the company for any loss occasioned to it by an *ultra vires* act.
- Directors and other officers shall be personally accountable to the third parties
- Money or property gained through an *ultra vires* transaction available in specie or capable of being identified shall be restituted (restored) to the other party.
- In case, an *ultra vires* loan, taken by a company is used for payment of its *intra vires* debts, the lender of the *ultra vires* loan is substituted in place of the creditor who has been paid off and as such can recover the money.

Self Assessment

8. Which of the following need not have MOA
   (a) Public company (b) Private company
   (c) Government company (d) Statutory Corporation
9. A company can change its name by passing
   (a) Ordinary resolution
   (b) Special resolution
   (c) Either by special resolution or by ordinary resolution
   (d) None of the above
10. Ultra vires means
    (a) Beyond the power (b) with in the power
    (c) Both (d) None of the above
11. Ultra vires loans granted by the company are
    (a) Void (b) Voidable
    (c) Valid (d) None of the above

5.4.1 The Effects and Exceptions of the Doctrine of Ultra vires – An Elaboration

Doctrine of *ultra vires* has been developed to protect the investors and creditors of the company. The doctrine of *ultra vires* could not be established firmly until 1875 when the Directors, & C., of the Ashbury Railway Carriage and Iron Company (Limited) v Hector Riche, (1874-75) L.R. 7 H.L. 653 (discussed above also) was decided by the House of Lords. A company called "The Ashbury Railway Carriage and Iron Company," was incorporated under the Companies Act, 1862. Its objects, as stated in the Memorandum of Association, were "to make, and sell, or lend on hire, railway carriages and wagons, and all kinds of railway plant, fittings, machinery, and rolling-stock; to carry on the business of mechanical engineers and general contractors; to purchase, lease, work, and sell mines, minerals, land, and buildings; to purchase and sell, as merchants,

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timber, coal, metals, or other materials, and to buy and sell any such materials on commission or as agents." The directors agreed to purchase a concession for making a railway in a foreign country, and afterwards (on account of difficulties existing by the law of that country), agreed to assign the concession to a Société Anonyme formed in that country, which société was to supply the materials for the construction of the railway, and to receive periodical payments from the English company.

The objects of this company, as stated in the Memorandum of Association, were to supply and sell the materials required to construct railways, but not to undertake their construction. The contract here was to construct a railway. That was contrary to the memorandum of association; what was done by the directors in entering into that contract was therefore, in direct contravention of the provisions of the Company Act, 1862.

It was held that this contract, being of a nature not included in the Memorandum of Association, was *ultra vires* not only of the directors but of the whole company, so that even the subsequent assent of the whole body of shareholders would have no power to ratify it. The shareholders might have passed a resolution sanctioning the release, or altering the terms in the articles of association upon which releases might be granted. If they had sanctioned what had been done without the formality of a resolution, that would have been perfectly sufficient. Thus, the contract entered into by the company was not a voidable contract merely, but being in violation of the prohibition contained in the Companies Act, was absolutely void. It is exactly in the same condition as if no contract at all had been made, and therefore, a ratification of it is not possible. If there had been an actual ratification, it could not have given life to a contract which had no existence in itself; but at the utmost it would have amounted to a sanction by the shareholders to the act of the directors, which, if given before the contract was entered into, would not have made it valid, as it does not relate to an object within the scope of the memorandum of association.

Later on, in the case of Attorney General v. Great Eastern Railway Co., this doctrine was made clearer. In this case the House of Lords affirmed the principle laid down in Ashbury Railway Carriage and Iron Company Ltd v. Riche but held that the doctrine of *ultra vires* "ought to be reasonable, and not unreasonable understood and applied and whatever may fairly be regarded as incidental to, or consequential upon, those things which the legislature has authorized, ought not to be held, by judicial construction, to be *ultra vires*."

The doctrine of *ultra vires* was recognised in Indian the case of Jahangir R. Modi v. Shamji Ladha *and* has been well established and explained by the Supreme Court in the case of A. Lakshmanaswami Mudaliar v. Life Insurance Corporation of India. Even in India it has been held that the company has power to carry out the objects as set out in the objects clause of its memorandum, and also everything, which is reasonably necessary to carry out those objects. For example, a company which has been authorized by its memorandum to purchase land had implied authority to let it and if necessary, to sell it. However, it has been made clear by the Supreme Court that the company has, no doubt, the power to carry out the objects stated in the objects clause of its memorandum and also what is conclusive to or incidental to those objects, but it has no power to travel beyond the objects or to do any act which has not a reasonable proximate connection with the object or object which would only bring an indirect or remote benefit to the company.

To ascertain whether a particular act is *ultra vires* or not, the main purpose must first be ascertained, then special powers for effecting that purpose must be looked for, if the act is neither within the main purpose nor the special powers expressly given by the statute, the inquiry should be made whether the act is incidental to or consequential upon. An act is not *ultra vires* if it is found:

- Within the main purpose, or
- Within the special powers expressly given by the statute to effectuate the main purpose, or

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- Neither within the main purpose nor the special powers expressly given by the statute but incidental to or consequential upon the main purpose and a thing reasonably done for effectuating the main purpose.

The doctrine of *ultra vires* played an important role in the development of corporate powers. Though largely obsolete in modern private corporation law, the doctrine remains in full force for government entities. An *ultra vires* act is one beyond the purposes or powers of a corporation. The earliest legal view was that such acts were void. Under this approach a corporation was formed only for limited purposes and could do only what it was authorized to do in its corporate charter.

This early view proved unworkable and unfair. It permitted a corporation to accept the benefits of a contract and then refuse to perform its obligations on the ground that the contract was *ultra vires*. The doctrine also impaired the security of title to property in fully executed transactions in which a corporation participated. Therefore, the courts adopted the view that such acts were voidable rather than void and that the facts should dictate whether a corporate act should have effect.

Over time a body of principles developed that prevented the application of the *ultra vires* doctrine. These principles included the ability of shareholders to ratify an *ultra vires* transaction; the application of the doctrine of *estoppel*, which prevented the defense of *ultra vires* when the transaction was fully performed by one party; and the prohibition against asserting *ultra vires* when both parties had fully performed the contract. The law also held that if an agent of a corporation committed a tort within the scope of the agent's employment, the corporation could not defend on the ground that the act was *ultra vires*.

Despite these principles the *ultra vires* doctrine was applied inconsistently and erratically. Accordingly, modern corporation law has sought to remove the possibility that *ultra vires* acts may occur. Most importantly, multiple purposes clauses and general clauses that permit corporations to engage in any lawful business are now included in the articles of incorporation. In addition, purposes clauses can now be easily amended if the corporation seeks to do business in new areas. For example, under traditional *ultra vires* doctrine, a corporation that had as its purpose the manufacturing of shoes could not, under its charter, manufacture motorcycles. Under modern corporate law, the purposes clause would either be so general as to allow the corporation to go into the motorcycle business, or the corporation would amend its purposes clause to reflect the new venture.

State laws in almost every jurisdiction have also sharply reduced the importance of the *ultra vires* doctrine. For example, section 3.04(a) of the Revised Model Business Corporation Act, drafted in 1984, states that "the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act." There are three exceptions to this prohibition: it may be asserted by the corporation or its shareholders against the present or former officers or directors of the corporation for exceeding their authority, by the attorney general of the state in a proceeding to dissolve the corporation or to enjoin it from the transaction of unauthorized business, or by shareholders against the corporation to enjoin the commission of an *ultra vires* act or the *ultra vires* transfer of real or personal property.

Government entities created by a state are public corporations governed by municipal charters and other statutorily imposed grants of power. These grants of authority are analogous to a private corporation's articles of incorporation. Historically, the ultra vires concept has been used to construe the powers of a government entity narrowly. Failure to observe the statutory limits has been characterized as *ultra vires*.

In the case of a private business entity, the act of an employee who is not authorized to act on the entity's behalf may, nevertheless, bind the entity contractually if such an employee would normally be expected to have that authority. With a government entity, however, to prevent a contract from being voided as *ultra vires*, it is normally necessary to prove that the employee actually had authority to act. Where a government employee exceeds her authority, the government entity may seek to rescind the contract based on an *ultra vires* claim.

Critique of the *Ultra vires* Doctrine

Creditors' Interests: The existence of the doctrine does not entitle a creditor dealing with a company to assume that it will only act *intra vires* and, if he neglects to enquire or, having enquired, draws the wrong conclusion, he may risk loss from which other creditors may fortuitously benefit. The doctrine could be more in the nature of a trap than a protection for the creditor. Indeed, there are instances where the doctrine had adverse effects even for a diligent creditor or third party dealing with a company, as he may spend considerable time and effort to ensure that a proposed transaction is *intra vires*.

In theory, no doubt the doctrine of *ultra vires* may provide protection by limiting the business and thus, preventing unauthorized operations, which may damage the solvency of a company and its ability to repay. In practice this is not a consideration, which weighs with creditors at all. The prolixity of memoranda of association, and the power of a company to alter its objects, and the ability of a company to operate through subsidiaries, makes it impractical to rely on the objects to impose any limitation on the businesses which the company may carry on. Such limitations may be, however, and in many cases imposed by creditors by including the necessary restrictions in their contracts with the company.

In practicality, a creditor lending funds on a long-term basis will normally impose conditions to ensure that the loan is applied for a particular purpose, and will check the object clause of the company. A creditor advancing short-term funds, or advances repayable on demand, is less likely to scrutinize the object clause of the company and be more ready to assume that, if it is a trading company, the borrowing is within its powers. Normally, the creditor lending funds on any significant scale will ascertain whether or not there are in the articles any restrictions on the directors' borrowing powers, but these articles normally expressly provide that any breach of the borrowing limit will not invalidate the borrowing.

Frequently, there will be a lending agreement, which will contain such restrictions on the activities of the company, which the lender considers prudent.

Consideration of the object clauses as a protection where such commercial instruments are issued is theoretical rather than practical, because most modern memoranda of association authorize widely diverse objects and in any event, the company can alter its objects or operate through subsidiaries.

One important and pertinent question in this regard is: what is the standing of a creditor regarding challenging of the alteration by the company.

This is a question which assumes a lot of importance since the creditors seem to be one class which has been most affected by the whole jumble of law. The researcher's view in this regard is that a creditor *per se* has no right and all his rights are merely contractual in nature which is a notion further affirmed by the fact that if the *ultra vires* doctrine is abolished, then the contractual capacity of the company will be more like that of a natural person. Further, the intervention of a creditor regarding the company entering into an *ultra vires* transaction is not practical since it is very difficult for a creditor to know of the transactions being entered into by the company. Thus, as such, the creditor has no practical means of knowing that what the company is doing and since his relationship with the company is more in the nature of a contract, there seems no justification to the researcher to allow the creditor to object to the alteration of the object clause of the company. In view of some commentators, even if such a right is created; that will be

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totally ineffectual for the reasons mentioned above by the researcher. In fact, to prove their point, the commentators cite the example of existence of such a right and subsequent withdrawal in December 1947, indicating that experience showed that such a right was unnecessary and ineffective. A very pertinent question in this regard is that can the creditors contractually bind the company so as not to alter the objects of the company in future? In view of the researcher the answer to this question will be no, since, first of all, this will be a matter which will ideally be regulated by the articles of association of the company since those will regulate the extent to which the directors of the company can enter into the agreement with the creditors. Further, the company cannot bind itself not to exercise its right conferred by the statute without shareholders approval.

Shareholders' Interests: No doubt shareholders interests are well protected in theory, by the law as well. However, in practicality, memoranda of association are excessively prolix, being designed to include every conceivable business. This defeats the object of having an object clause and confers no protection on members. It also fails to guide investors as to what is the real business of a company. One more important query in this regard can be that, what is the remedy available to the shareholder? In this regard, the researcher's view is that since the law has provided enough protection to the shareholders in this regard – approval by the CLB, there should ideally be no need for such a protection. In view of the researcher, perhaps this remedy is too far fetched and this point will be dealt with by the researcher while dealing with the practical aspects of the whole process of alteration.

The assumption that the entire public has access to the MoA is based on archaic thinking. Consequent to industrial growth and wide dispersal of shareholding *vis-a-vis* the vastness of India, those who deal with the company are generally confined to the place over which the Registrar of the Companies has jurisdiction. They may have a right to receive the required information by post; but such exercise will involve time and it may frustrate conclusions of dealing with a company.

The aforesaid concept of law is perhaps justified in England since that is a small country as compared to India. The assumption as to the possibility of automatic inspection at public registry, therefore, needs review.

It is not being canvassed that a company need not spell out in advance what it proposes to do. Of course, it is essential that the lines of the business are spelled out somewhere, but it is pointless to insist on the demarcation between the main objects and the ancillary objects; especially when the main objects embrace a score of activities.

Self Assessment

State whether the following statements are true or false:

12. The doctrine of *ultra vires* is an illusory protection to the shareholders and a pitfall to the outsiders.
13. An *ultra vires* act, even if endorsed by all the members of the company, is void.
14. A company cannot alter the conditions contained in its memorandum except in cases, in the mode and to the extent for which express provision is made in the Act.
15. The intention of the legislature is to prevent too easy an alteration of the conditions contained in MOA.
16. A company can shift its registered office to another state by passing an ordinary resolution and with the permission of CLB.

Notes

Case Study

Insurance Sector and Law

Over the years, it has been almost a standard practice for the agents of Life Insurance Corporation to give their customers a part of their commission. They usually pay the first quarter's premium on behalf of the customer. That this practice is illegal is a fact; and therefore, not a matter of opinion. However, there are two views over whether the law should prohibit this 'rebating', or not.

Most life insurance companies support banning of rebating, although they all agree that monitoring this is almost impossible. "There has to be a change in awareness level for all customers to refrain from rebating," says Ms Suniti Ghoshal, Head-Corporate Communications, Aviva Life Insurance (formerly, Dabur CGU Life Insurance).

"This industry has been with a monopoly player, hence, certain things have only been done without being questioned much," Ms Ghoshal said, in an e-mail to Business Line.

Other insurance companies agree. "An agent rebates in order to shorten his sales cycle.

This shortening of process often leads to misrepresentation resulting in poor service quality," says a spokesman of Max New York Life Insurance. However, another point of view of the same issue is that there is no point in prohibiting rebating by agents, which is any way extremely difficult to monitor. Advocates of this view point out that in most countries; insurance companies are even allowed to extend credit to their customers for premiums. In India, a claim is payable if and only if the premium has been received in full. Rebating is in a way an informal credit extended to the customer by the agent.

After all, the agent is paying out of his pocket. Why prohibit rebating only in the insurance industry, when discount is a way of life in all other industries?

But insurance companies do not like it. Mr Dilip Gazaaro, Head-Retail Sales, HDFC Standard Life, says that his company actually dismissed an agent for rebating.

At Aviva, the Financial Planning Advisers are trained to handle such demands, says Ms Ghoshal. "They can explain the customer as to why he needs to pay the agent for his service. If the customer can pay substantial amounts for premium, he also needs to ensure that the advice he receives and the service he avails of for his policy are the best in terms of quality and integrity." Max New York Life's spokesman echoes similar views. "We as an industry are also establishing a code of conduct against such practices. At the Life Insurance Executive Council, we have recommended that the penalty for rebating be increased from ₹500 to ₹10,000." There are others who believe that rebating should continue to be illegal, no matter how difficult it is to monitor. Says Mr N. Raveendran, Director, Alegion Risk Management Services (which proposes to become a general insurance broker), "Legalising rebating would drive away the serious agents who do not usually give rebates". He says that there would come a time, when the society matures enough to be willing to pay for a service, that rebating will automatically go away.

After all, you don't necessarily go to the doctor who charges the least. But legalising rebating would push back the arrival of such a time.

Question

Discuss the financial planning advisor role in insurance industry. (***Hint:*** Basically financial advisor is a main person who involve more and more in the planning of insurance sector).

Notes

5.5 Summary

- The memorandum serves a two-fold purpose. It enables shareholders, creditors and all those who deal with the company to know what its powers are and what is the range of its activities.
- Section 15 requires the memorandum to be printed, divided into paragraphs, numbered consecutively, and signed by at least seven persons (two in the case of a private company) in the presence of at least one witness, who will attest the signature.
- The objects of the company must not be illegal, immoral or opposed to public policy or in contravention of the Act.
- The change of name must be communicated to the Registrar of Companies within 30 days of the change.
- Section 17 provides for the shift of the registered office from one State to another and such shift involves alteration of memorandum.

5.6 Keywords

Liability Clause: Liability clause states the nature of liability of the members.

Memorandum of Association: The Memorandum of Association of a company is its charter which contains the fundamental conditions upon which alone the company can be incorporated.

The Capital Clause: Capital clause states the amount of share capital with which the company is registered and the mode of its division into shares of fixed value, i.e., the number of shares into which the capital is divided and the amount of each share.

The Object Clause: The objects clause defines the objects of the company and indicates the sphere of it activities.

5.7 Review Questions

1. Explain memorandum of association and state its contents.
2. State the rule laid down in 'Ashbury Railway Carriage Co. vs. Riche's case.
3. Discuss the legal significance of the different clauses in the memorandum of association.
4. Describe the circumstances under which the alteration of objects clause is permissible.
5. Describe the formalities to be complied with for changing the objects clause.
6. How are alterations made in a memorandum of association?
7. Write explanatory notes on "Doctrine of ultra vires and its implications".
8. Write explanatory notes on "Change of name clause".
9. Describe the steps to be taken by a company to effect changes in the location of its registered office from:
   (a) One place to another place in the same city;
   (b) One city to another city in the same state;
   (c) One state to another state.

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10. Explain the various clauses included in the memorandum of:
    (a) A limited company and
    (b) An unlimited company.

Answers: Self Assessment

1.	two-fold	2.	Section 14
3.	s.147	4.	Liability clause
5.	unlimited company	6.	(c)
7.	(b)	8.	(d)
9.	(c)	10.	(a)
11.	(a)	12.	True
13.	True	14.	True
15.	True	16.	False

5.8 Further Readings

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Notes

Unit 6: Articles of Association

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define articles of association;
- Describe registration of articles;
- Explain subject matter of articles;
- Know alteration of articles;
- Elaborate upon doctrine of indoor management.

Introduction

There may in the case of a public company limited by shares, and there shall in the case of an unlimited company or a company limited by guarantee or a private company limited by shares, be registered with the memorandum, articles of association signed by the subscribers of the memorandum, prescribing regulations for the company.

The articles of association of a company limited by shares may adopt all or any of the regulations contained in Table A in Schedule I.

In the case of any such company which is registered after the commencement of this Act, if articles are not registered, or if articles are registered, in so far as the articles do not exclude or modify the regulations contained in Table A aforesaid, those regulations shall, so far as applicable, be the regulations of the company in the same manner and to the same extent as if they were contained in duly registered articles.

6.1 Articles of Association – Meaning and Purpose

The articles of association of a company and its bye laws are regulations which govern the management of its internal affairs and the conduct of its business. They define the duties, rights, powers and authority of the shareholders and the directors in their respective capacities and of the company and the mode and form in which the business of the company is to be carried out. The Articles of association of a company have a contractual force between company and its members as also between the members *inter se* in relation to their rights as such members. They are subordinate to and are controlled by memorandum. Articles cannot supersede the objects as set out in the memorandum of association [Birds Investments Ltd. v. C.I.T. (1965) 35 Comp. Cas. 147 Cal.] The memorandum, as we have seen earlier, lays down the scope and powers of the company, whereas the articles govern the ways in which the objects of the company are to be carried out. Also the alteration of memorandum involves elaborate procedure, whereas the articles can be framed and altered by the members by passing special resolution. The memorandum is the area beyond which the actions of the company cannot go inside that area the shareholders may make such regulations for their own governance as they think fit. However, the articles must not be inconsistent with the memorandum. Also, as in the case of memorandum, the articles of the company must not contain anything which is against or repugnant to the provisions of the Companies Act (s.9).

6.2 Registration of Articles

Section 26 states that a public company limited by shares may register articles of association signed by the subscribers to the memorandum. If, however, it does not register its own articles, then the articles given in Table A of Schedule I automatically becomes applicable. Further, even if it does register articles of its own, Table A will still apply automatically unless it has been excluded or modified. There are actually three possible alternatives in which such company may adopt articles: (i) it may adopt Table A in full or, (ii) it may wholly exclude Table A and set out its own regulations in full, or (iii) it may set out its own articles and adopt part of Table A. The alternatives (ii) and (iii) are often employed; and partial adoption of Table A has particular advantage for small companies, because of economy in printing and also because any provision of Table A is legally beyond any doubt.

As regards a company limited by guarantee and unlimited liability company and, a private company limited by shares, s.26 provides for compulsory registration of articles prescribing regulations for the company. However, they may adopt any of the appropriate regulations of Table A.

In any case, the articles of a company must be: (i) printed, (ii) divided into paragraphs, numbered consecutively, (iii) signed by subscribers to the memorandum in the presence of at least one witness who shall attest the signatures. Also, articles are to be stamped with requisite stamp and filed along with the memorandum (s.3).

Notes

6.3 Subject Matter of Articles

The articles of a company usually deal with the following matters:

1. The business of the company;
2. The amount of capital issued and the classes of shares into which the capital is divided; the increase and reduction of share capital;
3. The rights of each class of shareholders and the procedure for variation of their rights;
4. The execution or adoption of a preliminary agreement, if any;
5. The allotment of shares; calls and forfeiture of shares for non-payment of calls;
6. Transfer and transmission of shares;
7. Company's lien on shares;
8. Exercise of borrowing powers including issue of debentures;
9. General meetings, notices, quorum, proxy, poll, voting, resolution, minutes;
10. Number, appointment and powers of directors;
11. Dividends – interim and final – and general reserves;
12. Accounts and audit;
13. Keeping of books – both statutory and others.

Self Assessment

Fill in the blanks:

1. The articles of association of a company limited by shares may adopt all or any of the regulations contained in Table A in ....
2. The .... of a company have a contractual force between company and its members as also between the members *inter se* in relation to their rights as such members.
3. Articles cannot supersede the objects as set out in the ....
4. .... states that a public company limited by shares may register articles of association signed by the subscribers to the memorandum.

6.4 Inspection of Copies of the Articles

A company shall, on being so required by a member, send to him within seven days of the requirement, on payment of one rupee, a copy of the articles. If a company makes default, the company and every officer of the company, who is in default, shall be punishable with fine up to ₹ 50 (s.39).

Task A company, in which the directors hold majority of the shares, altered its articles so as to give power to directors to require any shareholder, who competed with the company's business, to transfer his shares, at their full value, to any nominee of the directors. S had some shares in the company. Is S bound by the alteration? [***Hint:*** S shall be bound by the alteration. The alternation is in the general interest of the company.]

6.5 Alteration of Articles

Notes

Section 31 provides that subject to the provisions of the Act and to the conditions contained in its memorandum, a company may, by special resolution alter or add to its articles. A printed or type written copy of every special resolution altering the articles must be filed with the Registrar within 30 days of the passing of the special resolution.

The right to alter just by passing special resolution is so important that a company cannot in any manner deprive itself of the power to alter its articles. Also, the power to reduce or increase the number of members in the case of a company limited by guarantee without share capital, from time to time, as given in the articles can be done by a special resolution of the general body of members. However, in spite of the power to alter its articles, a company can exercise this power subject to certain limitations.

Limitations on Power to alter Articles and these are:

- The alteration must not exceed the powers given by the memorandum or conflict with the other provisions of the memorandum.
- The alteration must not be inconsistent with any provision of the Companies Act or any other statute. For example, no company can purchase its own shares (s.77) and if the articles of a company are altered so as to have the power to purchase its own shares, then such power will be void.
- The altered articles must not include anything which is illegal, or opposed to public policy or unlawful.
- The alteration must be *bona fide* for the benefit of the company as a whole. The alteration will not, however, be bad merely because it inflicts hardship on an individual shareholder.

Example: (i) A company had a lien on all shares "not fully paid" for calls due to the company. There was only one shareholder A, who owned fully paid-up shares. He also held partly-paid shares in the company. A died. The company altered its articles striking out the words "not fully paid up" and thus, gave itself a lien on all shares – whether fully paid up or not. The legal representative of A challenged the alteration on the ground that the alteration had retrospective effect.

Held: The alteration was good, as it was done bona fide for the benefit of the company as a whole, even though the alteration had a retrospective effect [Allen v. Gold Reefs of West Africa Ltd. (1900) 1 Ch. 656].

(ii) By an alteration in the articles, a company was empowered to expropriate shares held by any member who was in business in competition with the company. At the time of alteration, there was only one member doing business in competition with the company. He challenged the alteration.

Held: The alteration was valid, although only one member was at that time within the ambit of alteration, as the alteration was bona fide and for the benefit of the company [Sidebottom v. Kershaw Leese & Co. (1920) Ch. 154 (C.A.)].

- The alteration must not constitute a fraud on the minority by the majority. If the alteration is not for the benefit of the company as a whole, but for majority of the shareholders, then the alteration would be bad. In other words, an alteration to the articles must not discriminate between the majority shareholders and the minority shareholders so as to give the former an advantage of which the latter have been deprived.

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Example: In Brown v. British Abrasive Wheel Co. (1919) 1 Ch. 290, the majority which held 98 per cent of the shares passed a special resolution that upon the request of holders of 9/10th of the issues shares, a shareholder shall be bound to sell and transfer his shares to the nominee of such holders at a fair value. The alteration was held to be invalid since it amounted to an oppression of minority.

- There cannot be alteration of the articles so as to compel the existing members to take or subscribe for more shares or in any way to contribute to the share capital, unless they give their consent in writing (s.38).
- An alteration of articles to effect a conversion of a public company into a private company cannot be made without the approval of the Central Government (s.31).
- A company cannot justify breach of contract with third parties or avoid a contractual liability by altering articles.
- The amended regulation in the Articles of Association cannot operate retrospectively, but only from the date of amendment [Pyare Lal Sharma v. Managing Director, J & K Industries Ltd.].

6.6 Doctrine of Indoor Management

The doctrine of constructive notice throws a burden on people entering into contracts with the company that they are presumed to have read the documents, though in fact, they might not have read them. On the other hand, the doctrine of indoor management allows all those who deal with the company to assume that the provisions of the articles have been observed by the officers of the company. In other words, they are not bound to enquire into the regularity of internal proceedings. An outsider is not expected to see that the company carries out its internal regulations.

Example: The directors of a company were authorised by the articles to borrow on bond such sums of money as should from time to time, by a resolution of the company in general meeting, be authorised to be borrowed. The directors gave a bond to T without the authority of any such resolution. The question arose whether the company was liable on the bond.

Held: The company was liable on the bond, as T was entitled to assume that the resolution of the company in general meeting had been passed [The Royal British Bank v. Turquand (1856) 6 E & B 327].

Exceptions: The doctrine of indoor management is subject to the following exceptions:

1. ***Knowledge of Irregularity***: The rule does not protect any person who has actual or constructive notice of the want of authority of the person acting on behalf of the company.

Example: The articles of a company empowered the directors to borrow up to ≤ 1,000. They could exceed the limit of ≤ 1,000 with the consent of the company in general meeting. Without such consent, they borrowed ≤3,500 from themselves and took debentures. The company refused to pay the amount. ***Held:*** Their debentures were good to the extent of ≤ 1,000 only as they had notice of the internal irregularity [Howard v. Patent Ivory Co., (38 Ch. D. 156)].

2. ***No Knowledge of Articles***: The rule cannot be invoked in favour of a person who did not consult the memorandum and articles and thus, did not rely on them.

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Example: T was a director in the investment company. He, purporting to act on behalf of the company, entered into a contract with the Rama Corporation and took a cheque from the latter. The articles of the company did provide that the Directors could delegate their powers to one of them. But Rama Corporation never read the articles. Later, it was found that the directors of the company did not delegate their powers to T. Plaintiffs relied on the rule of Indoor Management. ***Held***: They could not, because they did not know the existence of the power to delegate. [Rama Corporation v. Proved Tin and General Investment Co. (1952) 1 All ER 554].

3. ***Void or illegal transaction***: The rule does not apply to transactions which are void or illegal *ab initio*, e.g., forgery.

Example: The secretary of a company forged signature of two of the directors required under the articles on a share certificate and issued the certificate without authority. The applicants claimed to be entitled to be registered as members of the company. ***Held:*** The certificate was a nullity and the holder of the share certificate could not take advantage of the doctrine of indoor management [Ruben v. Great Fingal Consolidated (1906) A.C 439].

4. ***Negligence***: If an officer of a company does something which would not ordinarily be within his powers, the person dealing with him must make proper enquiries and satisfy himself as to the officer's authority. If he fails to make inquiry, he cannot rely on the rule.

Example: A person who was sole director and principal shareholder of a company paid into his own account cheques drawn in favour of the company. The bank should have made enquiries as to the power of the director. The bank was put upon inquiry and was accordingly, not entitled to rely upon the ostensible authority of director [A. L. Underwood v. Bank of Liverpool (1924) 1 K. B. 775].

6.7 Constructive Notice of Memorandum and Articles

Section 610 provides that the memorandum and articles, when registered, become public documents and then they can be inspected by anyone on payment of a nominal fee. Therefore, any person who contemplates entering into a contract with the company has the means of ascertaining and is thus, presumed to know the powers of the company and the extent to which they have been delegated to the directors. In other words, every person dealing with the company is presumed to have read these documents and understood them in their true perspective. This is known as 'Doctrine of Constructive Notice'. Even if the party dealing with the company does not have actual notice of the contents, it is presumed that he has "constructive notice" of them.

Examples:

(i) One of the articles of a company provides that a bill of exchange to be effective must be signed by two directors. A bill of exchange is signed only by one of the directors. The payee cannot claim under the bill.

(ii) In Kotla Venkataswamy v. Ram Murthy AIR (1934) Mad. 579, the articles provided that all deeds and documents of the company shall be signed by the managing director, secretary and working director. A mortgage deed was accepted with secretary and working director's signature only. Held, the deed was invalid.

(iii) Similarly, if a person enters into a contract which is beyond the powers of the company, he cannot acquire any right under the contract against the company.

Notes

Self Assessment

5. Signature of memorandum and articles should be done by how many number of persons in case of public company.
   (a) 7 (b) 5
   (c) 4 (d) None of the above
6. Signature of memorandum and articles should be done by how many number of persons in case of private company.
   (a) 3 (b) 4
   (c) 2 (d) None of the above
7. Address of the registered office is situated in
   (a) MOA (b) AOA
   (c) Prospectus (d) None of these
8. Alteration of articles must be done only by passing
   (a) Special resolution (b) Ordinary resolution
   (c) Both (d) None of the above

6.8 Articles and Memorandum: Their Relation and Distinction

Section 36 provides that the memorandum and articles, when registered, bind the company and its members to the same extent as if they had been signed and sealed by each member and contained convenants on the part of each member to observe and be bound by all the provisions of the memorandum and articles. Thus, the company is bound to the members; the members are bound to the company; and the members are bound to the other members by whatever is contained in these documents. But neither a company nor its members are bound to outsiders. These relationships are discussed herein below:

6.8.1 Members bound to Company

Each member must observe the provisions of the articles and memorandum. For instance, a company has a right of lien on members' shares, or to forfeit the shares on non-payment of calls. Every member is bound by whatever is contained in the memorandum and articles.

Example: The articles of a company contained a clause that on the bankruptcy of a member, his shares should be sold to other person and at a price fixed by the Directors. 'B', a shareholder was adjudicated bankrupt. His trustee in bankruptcy claimed that he was not bound by these provisions and should be at liberty to sell the shares at the true value. Held, that the trustee was bound by the articles, as shares were purchased by 'B' in terms of the articles. [Borland Trustees v. Steel bros. Co. Ltd. (1901) 1 Ch. 279].

Each member is not only bound by the covenants of memorandum and articles as originally framed but as altered form time to time in accordance with the provisions of the Companies Act. The articles of associations are the regulations of the company binding on the company and on its shareholders. Further, the shareholders cannot among themselves enter into an agreement which is contrary to or inconsistent with the articles of association of the company.

6.8.2 Company bound to Members

Notes

Similarly, a company is bound to members by whatever is contained in its memorandum and articles of association. The company is bound not only to the "members as a body" but also to the individual members as to their individual rights. The members can restrain a company from spending money on ultra vires transactions. An individual member can make the company fulfill its obligations to him, such as to send the notice for the meetings, to allow him to cast his vote in the meetings.

Members bound to member. The articles bind the members inter se, i.e., one to another so far as rights and duties arising from the articles are concerned.

It is well settled that the articles of association will have a contractual force between the company and its members as also between the members *inter se* in relation to their rights as such members.

Example: The articles of a company provided that whenever any member wished to transfer his shares, he was under an obligation to inform the directors of his intention and the directors were under an obligation to take the said shares equally between them at a fair value. The directors refused to take the shares of a particular member on the ground that the Articles did not impose an enforceable liability upon them.

Held: The directors were under an obligation to purchase the shares, as members of the company, in terms of the provisions of the Articles. There was a personal liability of members *inter se* [Rayfield v. Hand (1960) Ch.1].

Whether Company or Members bound to Outsiders?

No, the memorandum or articles do not confer any contractual rights to outsiders against the company or its members, even though the name of the outsiders is mentioned in the articles.

Example: The articles of a company provided that Eley should be solicitor for life to the company and should not be removed from office except for misconduct. Later on he also became a member of the company. But after employing him as a solicitor for a number of years, the company discontinued his services. He, being a member, sued the company for damages for breach of the contract contained in the articles of association.

Held: His suit was dismissed on the ground that, he, as a solicitor, was no party to the articles. He must prove a contract independent of the articles. There was no infringement of his right as a member. The breach of contract was there but in his capacity as a non-member [Eley v. Positive Government Security Life Assurance Co., (1876) 1 Ex. D. 88].

Whether Directors are bound by whatever is contained in the Articles?

Yes, the directors of the company derive their powers from the articles and be subject to limitations, if any, placed on their powers by the articles. If they contravene any provisions of articles, two parties may be affected: (1) the company itself and (2) the outsiders.

In case of contravention of the provisions of the articles, the directors render themselves liable to an action at the instance of the members. However, members may ratify the act of the director, if they so desire. But if as a result of the breach of duty any loss has resulted to the company, the directors are liable to refund to the company any damage so suffered.

Further, where the directors contravene the provisions of the articles, it may affect outsiders' interest also. This is explained below with the help of a case, viz., Royal British Bank v. Turquand (1856) 119 ER 886.

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The plaintiffs contracted with a director of the defendant company, and gave him a cheque under the contract. The director could have been authorised under the company's articles, but was not in fact so authorised. The plaintiff had not seen the articles. The director misappropriated the cheque and the plaintiff sued the company. Is the company liable?

6.9 Legal Effect of Memorandum and Articles

The legal effect of articles may be summed up as follows:

1. The articles constitute a contract between the company and its members.
2. The articles bind the members to the company.
3. The articles bind the company to members as members.
4. The articles bind members to members.
5. The articles do not bind the company to outsiders.
6. The articles do not bind the company to any member in a capacity other than that of a member.

Self Assessment

State whether statement is true or false:

9. Every member is bound to the company by whatever is contained in the memorandum and articles.
10. The members of a company can restrain a company from spending money on *ultra vires* transactions.
11. The company is not bound to the individual members as to their non-corporate or individual rights.
12. The members of a company are bound to each other in relation to their rights as such members.
13. The memorandum or articles do not confer any contractual rights to an outsider against the company, even though his name is mentioned in the articles.

Case Study

Limited Liability Partnership

If she weren't a shade confused, she wouldn't be Wafers! Her uncle, a star CFO, was her inspiration and she wished to be like him - jet setting, globe trotting and knowledgeable. At the campus interview her senior had picked a job for ₹ 9 lakh and gosh he wasn't even a rank holder. Wafers knew that the industry offered fat pay packs but her heart actually lay in consulting. She wanted to join one of the Big Four firms with the long-term goal of becoming the next CFO.

K. Prahalad. Her professor had once told the class, "In life, you should do what the heart tells you." He was talking about careers! China said, "For chartered accountants there are a plethora of opportunities in the new international trading regime." Wafers agreed. She recalled reading in the ICAI website that "Opportunities would emerge at three

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Notes

fundamental levels in the WTO regime. At the government level, at the revenue authorities level and at the business unit level." China was surprised. "Wow! These CA students are so analytical," he told himself. "You mean to say, accounting firms will have opportunities at the international level," queried Muskan, Wafer's niece. She was in Class X.

"Yeah," said Wafers. And added, "Actually, the opportunities are not just in the industry. They are in practice as well." China remarked, "But that comes with a huge price. If the pink papers are to be believed, accounting firms in the US have millions of dollars worth of legal suits pending against them." Muskan asked, "So?" "So," replied China, "the liberalised trade scenario which offers potential to provide services across international borders will augment greater liability to firms in case of default." Muskan looked definitely confused.

Wafers explained. "Legally, accounting firms in India are allowed to function as sole proprietary concerns or as partnership firms. A partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or anyone of them acting for all." This set Muskan thinking. "So will I be liable for my partners' shortcomings even if I have been honest in conducting my duties," she asked. "That's the general idea," said China impressed by the kid asking the right questions.

"This traditional model is not equipped to meet the multi-competency, multi-disciplinary and multi-locational requirements of today's global and domestic clients," said China.

Wafers added, "Moreover, the major chunk of all benefits is drawn by the creamy layer of large firms." She had read a research report on "Who are India's top auditors and how much do they charge," which had, among others, documented the great divide in the accounting profession. "This is why the accounting fraternity is in favour of limited liability partnership," (LLP) she added. "But what is LLP?" asked China. Ha, that's why she loved China. The walking encyclopaedia had no inhibitions about seeking a clarification on a doubt, if he had one.

"A limited liability partnership is a form of organisation which shields a partner's assets from limitless liabilities that may accrue from the omissions and commissions of other partners," answered Wafers. Not for nothing was Wafers considered strong in law. "In LLP, every partner will be an agent of the partnership and not of the other partners," she added. "Isn't this a merger of the partnership form of organisation and the company form?" remarked China.

"Exactly," said Wafers. "It promises perpetual succession and a distinct legal identity were it to become law. Further, it requires only a minimum of two partners, having no cap on the maximum number of partners a firm can have," she added. "Section 11," said China hurriedly, "of the Companies Act bars the formation of a partnership consisting of more than 20 persons. Won't the firm have to register itself as a company?" "Yes and No." said Wafers "If LLP becomes law, Section 11 will have to be amended. The idea is to make LLP a vehicle for business expansion.

"How?" asked Muskan. Replied Wafers, "Because of the legal stipulation of unlimited liability among partners, Indian partnerships are mostly restricted to family members and persons who know each other thoroughly." She added, "LLP being a form of partnership having characteristics of a company will limit liability in the case of business failure or professional negligence litigation to the partner responsible." "You mean, only the negligent partner will be penalised and not the whole firm," asked China. "Yes," said Wafers.

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China played the devil's advocate. "Is it possible to prove that only a particular partner was negligent and not the others?" Wafers replied, "They will have to divide work amongst themselves appropriately. This could create disputes between partners, but crystal clear division of duties between partners will go a long way in reducing the same."

"Excellent," said Muskan. "The LLP form of organisation would help the small and medium practitioners by encouraging networking and specialisation of functions."

Wafers had a word of caution, "The decision to go for LLP will be based on the interplay of costs and benefits." China continued his black hat thinking, "Other forms of organisation are tried and tested. Why then should one go for something new?" Wafers answered this question philosophically quoting John Rockefeller, "If you want to succeed, you should strike out new paths rather than travel the worn out paths of accepted success." China smiled.

Question

Comment on "A partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or anyone of them acting for all". (***Hint:*** Refer partnership act)

6.10 Summary

- The articles of association of a company and its bye laws are regulations which govern the management of its internal affairs and the conduct of its business.
- Section 26 states that a public company limited by shares may register articles of association signed by the subscribers to the memorandum.
- Section 31 provides that subject to the provisions of the Act and to the conditions contained in its memorandum, a company may, by special resolution alter or add to its articles.
- The company altered its articles striking out the words "not fully paid up" and thus, gave itself a lien on all shares whether fully paid up or not.
- The doctrine of constructive notice throws a burden on people entering into contracts with the company that they are presumed to have read the documents, though in fact, they might not have read them.

6.11 Keywords

Alteration of Articles: Section 31 provides that subject to the provisions of the Act and to the conditions contained in its memorandum, a company may, by special resolution alter or add to its articles.

Article of Association: The articles of association of a company and its bye laws are regulations which govern the management of its internal affairs and the conduct of its business.

Doctrine of Indoor Management: Doctrine of indoor management allows all those who deal with the company to assume that the provisions of the articles have been observed by the officers of the company.

Notes

6.12 Review Questions

1. What are articles of association? Enumerate some of the items included therein.
2. Discuss whether it is legally compulsory for a company to have its own articles of association.
3. What restrictions should the articles provide to give a company the status of a private company?
4. Distinguish between articles and memorandum.
5. Explain the procedure laid down in the Companies Act, 1956 to alter the articles of a company.
6. Discuss the limits upon the powers of a company to alter its articles.
7. Discuss the binding effect of memorandum and articles, when registered, on the members and outsiders.
8. Explain the doctrine of constructive notice. Are there any exceptions to the said doctrine?
9. Explain and illustrate the 'Doctrine of Indoor Management'. What are the exceptions to this rule?
10. Explain the rule laid down in the Royal British Bank vs. Turquand and state the exceptions to the rule.
11. State the inter-relationship of Doctrine of Indoor Management with the Doctrine of Constructive Notice.
12. Examine the legal effect of the articles. How far is a provision depriving the company of the power to alter the articles valid?

Answers: Self Assessment

1. Schedule I
2. Articles of Association
3. Memorandum of Association
4. Section 26
5. (a)
6. (c)
7. (b)
8. (a)
9. True
10. True
11. False
12. True
13. True

6.13 Further Readings

Books

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S S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.

Online links

http://www.indialawinfo.com/bareacts/soga.html

www.en.wikipedia.org

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Unit 7: Prospectus

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Objectives

After studying this unit, you will be able to:

- Define prospectus;
- Know content of prospectus;
- Describe information memorandum;
- Explain abridged prospectus;
- Explain statement in lieu of prospectus.

Introduction

Prospectus or statement in lieu of prospectus to be filed by private company on ceasing to be private company. Every prospectus filed under sub-section (1) shall state the matters specified in Part I of Schedule II and set out the reports specified in Part II of that Schedule, and the said Parts I and II shall have effect subject to the provisions contained in Part III of that Schedule.

Every statement in lieu of prospectus filed under sub-section (1) shall be in the form and contain the particulars set out in Part I of Schedule IV, and in the cases mentioned in Part II of the Schedule, shall set out the reports specified therein, and the said Parts I and II shall have effect subject to the provisions contained in Part III of that Schedule.

Notes

7.1 Prospectus – Definition and Meaning

A prospectus, as per s.2 (36), means "any document described or issued as prospectus and includes any notice, circular, advertisement or other document, inviting deposits from the public or inviting offers from the public for the subscription or purchase of, any shares in or debentures of a body corporate". Thus, a prospectus is not merely an advertisement; it may be a circular or even a notice. A document shall be called a prospectus if it satisfies two things:

1. It invites subscriptions to shares or debentures or invites deposits.
2. The aforesaid invitation is made to the public.

What constitutes an offer to the public?

The following criteria is laid down as to what shall constitute an offer to the public:

An invitation to the public, shall include an invitation to any section of the public, whether selected as members or debenture holders of the company concerned, or as clients of the person issuing the prospectus or in any other manner.

In Rattan Singh vs. Moga Transport Co. Ltd. (1959) 20 Comp. Cas. 165, the learned judge held that, in all cases, the determination of the question of an offer being made to the public depends upon the facts and language of the notice, and the particular circumstances of each case.

In Nash vs Lynde (1929, A.C. 1585), Justice Viscount Summer observed: "The 'public' is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve; perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceeding needless by himself subscribing the whole. The point is that the offer is as such to be open to anyone, who brings his money and applies in due form, whether the prospectus was addressed to him on behalf of the company or not."

In this context it is relevant to discuss the concept of deemed prospectus.

7.1.1 Prospectus by Implication (Deemed Prospectus)

Section 64 has been designed to check the bypassing of the provisions of s.56 as given above, by making an offer of sale of shares or debentures through the medium of Issue Houses. The process involves allotment of shares to an Issue House who, in turn, will issue advertisement offering shares for sale. Since the advertisement is not issued by the company, it does not amount to a prospectus and thereby liability of non-compliance of s.56 provisions cannot be invoked. To check this malady, s.64 provides that all documents containing offer of shares or debentures for sale shall be included within the definition of the term 'prospectus' and, shall be deemed as prospectus by implication of law. All enactments and rules of law as to the contents of prospectuses and as to the liability in respect of statements and omissions from prospectuses shall apply in respect of such documents.

Further, s.64 provides that unless the contrary is proved, an allotment of, or an agreement to allot shares or debentures shall be deemed to have been made with a view to the shares or debentures being offered for sale to the public, if it is shown:

- that the offer of the shares or debentures for sale to the public was made within 6 months after the allotment or agreement to allot; or
- that at the date when the offer was made, the whole consideration to be received by the company in respect of the shares or debentures had not been received by it.

In case a document is deemed as prospectus, then it must contain the following information in addition to the information required to be stated in prospectus under s.56:

1. The net amount of consideration received or to be received, by the company in respect of the shares or debentures to which the offer relates; and

2. The place and time at which the contract under which the said shares or debentures have been or are to be allotted may be inspected.

For purposes of registration of a prospectus under s.60, the persons making the offer of sale to the public are to be deemed as directors of the company.

Where the person making the offer is a company or a firm, the documents (i.e., deemed prospectus) must be signed by at least two directors or one-half of the partners as the case may be.

Circumstance under which a Document containing an offer for Sale of Shares or Debentures be not deemed to be a Prospectus

Whether a document containing an offer for sale of shares or debentures is a prospectus or not, depends upon whether it extends an invitation to the public to subscribe or not. The prima facie test of 'public offer' or 'public invitation' is whether the terms of the offer or invitation are such that despite its limited circulation, it is open to any person who so chooses to bring his money and apply for shares in response to the invitation. If the offer or invitation is so open, then it constitutes a 'public offer'. If, on the other hand, an offer or invitation can be accepted only by the person to whom it is made and none other, then it will not be deemed to be an offer or invitation to the public.

The word 'public' includes any section of the public (s.67). It may, thus, include all registered medical practitioners in Delhi, all advocates of High Court of Delhi, all Englishmen living in India.

What does not constitute an offer to the Public or Circumstances under which a Document containing an offer for Sale of Shares or Debentures be not deemed to be a Prospectus

However, in the following cases, the document inviting subscription to shares or debentures of a company shall not be deemed as invitation to the public and hence, shall not be a prospectus:

- A document issued by a company by way of invitation to existing members or debenture holders, to subscribe to shares or debentures by way of 'right' is not a prospectus [s.56(5)].

- An invitation shall not be an invitation to the public if it cannot be calculated to result, directly or indirectly in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the invitation. Thus, it will not be an invitation to public where A receives the invitation, but B who is a friend of A does not receive the invitation but desires to subscribe, but the company does not accept his offer, as he (B) was not invited to make the offer. It was A, and A only for whom the invitation to subscribe to the shares was meant; no one else (whether B or not) could not have responded to the invitation extended to A only. On the other hand, it will become an invitation to the public where his (B's) or anyone's offer shall be accepted by the company.

  Thus, offering of shares to a director of Kith and Kins is not an invitation to the public to buy shares [Rattan Singh vs. Moga Transport Co. Ltd., supra].

Notes

- An offer to shareholders of an existing company (say 'A') of shares in a new company (say 'B') in exchange for existing shares of A, is not an offer to the public. (Government Stock and Other Securities Investment Co. vs. Manila Rail CO. [1897] AC 81).
- Where an invitation is made by the management of a company to selected persons for subscription or purchase by the persons receiving the offer or invitation, the shares or debentures and such invitation or offer is not calculated directly or indirectly to be availed of by other persons, such invitation or offer shall not be deemed as prospectus [s.67(3)]. In Nash vs. Lynd (1929) AC 158, a document marked 'strictly confidential' containing particulars of a proposed issue of shares was sent by the managing director to a co-director and through him passed on privately to a small circle of friends of the director. The House of Lords held that it was not a prospectus, as there had been no issue to the public.

However, an invitation to subscribe to its shares by a company (other than a non-banking finance company or a public financial institution) even though meant for subscription/purchase only by those who receive it, shall be considered as invitation to public if it is made to fifty persons or more. Thus, a private placement of its shares by such a company comes under the purview of 'public issue' if invitation is made to fifty or more persons.

Self Assessment

Fill in the blanks:

1. A prospectus, as per ...., means any document described or issued as prospectus and includes any notice, circular, advertisement.
2. The process involves ....to an Issue House who, in turn, will issue advertisement offering shares for sale.
3. In case a document is deemed as prospectus, then it must contain the following information in addition to the information required to be stated in prospectus ....
4. The word .... includes any section of the public (s.67).

7.2 Contents of Prospectus

Section 56 lays down that the matters and reports stated in Schedule II to the Act must be included in a prospectus. The format of a prospectus is divided into three parts.

In the first part, brief particulars are to be given about matters mentioned below:

1. ***General Information:*** Under this head, information is given about:
   (i) Name and address of registered office of the company.
   (ii) Name (s) of stock exchange (s) where application for listing is made.
   (iii) Declaration about refund of the issue, if minimum subscription of 90 per cent is not received within 90 days from closure of the issue.
   (iv) Declaration about the issue of allotment letters/refunds within a period of 10 weeks and, interest in case of any delay in refund, at the prescribed rate, under s.73.
   (v) Date of opening of the issue.
   (vi) Date of closing of the issue.
   (vii) Name and address of auditors and lead managers.

Notes

(viii) Whether rating from CRISIL or any rating agency has been obtained for the proposed debentures/preference shares issue. If no rating has been obtained, this should be answered as 'No'. However, if 'Yes', the rating should be indicated.

(ix) Names and addresses of the underwriters and the amount underwritten by them together with declaration by the Board of directors that the underwriters have sufficient resources to meet their respective obligations.

(x) Consent of the Central Government about the present issue as also particulars of letter of intent/industrial licence making clear in the statement that the Central Government does not undertake any responsibility for financial soundness or correctness of the statement(s).

(xi) Punishment if application for shares is made in a fictitious name (under s. 68A).

(xii) Names and addresses of trustees of the debenture trust deed, in case of issue of debentures.

Task A company issued a prospectus advertising that the company has a great Potential with "turnover of a million bags of cement in a year". It is discovered later that while the company has the installed capacity of one million bags, it had never produced more than 6 lac bags of cement in a year. A buyer of shares seeks remedy against the misleading statement. Would he succeed? [***Hint:*** Yes, he would succeed.]

2. ***Capital Structure of the Company:***

   (i) Authorised, issued, subscribed or paid-up capital.

   (ii) Size of the present issue, giving separately reservation for preferential allotment to promoters and others.

3. ***Terms of the Present Issue:***

   (i) Terms of Payment.

   (ii) How to apply i.e., making use of the application form, on the basis of study of prospectus and mode of payment.

   (iii) Any special tax benefits for the company and its shareholders.

   (iv) Rights of the instrument holders, such as they will get dividends for the whole year or for the period of holding only.

4. ***Particulars of the Issue:***

   (i) Object(s) of the issue.

   (ii) Project cost.

   (iii) Means of Financing (including contribution of promoters).

5. ***Company Management and Project:***

   (i) History and main objects and present business of the company, as also name and address of subsidiary, if any.

   (ii) Promoters and their background.

   (iii) Location of the project.

   (iv) Collaborations, if any, with details of any performance guarantee or assistance in marketing.

   (v) Nature of the product(s) export possibilities, export guarantee.

Notes

(vi) Stock market data for shares/debentures of the company including high and low price in each of the last three years and, monthly high and low during the last six months, if applicable.

(vii) Names, addresses and occupation of managing directors, whole-time directors, other directors including nominee directors and manager, mentioning any directorship held in other company, in each case.

(viii) Plant and machinery, technology, process, etc.

(ix) Infrastructure facilities for raw materials and utility like water and electricity.

(x) Schedule of implementation of the project and the progress made so far, giving relevant details like land acquisition, civil construction, installation of plant and machinery, trial production, date of commercial production, etc.

(xi) Approach to marketing and proposed marketing setup.

(xii) Future prospects, expected capacity utilisation during the first three years from the date of commencement of commercial production, and the expected year from which the company would be earning cash profits and net profits.

Part II of Schedule II requires the company to give detailed information. This part is further sub-divided into three parts viz., General Information, Financial Information and Statutory and Other Information.

1. ***General Information:*** It shall include information on matters like:

   (i) Consent of directors, auditors, solicitors, managers to the issue, registrars to the issue, bankers of the company, bankers to the issue and experts. If an expert's opinion was obtained, the same should be given.

   (ii) Change, if any, in directors and auditors during the last 3 years and reasons therefor.

   (iii) Procedure and time schedule for allotment and issue of certificates.

   (iv) Names and addresses of company secretary, legal advisor, lead managers, co-managers, auditors and bankers to the issue and brokers to the issue.

   (v) Authority for the issue and details of resolution passed therefor.

2. ***Financial Information:*** It includes:

   (i) A report by the auditors of the company with respect to (a) its profits and losses (distinguishing items of non-recurring nature), and assets and liabilities, and (b) the rate of dividend paid by the company during the preceding five financial years.

   If, however, no accounts have been made up in respect of any part of the period of five years ending on a date three months before the issue of the prospectus, the report shall contain a statement of that fact. If the company has subsidiaries, the report shall, in addition, deal with either the combined profits and losses and assets and liabilities of its subsidiaries or each of the subsidiary, so far as they concern the members of the company.

   (ii) A report by the accountants (who shall be qualified under the Act for the appointment as auditor of a company and who shall be named in the prospectus) on the profits and losses of the business for the preceding five financial years and on the assets and liabilities of the business on a date which shall not be more than 120 days before the date of the issue of the prospectus. This report is required to be given if the proceeds of the issue of the shares or debentures are to be applied directly in the purchase of any business.

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A similar report on the accounts of a body corporate by an accountant (who shall be named in the prospectus) if the proceeds of the issue are to be applied in the purchase of shares of the body corporate so that, that body corporate becomes a subsidiary of the acquiring company.

(iii) Principal terms of loans, and assets charged as security.

3. ***Statutory and Other Information:*** It includes information about:

(i) Minimum subscription.

(ii) Expenses of the issue i.e. fee payable to advisors, registrars to the issue, managers to the issue and trustees for the debenture holders.

(iii) Underwriting commission and brokerage.

(iv) Previous issue for cash.

(v) Previous public or rights issue; if any, during the last five years, along-with prescribed particulars.

(vi) Issue of shares otherwise than for cash.

(vii) Commission or brokerage on previous issues.

(viii) Revaluation of assets, if any, during the last five years.

(ix) Material contracts and, time and place where such documents may be inspected.

(x) Debentures and redeemable preference shares or other instruments issued but, remaining outstanding on the date of the prospectus and terms of their issue.

(xi) Purchase of any property with prescribed details.

(a) Details of directors, proposed directors, whole-time directors, their remuneration, appointment, remuneration and of manager or managing director, interests of directors, their borrowing powers and qualification shares.

Any amount or benefit paid or given within the preceding two years or intended to be paid or given to any promoter or officer, and consideration for payment of giving the benefit.

(b) Full particulars of the nature and extent of the interest, if any, of every director or promoter.

(xii) Restrictions, if any, on transfer and transmission of shares/debentures, and on their consolidation or splitting.

(xiii) Outstanding litigations relating to financial matters or criminal proceedings against the company or directors under schedule XIII.

(xiv) Any material development subsequent to the date of the latest balance sheet and its impact on performance and prospects of the company.

(xv) Management perception of risk factors (e.g. sensitivity to foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost/time over-run, etc.).

Part III of the Schedule gives explanations of certain terms and expressions used under Part-I and Part - II of the Schedule.

It also requires a declaration that all relevant provisions of the Act and the guidelines issued by the government have been complied with and nothing has been stated in the prospectus that is contrary to the provisions of the Act. Further, in clause 19 it has been stated that a company which has not been in existence for five years, then the period of actual life shall be substituted for five years.

7.3 Shelf Prospectus and Information Memorandum

Section 60A makes provisions for a shelf-prospectus in certain situations. A 'shelf-prospectus' means "a prospectus issued by any financial institution or bank, for one or more issues of the securities or class of securities specified in that prospectus".

Any public financial institution, public sector bank or scheduled bank whose main object is financing, shall file a shelf prospectus with the registrar before issue of securities. In such a situation, such a company need not file a prospectus afresh at every stage of offer of securities by it within a period of validity not exceeding one year.

But a company, filing a shelf prospectus is required to file an Information Memorandum (as given in s. 60B below), on all material facts relating to new charges created, changes in the financial position as have occurred between the first offer of securities and previous offer of securities within such period as may be prescribed by the Central Government, prior to making of a second or subsequent offer of securities under the shelf prospectus.

An information memorandum shall be issued to the public, along with shelf prospectus filed at the stage of the first offer of securities and, such prospectus shall be valid for a period of one year, from the date of opening of the first issue of securities.

Where an update of information memorandum is filed every time an offer of securities is made, such memorandum together with the shelf prospectus shall constitute the prospectus.

Section 60B provides as follows as regards information memorandum:

- A public company making an issue of securities may circulate information memorandum to the public prior to filing of a prospectus.
- A company inviting subscription by an information memorandum is bound to file a prospectus, prior to the opening of the subscription lists and the offer as a red-herring prospectus, at least three days before the opening of the offer.
- The information memorandum and red-herring prospectus shall carry same obligations as are applicable in the case of a prospectus.
- Any variation between the information memorandum and the red-herring prospectus shall be highlighted as variations by the issuing company.
- Every variation as made and highlighted under (iv) is to be individually intimated to the persons invited to subscribe to the issue of securities.
- In the event of the issuing company or the underwriters to the issue who have invited or received advance subscription by way of cash or post-dated cheques or stock-invest, the company or such underwriters or bankers to the issue shall not encash such subscription moneys or post-dated cheques or stock invests before the date of opening of the issue, without having individually intimated the prospective subscribers of the variation and, without having offered an opportunity to such prospective subscribers to withdraw their application and cancel their post-dated cheques or stock-invest or return of subscription paid.

Notes

- The applicant or proposed subscriber can exercise his right to withdraw from the application, on any intimation of variation within seven days from the date of such intimation and, shall indicate such withdrawal in writing to the company and the underwriters.
- Any application for subscription, which is acted upon by the company or underwriters or bankers to the issue, without having given enough information of any variations, or the particulars of withdrawing the offer or an opportunity for cancelling the post-dated cheques or stock-invest or stop payments for such payments shall be void. Further, the applicants shall be entitled to receive a refund or return of its post-dated cheques or stock-invest or subscription moneys on cancellation of its application, as if the said application had never been made and, the applicants are entitled to receive back their original application and interest at 15%, from the date of encashment till payment of realisation.
- Upon the closing of the offer of securities, a final prospectus stating therein the total capital raised, whether by way of debt or share capital and, the closing price of the securities and any other details as were not complete in the red-herring prospectus, shall be filed in the case of listed public company with SEBI and registrar and in any other case with the registrar only.

Self Assessment

5. .... are required to file prior to making second and subsequent issue of securities in case shelf prospectus are filed:

   (a) Information memorandum (b) Information articles

   (c) Form 13 (d) None of the above

6. Information memorandum + shelf prospectus together constitutes ....

   (a) Memorandum (b) Articles

   (c) Prospectus (d) None of the above

7. Validity period of information memorandum is ....

   (a) 1 year (b) 2 years

   (c) 3 years d. 4 years

8. .... prospectus were issued in order to test the market before finalizing issue size/ price.

   (a) Deemed (b) Shelf

   (c) Red herring (d) None of the above

9. If there is any variation in case of R.H.P .... days should be given for withdrawal of application

   (a) 1 (b) 3

   (c) 5 (d) 7

10. In case of redherring prospectus, the refund is made with an interest @ ________

    (a) 12 (b) 13

    (c) 15 (d) 16

Notes

7.4 Red Herring Prospectus

The 'red-herring' prospectus means "a prospectus which does not have the complete particulars on the price of the securities offered and the quantum of securities offered".

Task X and Co., Ltd., intended to buy a rubber estate in Peru. Its prospectus contained extracts from an expert's report giving the number of rubber trees in the estate. The report was inaccurate. Will any shareholder buying the shares of the company on the basis of the above representation have any remedy against the company? Can the person authorizing the issue of the prospectus escape from the liability?

7.5 Abridged Prospectus

Section 56(3) requires that no one shall issue any form of application for shares or debentures of a company unless, the same is accompanied by a memorandum, (known as 'Abridged Prospectus') containing such salient features of prospectus as may be prescribed. Thus, instead of appending full prospectus, an 'abridged prospectus' need only be appended to the application form.

In order to provide for greater disclosure of information to prospective investors so as to enable them to take an informed decision regarding investment in shares and debentures, Form 2-A has been prescribed as a format of abridged prospectus. It is further required that the abridged prospectus and the share application form should bear the same printed number and the two should be separated by a perforated line. Accordingly, the investor may detach the application form before submitting the same to the company or the designated bankers.

7.5.1 When 'Abridged Prospectus' is not Necessary

In the following circumstances, an 'abridged prospectus' containing the prescribed particulars as per Form 2A, need not accompany the application forms:

- In the case of a *bona fide* invitation to a person, to enter into an underwriting agreement with respect to the shares or debentures.
- When shares or debentures are not offered to the public.
- Where offer is made only to existing members/debenture holders of the company by way of rights, whether with or without the right of renunciation.
- In the case of issue of shares or debentures which are, in all respects similar to those previously issued and dealt in, and quoted on a recognised stock exchange.

Penalty: Non-compliance of the aforesaid provisions by any person shall attract punishment in terms of fine which may extend to ₹5,000.

Besides, the omission from a prospectus of a matter required to be included by s.56, may give rise to an action for damages, at the instance of a subscriber for share or debentures who has suffered loss thereby. It should be noted that the Act does not say that directors shall be liable, but this seems to be implied from s.56 (4).

Self Assessment

11. When there is a untrue statement in a prospectus who can sue

    (a) Subscribed in primary market (b) Subscribed in secondary market

    (c) Rights issue (d) None of the above

Notes

12. Definition of prospectus was given under which sec.

    (a) 2 (30) (b) 2 (32)

    (c) 2 (34) (d) 2 (36)

13. Which of the following are not required to issue prospectus?

    (a) Private company (b) Incase of right issue

    (c) Sweat equity issue (d) All the above

14. Which one of the following has a right to claim compensation for any loss due to misstatement in prospectus

    (a) Purchasing shares in Primary Market

    (b) Secondary Market

    (c) Subscribers to memo.

    (d) All the above

7.6 Misstatements in Prospectus and their Consequences

According to s.65 (1): (a) A statement included in a prospectus shall be deemed to be untrue, if the statement is misleading in the form and context in which it is included; and (b) Where the omission from a prospectus of any matter is calculated to mislead, the prospectus shall be deemed in respect of such omission, to be a prospectus in which an untrue statement is included. The expression 'included' with reference to a prospectus means, included in the prospectus itself or contained in any report or memorandum appearing on the face thereof or by reference incorporated therein or issued therewith.

Example: A company issued a prospectus. All the statements included therein were literally true. One of the statements disclosed the rates of dividends paid for a number of years. But dividends had been paid not out of trading profits but out of realised capital profits. This material fact was not disclosed. ***Held:*** The prospectus was false in material particulars and Lord Kylsant, the managing director and chairman, who knew that it was false, was held guilty of fraud [Rex vs. Kylsant, (1932) 1 K. B. 442].

A person who has applied for shares in the company and, who has been allotted shares, has certain remedies against the company and the persons issuing the prospectus. But a buyer of shares in the open market or a subscriber to the memorandum has no such right. If, however, a prospectus is issued with the object of inducing persons to buy shares in the open market, any person who buys shares even in the open market on the basis of the statements made in it, has a right of action if the statements are untrue or there is material omission from the prospectus.

A false statement or omission of material facts gives rise to civil as well as criminal liability.

7.7 Statement in Lieu of Prospectus

If a public company makes a private arrangement for raising its capital then it must file a statement in lieu of prospectus with the Registrar, at least three days before any allotment of shares or debentures can be made. Schedule III contains a model form of a Statement in Lieu of Prospectus in pursuance of s.70; Schedule IV contains a model form of a Statement in Lieu of Prospectus when a private company is converted into a public company in pursuance of s.44. If allotment of shares or debenture is made without filing the Statement in lieu of Prospectus, the allottee may avoid it within two months after the statutory meeting, or where no such meeting is to be held, within two months of the allotment. Contravention also renders the company and every director liable to a fine up to ₹ 10,000.

A prospectus issued by a company contained a promise of subscription of a substantial amount by some persons so as to induce the public to subscribe. The plaintiff who was allotted 10 shares alleges material misrepresentation. Decide upon the case. [Hint: Those responsible for making such a statement in the prospectus shall be held liable. See Ss.62, 63, 68 and 69 of the Companies Act, 1956.]

7.8 Underwriting Commission and Brokerage

In the event of the issuing company or the underwriters to the issue who have invited or received advance subscription by way of cash or post-dated cheques or stock-invest, the company or such underwriters or bankers to the issue shall not encash such subscription moneys or post-dated cheques or stock invests before the date of opening of the issue, without having individually intimated the prospective subscribers of the variation and, without having offered an opportunity to such prospective subscribers to withdraw their application and cancel their post-dated cheques or stock-invest or return of subscription paid.

The applicant or proposed subscriber can exercise his right to withdraw from the application, on any intimation of variation within seven days from the date of such intimation and, shall indicate such withdrawal in writing to the company and the underwriters.

Any application for subscription, which is acted upon by the company or underwriters or bankers to the issue, without having given enough information of any variations, or the particulars of withdrawing the offer or an opportunity for cancelling the post-dated cheques or stock-invest or stop payments for such payments shall be void. Further, the applicants shall be entitled to receive a refund or return of its post-dated cheques or stock-invest or subscription moneys on cancellation of its application, as if the said application had never been made and, the applicants are entitled to receive back their original application and interest at 15%, from the date of encashment till payment of realisation.

Brokerage Contracts*:* In addition to underwriters, a company may also enter into brokerage contracts with brokers. A broker is a person who undertakes to 'place' shares, i.e., find persons who will buy shares, in consideration of an agreed brokerage and if he fails to place any of the shares, he is not personally liable to take them, nor is he entitled to any brokerage in respect of shares not placed. The underwriter, on the other hand, is bound to take up the shares, which the public has not taken and is entitled to the whole of the agreed commission.

It may be noted that there must be authority in the articles to pay brokerage, and the brokerage must be disclosed in the prospectus, or statement in lieu of prospectus, as the case may be and it should pay a reasonable brokerage (s.76).

Self Assessment

State whether the following statements are true or false:

15. A person can avoid the contract to purchase shares in the company even if he has purchased shares in the open market and has not gone through the prospectus containing untrue statements.

16. An allottee of shares can retain the shares and can sue the company for damages in case he finds that the prospectus contained untrue statements.

Notes

17. A director can avoid liability for misstatements in the prospectus if he proves that he has reasonable ground to believe that the statement alleged to be untrue is true.
18. An expert is not criminally liable in respect of misstatements in the prospectus.
19. Where a prospectus contains untrue statements, the persons who authorized its issue are punishable with fine up to ₹ 5,000.

Case Study

Contract Termination

In the recent decision of *Olivaylle Pty Ltd v Flottweg GMBH & Co* KGAA (No 4) (2009) 255 ALR 632, a single judge of the Federal Court held that a purported termination of a contract for the sale of goods by the purchaser for an alleged breach of that contract was invalid. The judge also made an important observation about the acceptance of agreements in the age of email communications.

Briefly, the facts of the case are as follows. The director and controlling mind of Olivaylle sought to establish a large olive grove and olive oil manufacturing plant in central western Victoria. While waiting for the first stage of the grove to reach maturity, the director of Olivaylle tendered for a number of international producers of equipment for the processing of olives and, on 8th February 2005, entered into a written contract with Flottweg, a large international manufacturer of such equipment. Prior to entering into the contract, Olivaylle paid a deposit of approximately [euro] 140. It was a term of the contract that Flottweg would guarantee that the equipment supplied would be in accordance with certain design and quality specifications, and that Olivaylle would be entitled to exercise a right to a reduction in the purchase price or a "withdrawal" from the contract on the expiry of a "reasonable period of grace" after notice in writing of a failure to meet such specifications. Such a notice was delivered on 21st February 2006 alleging purported defects in the production line process and requiring those defects to be remedied by 30th June 2006, failing which Olivaylle asserted that it would withdraw from the contract and demand the return of its deposit. On the passing of 30th June 2006, Olivaylle did just that - to which Flottweg took issue and proceedings were commenced.

Essentially, Olivaylle's case was that the requisite "reasonable period of grace" had expired, entitling it to terminate or "withdraw" from the contract. Further, in order to give business efficacy to the contract, it was an implied term of the contract that Olivaylle was, upon its withdrawal from the contract, entitled to its deposit back and was not required to make any further payments under the contract.

Logan J also expressed the view (which in the end wasn't necessary for his decision) that the instantaneous communication rule applies when considering when and where the acceptance of an offer by email occurs. His Honour suggested that he would employ an analogy to telexes - the place where the message is received is where the contract is accepted, rather than the postal acceptance rule which states that acceptance occurs at the time and place where the letter was posted. In this case, Flottweg's acceptance was communicated by email (sent in Germany) to Olivaylle at its olive grove in Victoria. Thus, if the Federal Court position in this regard is to be followed, it appears that a contract will be deemed to be made, and therefore, the law that applies will be, where the email acceptance was received.

Contd...

Notes

Question

Is it right on the part of Olivaylle to nominate 30th June 2006 as the reasonable period of grace? Why? (***Hint:*** Refer para 2 in the case)

7.9 Summary

- A prospectus, as per s.2 (36), means any document described or issued as prospectus and includes any notice, circular, advertisement.
- Section 64 has been designed to check the bypassing of the provisions of s.56 as given above, by making an offer of sale of shares or debentures through the medium of Issue Houses.
- Whether a document containing an offer for sale of shares or debentures is a prospectus or not, depends upon whether it extends an invitation to the public to subscribe or not.
- Section 56 lays down that the matters and reports stated in Schedule II to the Act must be included in a prospectus.
- Section 60A makes provisions for a shelf-prospectus in certain situations.
- Section 56(3) requires that no one shall issue any form of application for shares or debentures of a company unless, the same is accompanied by a memorandum, (known as 'Abridged Prospectus').

7.10 Keywords

Abridge Prospectus: An 'abridged prospectus' need only be appended to the application form.

Prospectus: A prospectus, as per s.2 (36), means any document described or issued as prospectus and includes any notice, circular, advertisement.

Red Herring Prospectus: The 'red-herring' prospectus means, a prospectus which does not have the complete particulars on the price of the securities offered and the quantum of securities offered.

Shelf Prospectus: A 'shelf-prospectus' means, a prospectus issued by any financial institution or bank, for one or more issues of the securities or class of securities specified in that prospectus.

7.11 Review Questions

1. Define a prospectus. Detail out its contents.
2. Explain the provisions of the Companies Act, 1956 with regard to the registration of a prospectus of a public company going for public issue of equity shares. What are the documents required to be submitted by the company to the Registrar for this purpose?
3. Explain the remedies available to an allottee who has subscribed for the shares on the faith of a false and misleading prospectus.
4. Describe the defences available to a director in case of a suit against him for misstatements made in the prospectus.
5. Enumerate cases in which a prospectus is not required to be issued by a public company.
6. State the consequences of non-disclosure of matters, which ought to be included in the prospectus.

Notes

7. State the circumstances when the Registrar must refuse the registration of a prospectus.
8. Explain the nature and extent of liability of an expert in respect of a prospectus containing a misstatement.
9. Explain the extent of civil and criminal liability for misstatements in the prospectus.
10. Who are liable for misstatements in a prospectus?
11. How does a prospectus differ from a statement in lieu of prospectus?
12. Explain the terms 'underwriting' and 'underwriting commission'. State the conditions which are to be fulfilled for the payment of underwriting commission.

Answers: Self Assessment

1. s.2 (36)
2. allotment of shares
3. under s.56
4. 'public'
5. (a)
6. (c)
7. (a)
8. (c)
9. (d)
10. (c)
11. (a)
12. (d)
13. (d)
14. (a)
15. False
16. False
17. False
18. True
19. False

7.12 Further Readings

Books

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Notes

Unit 8: Membership in a Company

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define member;
- Describe shareholder;
- Explain modes of becoming member;
- Know partnership firm;
- Describe cessation of membership.

Notes

Introduction

A firm may be a member of any association or company licensed under this section, but on the dissolution of the firm, its membership of the association or company shall cease.

A licence may be granted by the Central Government under section 25 on such conditions and subject to such regulations as it thinks fit, and those conditions and regulations shall be binding on the body to which the licence is granted, and where the grant is under sub-section (1), shall, if the Central Government so directs, be inserted in the memorandum, or in the articles, or partly in the one and partly in the other.

It shall not be necessary for a body to which a licence is so granted to use the word "Limited" or the words "Private Limited" as any part of its name and, unless its articles otherwise provide, such body shall, if the Central Government by general or special order so directs and to the extent specified in the direction, be exempt from such of the provisions of this Act as may be specified therein.

8.1 Member — Definition and Meaning

Section 41 provides that:

1. The subscribers of the memorandum of a company shall be deemed to have agreed to become members of the company and on its registration, shall be entered as members in its register of members.
2. Every other person who agrees in writing to become a member of a company and whose name is entered in its register of members, shall be a member of the company.
3. Every person holding equity share capital of a company, and whose name is entered as beneficial owner in the records of the depository, shall be deemed to be a member of the concerned company (vide Depository Act, 1996).

On this basis, there are two pre-requisites for a person to become a member of a company:

1. The agreement in writing to take shares of the company; and
2. The registration of his name in its register of members.

Besides, a person may also become a member of a company through the depository system.

Thus, a person can agree to take shares of a company either as the subscriber at the initial stage of its formation or in any of the following manner:

1. By subscribing to its further or new shares;
2. On transfer of its shares from an existing member;
3. On acquisition or purchase of its shares (for example, take-over bid, renunciation of rights shares by an existing member); and
4. On acquisition of its shares by devolution (for example, transmission of shares to legal heirs of a deceased member, on insolvency, upon merger/amalgamation through court's order);
5. On conversion of convertible debentures or loans pursuant to the terms of issue of such debenture or loan agreement respectively.

The fundamental difference between the subscribers who agree to take shares at the time of formation of the company, and persons who agree to take shares later is that the former become members immediately on incorporation of the company, that is, they automatically become members. The latter, though having agreed to take shares, become members only after their names are registered in the register of members of the company.

8.2 Member and Shareholder

In the case of a company limited by shares, the persons whose names are put on the register of members are the members of the company. They may also be called shareholders of the company as they have been allotted shares and are holding them in their own right. In such a situation, the terms 'member' and 'shareholder' are interchangeably used to mean the same person. In Srikanta Data vs. Venkateshwara Real Estate Enterprises (P) Ltd. (1990) 68 Comp. Cas. 216 (Kar), it was held that unless the context otherwise requires, the word 'member' under s.2(27) means a 'shareholder' excepting a person, who is a bearer of a share warrant of the company. But in the case of an unlimited company or a company limited by guarantee, a member may not be a shareholder, for such a company may not have a share capital. However, sometimes a distinction is maintained between a member and a shareholder in the case of a company having a share capital. In other words, as regards the same set of shares one person may be a member and another be the shareholder of the company. This distinction arises in the following situations:

1. X is a member of a company limited by shares. His name is placed on the register of members as he is holding shares in his own right and, therefore, whether we call him a member or a shareholder, it is immaterial. In such a situation, the terms 'member' and 'shareholder' may be used interchangeably. Now, in the following three situations he will cease to be a shareholder, though he continues to be the member of the company:

   (i) *On Sale:* X sells the shares to Y. He fills in a share transfer form and hands it over to Y. He also gives the share certificate representing the shares to Y. In return for sale of shares, he receives consideration from Y. X is no longer a shareholder as he has sold the shares and property in the shares has passed to Y. But the name of X continues to be on the register of members till the transfer of shares is registered by the company in favour of Y. Thus, a person who acquires the shares in the open market may be a shareholder but he does not become the member immediately. It is only when his name is entered in the register of members that he becomes a member of the company.

   (ii) *On Death:* X dies and his property, including shares, is inherited by Y, his legal representative. X is no longer the shareholder. He is not in existence to hold the shares. Y is holding the shares in his own right and, therefore, can rightly be called the shareholder. But X continues to be the member as his name still appears on the register of members. However, as soon as Y gets his own name registered in the register of members, then X will cease to be a member.

   (iii) *On Becoming Insolvent:* X becomes insolvent and his property, including shares, vests in the Official Receiver or Official Assignee. The Official Receiver or Assignee is holding the shares in his own right. Therefore, X is no longer the shareholder, though he continues to be the member of the company.

2. A person who is holding a share warrant is a shareholder but he is not a member of the company as his name is struck off the register of members (s.115).

3. A person who subscribes to the memorandum of association immediately becomes a member, even though no shares are allotted to him. Till shares are allotted to the subscriber, he is a member but not a shareholder of the company.

4. In the case of a company limited by guarantee having no share capital or an unlimited company having no share capital, there will be only 'members' but not 'shareholders'.

Self Assessment

Fill in the blanks:

1. A ....may also become a member of a company through the depository system.

2. A person can agree to take shares of a company either as the .... at the initial stage of its formation.

3. In the case of a company limited by shares, the persons whose names are put on the register of members, are ....

4. Sometimes a distinction is maintained between a member and a ....in the case of a company having a share capital.

8.3 Modes of Becoming Member

A person may become a member or a shareholder of a company by any of the following ways:

1. ***By Subscribing to the Memorandum of Association:*** The subscribers of the memorandum of a company are deemed to have agreed to become members of the company only by reason of their having signed the memorandum. A subscriber to the memorandum becomes a member, the moment the company is registered and it is not necessary that their names must have been entered in the register of members.

   Further, by subscribing the memorandum every one of the subscribers is deemed to have contracted to become a shareholder in respect of the shares he subscribed for.

> *Task* M Company Limited issued 2,00,000 equity shares of ₹ 10 each. You are allotted 100 shares. Explain any ten rights you have as a member of the company.

2. ***By Agreement and Registration:*** Section 41(2) provides that, apart from the subscribers of the memorandum, 'every other person who agrees in writing to become a member and whose name is entered in its register of members shall be a member of the company'. It follows that except in the case of the subscribers to the memorandum, a person does not become a member of the company until his name is duly recorded in the register of members.

   Registration of the name of a person as a member of a company may arise:

   (i) *Upon application and allotment.*

   (ii) *By transfer.* The member may acquire shares from an existing member by sale, gift or some other transaction.

   (iii) *By transmission.* Here a person becomes a shareholder by transmission of shares to him through death, lunacy or insolvency of the member of a company.

   (iv) *By estoppel.* This arises when a person holds himself out as a member, or knowingly allows his name to remain on the register, when he has actually parted with his shares. In the event of winding up, he will be liable, like other genuine members, as

Notes

a contributory. However, he may escape liability by applying for removal of his name under s.155.

(v) *By agreeing to purchase qualification shares.* A person who signs and delivers to the registrar a written undertaking, to take from the company and pay for qualification shares, is in the same position as if he had subscribed to the memorandum for a similar number. As such, he is also deemed to have become a member automatically on incorporation of the company.

8.4 Who may become a Member

Subject to the provisions of law, the memorandum and the articles, any person *sui juris* can become a member of a company. The position of certain persons in this regard is given below:

8.4.1 Minor

The position of a minor as a member of a company is as follows:

- As a minor is wholly incompetent to enter into a contract [Mohiri Bibi vs. Dharmodas Ghose, (1903) 30 Cal. 539 (P.C)], an agreement by a minor to take shares is void and hence, he cannot be a member of a company.
- If shares are allotted to a minor in response to his application and his name entered on the register of members, in ignorance of the fact of minority, the company can repudiate the allotment and remove his name from the register on coming to know of the minority of the member. The company must repay all money received from him in respect of the allotted shares.
- The minor can also repudiate the allotment during his minority and he shall be returned the amount he paid towards the allotment of shares.
- If the name of the minor continues on the register of members and neither party repudiates the allotment, the minor does not incur any liability on the shares during minority and he cannot be held a contributory at the time of winding up [Fazalbhoy Jaffar vs. The Credit Bank of India (1914) 39 Bom. 331].
- If an application for shares is made by a father as guardian of his minor child and the company registers the shares in the name of the child describing him as a minor, neither the minor nor the guardian can be placed on the list of contributories at the time of winding up [Palaniappa vs. Official Liquidator, Pasupati Bank Ltd., AIR 1942 Mad. 470 and 875].
- If somehow the name of a minor appears on a register of members and in the meantime he attains majority and if he does not want to continue to be a member, then he must repudiate his liability on the shares on the grounds of minority. The company cannot take defence on the principle of estoppel that, the minor had fraudulently misrepresented his age or, had received dividends and other privileges as a member. However, if he had received dividends and exercised his rights as a member of the company after attaining majority, then he cannot repudiate his liability on shares.
- In case of transfer of partly-paid shares to a minor, the company may refuse to register him as a member. In case, the company, in ignorance of the minority, has permitted the transfer, then the company may remove the name of the minor and replace it by that of transferor, even though the latter may have been ignorant of the minority.

Notes

- In case of fully paid shares, a minor's name may be admitted in the register of members, if he happens to acquire the same by way of transfer or transmission. In Devan Singh vs. Minerva Films Ltd. (AIR 1956 Punjab 106), the court held that there is no legal bar to a minor becoming a member of a company by acquiring shares (by way of transfer) provided the shares are fully paid-up and no further obligation or liability is attached to them.

8.4.2 Company

A company, being an artificial person and a separate legal entity may become a member of another company, if it is so authorised by its memorandum to purchase shares. This is, however, subject to the provisions of s.42. Under this section, a subsidiary company cannot be member of its holding company and any allotment or transfer of shares in a holding company to its subsidiary, or even to a nominee for such subsidiary, is void, except that a subsidiary company may:

- Hold shares in the holding company in the capacity of a personal representative of a deceased shareholder, or
- Hold such shares as trustees, (except where the holding company or another subsidiary is beneficially interested under the trust otherwise than merely by way of the holding company's business), or
- Remain a member of its holding company, if it was a member before April 1, 1956, but may not vote at meetings of a holding company or any class of its members.

As has been mentioned earlier, a company cannot purchase its own shares (s.77) and, therefore, cannot become a member of itself. However, a company may acquire a beneficial interest in its own shares, as by the exercise of its paramount lien on the shares of a member as security for moneys owed by him to the company, or by forfeiture of shares for non-payment of calls.

8.4.3 A Partnership Firm

A partnership firm being an unincorporated association and therefore, not having a separate legal entity distinct from the partners, cannot be registered as a member in the register of members of a company. However, partners, either individually or in their joint names (as joint members) may hold shares in a company as a part of the partnership property. But a partnership firm may become a member of a company registered under s.25 of the Companies Act, 1956 (i.e., associations not for profit).

8.4.4 A Foreigner

As per the Law of Contract, a foreigner can enter into contracts and therefore, can purchase shares in a company but this is subject to the provisions of Foreign Exchange Management Act, 1999 (FEMA).

When the country, of which the foreigner is resident, is at war with India, then the foreigner becomes an alien enemy and therefore, his power of voting at company meetings and his right to receive notices for meetings, etc., are suspended during the war-period.

8.4.5 President of India/Governor of a State

In the case of a government company, the shares can be held in the name of the President of India/Governor of a State.

Notes

8.4.6 Society registered under the Societies Registration Act, 1860

A society registered under the Societies Registration Act, 1860 is treated as a 'person' having a separate legal entity distinct from the members constituting it. Therefore, such a society can become member of a company under s.41 (2) of the Companies Act, 1956.

8.4.7 Trade Union

A trade union registered under the Trade Union Act 1926, is a body corporate and thus, can sue and be sued, and can enter into contracts in its own name. Thus, a registered union can become a member under s.41 of the Companies Act, 1956.

Task Mr. P who is a member of A Ltd., has been declared insolvent. However, his name appears in the register of members of A Ltd. Can he attend the AGM of A Ltd., and receive the 20 percent dividend declared by it? [***Hint:*** He can attend the meeting and also receive the dividend declared by the company. However, he has to hand over the dividend to the official receiver or assignee.]

8.5 Cessation of Membership

A person may cease to be a member of a company when:

- He transfers his shares to another person and the shares are registered in the name of the transferee;
- His shares are forfeited by the company for non-payment of calls;
- He surrenders his shares to the company and the latter accepts the surrender;
- His shares are sold by the company to enforce its lien and the buyer of these shares is registered as a member;
- He dies and his legal heir gets his own name registered in the register of members or sells shares to a party who gets his name registered with the company;
- He is adjudged insolvent and the official receiver/official assignee either transfers the shares to a third party who gets registered as a member or disclaims shares;
- He was holder of redeemable preference shares which have now been redeemed by the company;
- He rescinds the contract of membership on the ground of fraud or misrepresentation;
- His shares are purchased either by another member of the company or by the company itself by an order of a court under s.402;
- He has got share warrants issued in exchange for share certificates of fully paid-up shares; and
- On the commencement of winding up (but he will be liable as a contributory and is also entitled to a share in the surplus assets, if any).

As mentioned earlier, a company may be member of another company. In such a situation if the shareholding company is being wound up, then the membership will come to an end if the liquidator disclaims the shares.

8.6 Rights of Members

Notes

A member of a company has a number of rights vis-à-vis the company. These are conferred on him either by the Act or, by the articles of the company. Some of the most important rights of a member are:

- To have the certificate of shares held ready for delivery to him within three months from the date of allotment;
- To have his name entered in the register of members if it had not been entered or has been wrongly removed;
- To transfer shares subject to the provisions of the Act and the articles;
- To receive notices of meetings, to attend meetings and to vote thereat (either in person or by proxy);
- To inspect the register of members and register of debenture holders and get extracts therefrom (s.163);
- To obtain copies of memorandum and articles on request and payment of the prescribed fees;
- To have the first option to buy any new shares on a further issue of shares by the company (s.81);
- To participate in the election of directors and appointment of auditors;
- To get a copy of the balance sheet and profit and loss account at least 21 days before the annual general meeting;
- To apply to the court to have any "variation of shareholders' rights" set aside (s.106);
- To nominate a person to whom his shares in the company shall vest in the event of his death (s.109 A);
- To obtain, on request, minutes of proceedings at general meetings (s.196);
- To participate in the removal of directors by passing an ordinary resolution (s.284);
- To petition to the court for prevention of mismanagement and oppression (s.399);
- To petition to the court for an order of injunction restraining the directors from going ahead with an ultra vires act;
- To petition for compulsory winding up;
- To participate in passing a special resolution for voluntary or compulsory winding up;
- To participate in the surplus assets, if any, on the liquidation of the company.
- To inspect the following registers: (a) of investments not held in company's name (s. 49); (b) of charges and copies of instruments creating charges (s. 144); (c) of members and index thereof (s. 150 and s. 151); (d) of debenture holders and index thereof (s. 152); (e) of foreign members (s. 158); (f) of contracts in which directors are interested (s. 301); (g) of directors shareholdings (s. 307); of directors, managing director, manager, secretary (s. 303); of loans and investments (s. 372A).

Notes

8.7 Liability of Members

A member is also subject to certain liabilities and obligations either by the Act or by the articles. Some of the important ones are:

- If shares are not allotted for a consideration other than cash, then a member must pay the whole nominal value of his shares in cash.
- If a member is holding partly paid-up shares, and the company goes into liquidation, then he becomes liable as contributory to pay, if called upon to do so, towards the assets of the company (s.429).
- A person may be included in the 'B' list of contributories, as a past member and required to pay to the extent of the amount remaining unpaid on the shares, which he held within one year prior to the commencement of winding up, if (i) on the commencement of winding up, debts exist which were incurred while he was a member; and (ii) the contributories of the 'A' list (i.e., present members) are not able to satisfy the contribution required from them in respect of their shares.
- As mentioned earlier, the liability of members becomes unlimited and several, even in the case of a limited liability company (s.45).
- A member is bound to the company by all the covenants of the articles; e.g., a company may have a paramount lien on a member's shares for any amount due from him to the company.
- In the case of a company limited by guarantee, the member may be asked to contribute to the extent of his guarantee at the time of winding up.

8.8 Register of Members (Sec. 150)

Section 150 read with s.168 requires every company to keep a register of members ordinarily at its registered office. The register must contain the following particulars:

- The name, address and occupation of each member;
- The number of shares held by each member, distinguishing each share by its number and amount paid-up;
- The date of entry in the register;
- The date on which a person ceased to be a member.

Where fully paid-up shares have been converted into stock, the fact that stock has been issued is to be entered against the name of the member in the register of members.

It is the duty of the company to maintain the register of members. A company cannot take advantage of its failure to maintain the prescribed register of members. Thus, in N. Satyaprasad Rao and others vs. V.L.N Sastry & Others [(1988)64 Comp. Cas. 492], it was held that, where register does not incorporate name of all shareholders as members, those shareholders who have been issued share certificates can exercise their rights as members.

8.8.1 Index of Members

Section 151 requires every company with more than 50 members, to keep an index of names of members, unless the register itself is in the form of an index. The index of members is required to be kept at the same place as the register of members. The register of members is open to

Notes

inspection by members free of charge and by non-members on payment of one rupee for two hours a day during business hours.

A company may close the register at any time, by giving seven days' previous notice, by an advertisement in a newspaper circulating in the district in which the registered office of the company is situated. However, the aggregate number of days for which it can be closed in a year cannot exceed 45 days. Also, it cannot be closed for more than 30 days at a time.

Section 157 provides that a company with a share capital may, if authorised by its Articles, keep in any country outside India a branch register of members resident there, called a Foreign Register. The registrar must be informed of the place where this register is kept. The foreign register is deemed part of the company's principal register and must be maintained in the same manner as the principal register.

Task The majority of the shareholders of a company passed a resolution to alter its articles, and authorised the directors to require any shareholder to compulsorily transfer shares of such shareholder competed with the company's business. The plaintiff shareholder who competed with the company's business challenged the validity of the resolution. Decide. [***Hint:*** The resolution is valid; it being in the general interest of the company.]

8.8.2 Rectification of Register of Members

Section 111 provides for the rectification of the register of members by the CLB on an application by any person aggrieved such as member, transferor, transferee, the company. The CLB may order for rectification of the register: (i) where the name of any person is, without sufficient cause, entered in or omitted from the register of members of a company; (ii) where default or unnecessary delay occurs in entering on the register the fact that a person has ceased to be a member of the company.

Where the CLB has ordered the rectification of the register, the rectification should be made and notice of rectification must be filed with the Registrar within 30 days of the order of the CLB.

Self Assessment

5. Which of the given below members are not shareholders
   (a) Minors
   (b) Insolvent
   (c) Share warrant holders
   (d) All of the above
6. Which of the following is a right of the members of a company
   (a) Right to have share
   (b) Right to Appoint Auditor
   (c) Right to Appoint Director
   (d) All of the above
7. Which of the following is not a member of a company?
   (a) Partnership firm
   (b) Foreigner
   (c) Government
   (d) HUF
8. For quorum, the Joint holders will be collectively counted as how many members.
   (a) 1
   (b) 2
   (c) 3
   (d) 4

Notes

8.9 Annual Return

Section 159 provides that every company having a share capital must prepare and file within 60 days from the date on which its annual general meeting is held, or if no annual general meeting is held, from the date when the meeting ought to have been held, with the registrar an Annual Return in accordance with Part I of Schedule V, which prescribes the contents as follows:

1. The address of the registered office of the company;
2. The name and address of the country where foreign register of members is kept;
3. A summary of share capital and debentures:
   (i) The number of shares issued for cash;
   (ii) The number of shares issued for consideration other than in cash;
   (iii) The nominal amount of capital in respect of each class of shares;
   (iv) The number of shares into which nominal capital is divided;
   (v) The number of shares taken up to the last annual general meeting;
   (vi) The amount called up;
   (vii) The total amount of commission paid;
   (viii) The discount allowed on any shares or debentures;
   (ix) The shares forfeited and the amount paid-up thereon;
   (x) The share warrants issued and surrendered.
4. The total indebtedness of the company in respect of all charges (including mortgages) which are required to be registered with the registrar under s.125.
5. A list of present members and debenture-holders and also of past members who have ceased to be members or debenture-holders since the date of the last annual general meeting, giving full particulars of the number of shares or debentures held and details of transfer, if any.
6. A list of its directors, managing directors, and managers, past and present.

With a view to avoid repetition of cumbersome particulars, notes appended to the annual return in Schedule V, it is provided that, where any of the five preceding returns has given full particulars as to past and present members and the shares held and transferred by them, the return in question may contain only such of the particulars as relate to, persons ceasing to be or becoming members and, to shares transferred or to changes in the number of shares held since the date of one of these returns.

Where any of the company's shares are converted into stock, notice regarding which has been given to the registrar, the list must state the amount of stock held by each member instead of shares so converted previously held by him.

Signing of the annual return (s.161). The copy of the annual return to be filed with the registrar shall be signed both by a director and by the manager or secretary of the company or where there is no manager or secretary, by two directors of the company, one of whom shall be the managing director where there is one.

In case of a company whose shares are listed on a recognised stock exchange, the copy of such annual return shall also be signed by a secretary in whole-time practice.

Notes

If default is made in filing the annual return, the company and every officer in default is liable to be fined up to ₹ 500 per day during the period of default.

Self Assessment

State whether the following statements are true or false:

9. It is not mandatory for a company to maintain a register of members.
10. A register of members remain open for inspection by its members for at least two hours every day except when the register is closed.
11. A company cannot close its register of members for more than 45 days in a year.
12. At any one time, the company cannot close its register of members for more than 30 days.
13. A company cannot transfer shares during the period when the register of members is closed.

Case Study

Client and Company Relations

Deepak, a client of City Limouzines India Ltd., received a cheque of amount ₹ 6000 dated 2-Sep-2009 from City Limouzines India Ltd, and deposited same cheque on 7-Sep-2009 in his Bank, which bounced with narration "Insufficient Balance".

He called on City Limouzines India Ltd., help line regarding same, but did not get any satisfactory response from help line, He called on "Toll Free/24X7 Helpline: 23814792". At 2:16 PM on 12-Sep-2009, a lady picked the call and she didn't show any interest to resolve his query/concern, she hanged the phone stating that "We will dispatch a letter after 20th Sep then check."

Deepak states that, as per his knowledge and as per company websites "City Limouzines" India Ltd. is an ISO approved company. He is unable to understand how a cheque of amount ₹6000 can get bounced with narration "Insufficient Balance"? He sent mails regarding same on given e mail ID "info@citylimouzines.com" but till date, has not heard from the company".

It is a very serious case; if company is indulging in Fraud, as it will impact all investors.

He lodges a complaint with the consumer court requesting them to take legal action against City Limouzines India Ltd.

Questions

1. Analyse the legal actions which should be taken by the Consumer court for the protection of Investors. (***Hint:*** recall consumer protection act again)
2. What penalties should be forced on the company?

8.10 Summary

- Every other person who agrees in writing to become a member of a company and whose name is entered in its register of members, shall be a member of the company.

Notes

- In the case of a company limited by shares, the persons whose names are put on the register of members, are the members of the company.
- A subscriber to the memorandum becomes a member, the moment the company is registered and it is not necessary that their names must have been entered in the register of members.
- The minor can also repudiate the allotment during his minority and he shall be returned the amount he paid towards the allotment of shares.
- A company, being an artificial person and a separate legal entity may become a member of another company, if it is so authorised by its memorandum to purchase shares.

8.11 Keywords

Company: A company, being an artificial person and a separate legal entity may become a member of another company, if it is so authorised by its memorandum to purchase shares.

Member: Person who agrees in writing to become a member of a company and whose name is entered in its register of members, shall be a member of the company.

Partnership Firm: A partnership firm being an unincorporated association and therefore, not having a separate legal entity distinct from the partners, cannot be registered as a member in the register of members of a company.

Shareholders: Members may also be called shareholders of the company as they have been allotted shares and are holding them in their own right.

Trade Union: A trade union registered under the Trade Union Act 1926, is a body corporate and thus, can sue and be sued, and can enter into contracts in its own name.

8.12 Review Questions

1. Define the term 'members'.
2. Explain the ways of acquiring membership in a company.
3. Under what circumstances does a person cease to be a member of a company?
4. State the provisions of the Companies Act, 1956 relating to maintenance of the register of members and Index of Members of a company.
5. To what extent is it possible for a minor to become a member of a company, under the provisions of the Companies Act, 1956? Explain.
6. What is the reporting obligation of the shareholder in case he is not the beneficial owner of the shares (BENAMI shareholding)?
7. What are the particulars entered in the register of members? How many years should the register of members be preserved?
8. Comment on the following statements:
   (i) In a company, all shareholders are members but all members need not be shareholders.
   (ii) Every shareholder of a company is known as a member, while every member may not be known as a shareholder.
   (iii) A minor cannot become member of a company.

Notes

9. Distinguish between:
   (i) A member and a shareholder in a company.
   (ii) Forfeiture and surrender of shares.
10. Write with reasons whether the following can become members of a company:
    (i) Minor
    (ii) Foreigner
    (iii) A company.

Answers: Self Assessment

1.	person	2.	subscriber
3.	the members of the company	4.	shareholder
5.	(d)	6.	(d)
7.	(a)	8.	(a)
9.	False	10.	True
11.	True	12.	True
13.	True		

8.13 Further Readings

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Notes

Unit 9: Share and Share Capital

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Contd...

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Objectives

After studying this unit, you will be able to:

- Define shares;
- Explain the various kinds of shares;
- Describe the equity share;
- Know the share capital;
- Describe share capital alteration;
- Know reduction of share capital.

Introduction

In the case of an unlimited company, the articles shall state the number of members with which the company is to be registered and, if the company has a share capital, the amount of share capital with which the Company is to be registered.

In the case of a company limited by guarantee, the articles shall state the number of members with which the company is to be registered.

In the case of a private company having a share capital, the articles shall contain provisions relating to the matters specified in sub-clauses (a), (b) and (c) of clause (iii) of sub-section (1) of section 3; and in the case of any other private company, the articles shall contain provisions relating to the matters specified in the said sub-clauses (b) and (c). [S. 27]

9.1 Shares

Section 2(46) defines a share as "a share in the share capital of a company and includes stock except where a distinction between stock and share is expressed or implied".

This definition does not bring out the meaning of a share in its true perspective.

A share signifies the following:

- The interest of a shareholder in the company; the right to receive dividend, attend meetings, vote at the meeting and share in the surplus assets of the company, if any, in the event of the company being wound up [Bacha F. Guzdar vs. Commissioner of Income Tax, Bombay, L. R. 617 SC];
- The liability of the shareholder in the company to pay calls on shares until fully paid up;
- The right of the shareholder to transfer the shares subject to the articles of association (For this purpose s.82 classifies shares as movable property, transferable in the manner provided in the articles);
- Binding covenants on the part of the company as well as the shareholder, as given in the articles of the company.

Notes

Thus, a share of a company in the hands of a shareholder signifies a bundle of rights and obligations [Viswanath vs. East India Distilleries (1957) 27 Comp. Cas. 175]. But a share is not a negotiable instrument. [C.I.T. vs. Associated Industrial Dev. Co. (1969) 2 Comp. L.J. 19]

Section 83 requires that each share in a company having a share capital must be distinguished by its distinctive number.

[The Companies (Amendment) Act, 1999 amended s.82 to the effect that for the word 'shares', the words 'shares and debentures' shall be substituted.]

9.1.1 Share vs. Share Certificate

A common man uses 'share' and 'share certificate' to mean the same. It is, therefore, important to note the exact differences between the two. Section 82, in this regard describes a share as "a movable property, transferable in the manner provided by the articles of the company". Section 84, on the other hand, describes a 'share certificate' to mean "a certificate, under the common seal of the company, specifying any shares held by any member". Section 84 further suggests that a share certificate shall be *prima facie* evidence of title of the member to such shares. Thus, whereas 'share' represents property, 'share certificate' is an evidence of the title of the member to such property.

Each share bears a distinctive number and it is not the same as share certificate number, the two are different. In fact, a share certificate may be an evidence of many shares, say 50, 100 or even 1 lakh. Thus, whereas there will be only one number as the share certificate number for one certificate, there will be as many distinctive numbers in respect of shares as are evidenced by the share certificate.

Thus, the share certificate, being *prima facie* evidence of title, it gives the shareholder the facility of dealing more easily with his shares in the market. It enables him to sell his shares by showing at once marketable title.

Also, a share certificate serves as an *estoppel*, as to payment against a bona fide purchaser of the shares from alleging that, the amount stated as being paid on shares has not been paid. However, a person who knows that, statements in a certificate are not true, cannot claim an *estoppel* against the company.

9.1.2 Share vs. Stock

The share capital of a company is divided into a number of indivisible units of specified amount. Each of such unit is called a 'share'. Thus, if the share capital of the company is ₹ 5,00,000 divided into 50,000 units of ₹ 10 each, unit of ₹ 10 shall be called a share of the company.

The term 'stock' may be defined as the aggregate of fully paid-up shares of a member merged into one fund of equal value. It is a set of shares put together in a bundle. The 'stock' is expressed in terms of money and not as so many shares. Stock can be divided into fractions of any amount and such fractions may be transferred like share. Such fractions, unlike the shares, bear no distinctive numbers.

A company cannot make an original issue of the stock. A company limited by shares may, if authorised by its articles by a resolution passed in the general meeting, convert all or any of its fully paid-up shares into stock [s.94 (1) (c)]. On conversion into stock, the register of members must show the amount of stock held by each member instead of the number of shares. The conversion does not affect the rights of the members in any way.

Notes

The main difference between shares and stocks are:

	Share	Stock
1.	A share has a nominal value.	A stock has no nominal value.
2.	A share has a distinctive number that distinguishes it from other shares. (Except where it is held under Depository mode.)	A stock bears no such number.
3.	Shares can be issued originally to the public.	A company cannot make an original issue of stock. Stock can be issued by existing company by converting its fully paid-up shares.
4.	A share may either be fully paid-up or partly paid-up.	A stock can never be partly paid-up. It is always fully paid-up.
5.	A share cannot be transferred in fractions. It is transferred as a whole.	A stock may be transferred in any fractions.
6.	All the shares are of equal denomination.	Stock may be of different denominations.
7.	Shares can be i ssued by any company, public or private.	Stock can be issued only by a public company limited by shares.

Self Assessment

Fill in the blanks:

1. Share is define in section ....
2. Section 83 requires that each share in a company having a share capital must be distinguished by its ....
3. A common man uses 'share' and 'share certificate' to mean the ....
4. The share capital of a company is divided into a number of indivisible units of specified amount. Each of such unit is called a ....
5. The term .... may be defined as the aggregate of fully paid-up shares of a member merged into one fund of equal value.

9.2 Kinds of Shares

As mentioned above, a share carries certain rights and is subject to some obligations. A company may issue all shares with same rights and obligations. However, it may issue different types of shares with different rights and liabilities attached to them so as to satisfy the needs of different types of investors. In such a case, the rights attached to the different classes of shares are called "class rights". The class rights normally relate to voting, dividends, return of capital or share in the surplus assets of the company (the last two rights being available at the time of winding up) and are invariably set out in the articles of the company.

The most common classes of shares are:

1. Preference;
2. Equity or Ordinary;
3. Deferred or Founders'.

Notes

A public company and a private company which is a subsidiary of a public company may not issue shares other than equity, preference and Cumulative Convertible Preference Shares (CCPS).

Further, SEBI has allowed companies to issue other financial instruments subject to its guidelines. Consequently, many companies have issued to their promoters and directors convertible warrants which can be converted into shares by them at their convenience at any time within 18 months from the date of their issue.

9.2.1 Preference Share

A preference share is one which carries the following two rights, over holders of equity shares:

1. A preferential right in respect of dividends at a fixed amount or at a fixed rate,
2. A preferential right in regard to repayment of capital on winding up.

The preference or priority of the preference shareholders is in relation to the rights of equity shareholders [s.85].

9.2.2 Participating and Non-participating Shares

If a preference share carries either one or both of the following rights then it is known as a participating share:

1. To participate further in the profits either along with, or after payment of a certain rate of dividends on equity shares,
2. To participate in the surplus assets at the time of winding up [s.85].

Thus, if a preference share does not carry either of these rights, then it will be known as a non-participating share. It should be remembered that, preference shares are always presumed to be non-participating unless, expressly described as participating.

9.2.3 Cumulative and Non-cumulative Preference Shares

If a preference share carries the right for payment of arrears of dividend from future profits, then such a share is known as cumulative preference share. Thus, dividends not paid in any year or years accumulate and are paid out whenever profits are available.

If a preference share does not carry the right to dividend in arrears, then such a preference share is known as non-cumulative or simple share. Thus, if no profits are available in a year, the holders get nothing nor can they claim unpaid dividend in subsequent years. It should be remembered that preference shares are always presumed to be cumulative unless expressly described as non-cumulative.

9.2.4 Redeemable and Irredeemable Shares

A preference share which can be redeemed upon the resolution of the board of directors, if the articles so provide, is known as redeemable preference share (s.80). A company can issue redeemable preference shares if it complies with the following requirements:

1. Such shares are to be issued as redeemable preference shares; shares issued earlier cannot be converted into redeemable preference shares;
2. There must be authority in the articles to issue redeemable preference shares;
3. The shares can be redeemed only when they are fully paid up;

4. The shares may only be redeemed: (a) out of profits of the company which would otherwise be available for dividend, or (b) out of the proceeds of a new issue of shares - not necessarily of redeemable preference shares made for the purpose of redemption;

5. If there is a premium payable on redemption, it must have been provided out of profits or out of the securities premium account before the shares are redeemed;

6. Where the shares are redeemed out of profits, a sum equal to the nominal amount of the shares redeemed is to be transferred out of profits to the "Capital Redemption Reserve Account."

The redeemable preference shares can be redeemed by the company either at a fixed date, or after a certain period of time, or at the option of the company. But redemption of such shares shall not be taken as reducing the nominal capital of the company.

9.2.5 Irredeemable Preference Shares

No company limited by shares can issue any preference shares which are irredeemable or are redeemable after the expiry of ten years from the date of issue. Also, once the company has redeemed the shares, or it is about to redeem them, it may issue new shares up to the same nominal amount and it will be presumed that the preference shares were never redeemed. In such a situation, the company's capital is not deemed to be increased and, therefore, no stamp duty is to be paid. This privilege is available only if the redemption takes place within one month after the making of the fresh issue [s.80 (4)].

Non-compliance with the provisions of s.80 will render the company and every officer of the company who is in default liable to a fine up to ₹ 10,000.

9.2.6 Equity Share

'Equity share' means a share which is not a preference share (s.85). The rate of dividend is not fixed. The Board of directors recommends the rate of dividend which is then declared by the members at the AGM. Before recommending dividend on equity shares, the BOD have to comply with the provisions of law as regards depreciation, transfer of a minimum amount to reserves, etc.

The holders of equity shares have voting rights in proportion to the paid-up equity capital of the company [s.87(1)].

The Companies (Amendment) Act, 2000, substituted a new section for s.86. It provides that the share capital of a company limited by shares shall be of two kinds only, namely:

1. Equity Share Capital
   (i) With voting rights or
   (ii) With differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed; and
2. Preference Share Capital.

Prior to the amendment to the Companies Act in 2000, public companies were not allowed to issue equity shares with differential rights.

Thus, companies are now allowed to issue non-voting equity shares. However, these shares can be issued subject to the rules and conditions prescribed by the Department of Companies Affairs.

Notes

The Department of Companies Affairs has notified the rules, "The Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001" which, *inter alia*, provide for the following:

1. Share with differential voting rights, including non-voting shares, cannot exceed 25 per cent of the total issued share capital.
2. The company issuing such shares must have distributable profits in the three years preceding such issues.
3. Companies will not be allowed to convert its equity capital with regular voting rights into shares with differential voting rights and vice versa.
4. Issue of such shares must be approved by the shareholders by way of a resolution in a general meeting:

   The notice of the general meeting to shareholders shall carry an explanatory statement detailing, *inter alia,* the following:

   (i) Voting rights which shares with differential rights will carry;

   (ii) Scale or proportion to which the voting rights of such shares will vary;

   (iii) That the members holding equity shares with differential rights will be entitled to bonus and rights shares of the same class.
5. Listed companies must obtain the shareholders' approval through postal ballot.
6. Companies which have defaulted in filing annual returns during the preceding three years or have failed to repay their deposits or interest thereon on due date or redeem debentures on due date or pay dividend after becoming due, will not be eligible to issue shares with differential rights.
7. Companies which have defaulted in addressing investors' grievances will not be allowed to issue such shares.
8. Issue of such shares must be authorized by articles of the company.
9. The company should not have been convicted of any offence under SEBI Act, 1992, Securities Contract (Regulation) Act, 1956 and FEMA, 1999.
10. Members holding equity shares with differential rights shall be entitled to bonus and rights issue of the same class.

The holders of equity shares carrying voting rights shall have voting rights in proportion to the paid-up equity capital of the company, in case the voting is by poll [s.87(1)].

Rights/Powers of Equity Shareholders

In particular, the equity shareholders have the following rights/powers:

- He can ask for a copy of memorandum and articles (s.39).
- He is entitled to receive offer to subscribe to further issue of capital on rights basis (s.81).
- The shareholders holding not less than 10 per cent of the issued shares, having not consented to in favour of resolution for variation of rights may apply to the court for cancellation of the variation of the rights of shareholders (s.107).
- He has a right to apply to the CLB for rectification of register of members (s.111).
- He has a right to inspect documents and registers to be kept by the company and ask extracts therefrom (s.163).

- He can apply to the CLB to call AGM if default is made in calling the same by a company (s.167).
- A corporate body, being member of a company, can appoint a representative to attend general meeting of the company (s.187).
- He has a right to inspect minutes of general meetings and ask for extracts therefrom (s.196).
- He is entitled to receive fully paid-up bonus shares as and when issued (s.205).
- A shareholder, also being a director, can inspect books of account of the company during business hours (s.209).
- He is entitled to have copies of account and auditor's report or statement of salient features (s.219).
- Two hundred shareholders or shareholders having one-tenth voting power may ask the Central Government for investigation of the affairs of the company (s.235).
- He can send a notice to the company signifying his candidature or that of any other person to the office of director to be elected at the AGM (s.257).
- He can give a special notice of a resolution for removal of a director (s.284).
- Shareholders having substantial holding can present the case to CLB for removal of any incompetent managerial personnel. The Central Government has the power to remove managerial personnel on recommendation of the CLB (s.388).
- He can apply to the CLB for relief in case of oppression or mismanagement of the affairs of the company (s.397 and s. 398).
- He can complain for the non-compliance of any of the provisions of the Companies Act, 1956, to the registrar and CLB.

9.2.7 Cumulative Convertible Preference Shares (CCPS)

The Government *vide* its guidelines dated 19th August, 1985 permitted issue of another class of shares by public limited companies, called cumulative convertible preference shares.

The guidelines issued by the Ministry of Finance in this regard are as follows:

1. ***Applicability:*** The guidelines will apply to the issue of CCPS by public limited companies which propose to raise finance.
2. ***Objects of the Issue:*** The objects of the issue of the above instrument should be for any of the following purposes: (a) Setting-up of new projects; (b) Expansion or diversification of existing projects; (c) Normal capital expenditure for modernisation; and (d) Working capital requirements.
3. ***Quantum of Issue:*** The amount of CCPS cannot exceed the equity shares offered to the public for subscription. However, in case of projects assisted by financial institutions, the quantum of issue would be approved by the financial institutions/banks.
4. ***Terms of Issue:*** Following are the terms of issue of CCPS:
   (i) CCPSs would be deemed to be equity issue for the purpose of calculation of debt equity ratio as may be applicable.
   (ii) The entire issue of CCPSs would be convertible into equity shares between the end of 3 years and 5 years as may be decided by the company and approved by SEBI.

(iii) The conversion of the CCP shares into equity would be deemed as being one resulting from the process of redemption of the preference shares out of the proceeds of a fresh issue of shares made for the purposes of redemption.

(iv) The rate of preference dividend payable on CCP shares would be 10%.

(v) The guidelines in respect of preference shares regarding ratio of 1:3 as between preference shares and equity shares would not be applicable to this new instrument.

(vi) On conversion of the preference shares into equity shares, the right to receive arrears of the dividend, if any, on the preference shares up to the date of conversion shall devolve on the holder of the equity shares on such conversion. The holder of the equity shares shall be entitled to receive the arrears of dividend as and when the company makes profit and is able to declare such dividend.

(vii) The aforesaid CCP share would have voting rights as applicable to preference share under the Companies Act.

(viii) The conversion of aforesaid preference shares into equity shares would be compulsory at the end of 5 years; and the aforesaid preference shares would not be redeemable at any stage.

5. ***Denomination:*** The face value of CCP share will ordinarily be ₹ 100 each.

6. ***Listing:*** CCP shares shall be listed on one or more stock exchange in the country.

7. ***Articles of Association of the Company and Resolution of the General Body:*** The articles of association of the company proposing to issue CCPSs should contain a provision for issue of such shares. Further, the company must submit with the application to SEBI a certified copy of a special resolution in this regard under s.81 (1A) of the Companies Act, duly passed in the general meeting of the company. This resolution must approve the issue of CCP shares and provide for compulsory conversion of the preference shares between the 3rd to 5th year, as the case may be.

Task A buys from B 400 shares in a company on the faith of a share certificate issued by the company. A tenders to the company a transfer deed duly executed together with B's share certificate. The company discovers that the certificate in the name of B has been fraudulently obtained and refuses to register the transfer. Advise A. [***Hint:*** A has a right to be registered as a shareholder or receive compensation from the company to the extent of the value of the shares at the time of refusal to register the transfer as a share certificate works as an estoppel against the company.

9.2.8 Deferred or Founders' Shares

A pure private company can issue shares of a type other than those discussed above (s.90). Thus, it may issue what are known as deferred shares. As deferred shares are normally held by promoters and directors of the company, they are usually called founders' shares. They are usually of a smaller denomination, say one rupee each. However, they are generally given equal voting rights with equity shares, which may be of higher denomination, say ₹10 each. As regards payment of dividend to holders of such shares, the articles usually provide that these shares will carry a dividend fixed in relation to the profits available after dividends have been declared on the preference and equity shares. Thus, the promoters, founders and directors have a very direct interest in the success of such a company: the greater the profits of the company, the higher their dividends.

It is to be remembered, however, that as and when the private company converts itself into a public company, it will have to alter its capital structure and retain only equity share capital and preference share capital (including CCPs), if any.

9.2.9 Non-voting Shares

'Non-voting shares' as the term suggests, are shares which carry no voting rights. These are contemplated as altogether a different class of shares which may carry additional dividends in lieu of the voting rights. The Companies (Amendment) Act, 2000 provided for issue of such type of equity shares under s.86.

9.2.10 Sweat Equity Shares

The Companies (Amendment) Act, 1999, allowed issue of sweat equity shares subject to fulfillment of certain conditions. A new Section - 79A was inserted for this purpose. The provisions are:

Notwithstanding anything contained in s.79, a company may issue sweat equity shares of a class of shares already issued if the following conditions are satisfied: (a) the issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting; (b) the resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued; (c) at least one year has, at the date of the issue, elapsed since the date on which the company was entitled to commence business; (d) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations of SEBI. In case of a company whose shares are not listed on any recognised stock exchange, the sweat equity shares may be issued in accordance with the guidelines as may be prescribed. For purposes of this section, the expression 'a company' means company incorporated, formed and registered under this Act and includes its subsidiary company incorporated in a country outside India.

The expression "sweat equity shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

However, all the limitations, restrictions and provisions relating to equity shares shall be applicable to such sweat equity shares.

9.2.11 Bonus Shares

A company may, if the articles so provide, capitalise profits by issuing fully paid-up shares to the members thereby transferring, the sums capitalised from the profit and loss account or Reserve Account to the Share Capital [s.205 (3)]. Such shares are known as bonus shares and are issued to the existing members of the company free of charge.

The issue of bonus shares is regulated, not only by the Companies Act, 1956 but also by the guidelines issued by SEBI in this regard.

SEBI guidelines for the issue of Bonus shares, 2000 provide as follows:

- No bonus issue shall be made within 12 months of any public/right issue.
- The bonus issue shall only be made out of free reserves built out of the genuine profits or share premium collected in cash only.
- The reserves created by revaluation of fixed assets cannot be capitalised.

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- The declaration of bonus issue, in lieu of dividend, cannot be made.
- The bonus issue is not made unless the partly-paid share, if any, existing, are made fully paid up.
- The company (a) has not defaulted in payment of interest or principal in respect of fixed deposits, and interest on existing debentures or principal or redemption thereof, and (b) has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus, etc.
- A company which announces its bonus issue after the approval of the BOD must implement the proposals within a period of 6 months from the date of such approval and shall not have the option of changing the decision.
- There should be a provision in the articles of the company for capitalisation of reserves; etc. and, if not, the company shall pass a resolution at its general body meeting making provisions in its articles for capitalisation of reserves, etc.
- Consequent to the issue of bonus shares if the subscribed and paid-up capital exceed the authorised share capital, a resolution shall be passed by the company at its general body meeting for increasing the authorised share capital.
- No company shall, pending conversion of FCDs/PCDs, issue any shares by way of bonus, unless similar benefit is extended to the holders of such FCDs/PCDs. Through reservation of shares in proportion to such convertible part of FCDs/PCDs. The shares so reserved may be issued at the time of conversion of such debentures on the same terms on which the bonus issues were made.

Self Assessment

6. Consider the following functions of a stock exchange:

   (i) Providing a ready market for securities

   (ii) Helping capital formation

   (iii) Regulating the capital structure of a company

   (iv) Regulating the public deposits with companies

   Of the above functions:

   (a) (i), (ii), (iii) and (iv) are correct (b) (i), (ii), and (iii) are correct

   (c) (i) and (ii) are correct (d) none is correct

7. Match List-I with List-II and select the correct answer using the codes given below the lists:

	List-I		List-II
A.	Minimum issued capital for being listed on a stock exchange	1.	One crore
B.	Exemption from the consent of controller of capital issues for issue of shares	2.	Three crores
C.	Amount payable on shares to be called only in installments and not in one stroke	3.	Issued capital of less than ₹ 3 crores
D.	Listing in OTC exchange	4.	Issued capital of ₹ 50 crores and above

	A	B	C	D
(a)	2	1	4	3
(b)	1	3	4	2
(c)	2	1	3	4
(d)	4	3	1	2

9.3 Alteration of Capital

Alteration is making changes whether by way of addition, deletion or modification to the existing thing. Similarly, in case of alteration of Capital Clause it means making changes to the existing Capital Structure of the company, which may be required at several times and on several occasions like if company goes for capital restructuring or if it is looking for some extra funds and the Authorised Share Capital of the Company don't permit it to do so because of the limited Capital stated there.

9.3.1 Why alteration is required?

At various instances and occasions there arises a need to alter its various parts in various forms like increase, subdivision, reclassification, consolidation, conversion, cancellation, reduction and many more. Generally the people have a misconception that alteration of capital is alteration of Authorised Share capital but it's not true at all as alteration can be made at various stages like by just increasing the paid up capital.

9.3.2 How it is done?

If the alteration is made to any clause other than Authorised Capital then one need not modify the Charter of the Company i.e., Memorandum of Association of Company and/or Articles of Association of the Company, as it can just be done either by according the Board Consent or shareholders Consent as the situation demands. However, if the Authorised Share Capital is to be altered, a detailed procedure as outlined below has to be followed:

1. ***Prior Stage:*** At this stage, the in-house consent i.e., of management is accorded by passing a Board Resolution by simple majority at a duly convened Board Meeting or either by circulation. When such consent is attained, then a proper notice is sent to all the shareholders of the company to intimate them about the ensuing General Meeting for the said purpose. The Notice is to be attached with the relevant Explanatory Statement.

2. ***Conduction of Meeting and according the consent of Shareholders:*** When a proper notice is sent then comes the stage of convening the meeting, which can be convened only if there is a proper Quorum. At the meeting one needs to accord the consent of shareholders of the company by passing an ordinary resolution/or special resolution as the situation demands like if it's the case of increase, consolidation, sub-division, conversion or cancellation of Share Capital under section 94 of the Companies Act, 1956; then ordinary resolution is required however, in case of reduction of Share Capital under Section 100 of the Companies Act, 1956, then consent is to be accorded by way of Special Resolution and not only this along with the special resolution, the consent of court is also required.

3. ***Proceedings on the consent accorded:*** Once the consent of the shareholders is accorded and in case of reduction of share capital, the approval of court is also obtained then the necessary changes are to be made to the Memorandum of Association of the Company and if required then to the Articles of Association of the company as well and an intimation to the Registrar

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of Companies is made by way of filing the E-form 5, E-form 23 and E-form 21 as may be required according to the alteration made. Stamp duty is also to be paid in case of increase which is to be paid as per the relevant State Stamp Act. The said E-Forms are to be filed with the concerned Registrar of Companies.

4. ***Approval of the said Change:*** Mere intimation to the Registrar of Companies is not sufficient if alteration is to be made. The form needs to be approved by the concerned Registrar of Companies. Hence, it is always advisable to keep a check on the status of the E-form filed.

Task The capital of X Ltd., is ₹ 50 lakhs, consisting of equity share capital of ₹ 40 lakhs and redeemable preference share capital of ₹ 10 lakhs. The preference share capital is to be redeemed before 31st December, 2005. The company is running in losses and its accumulated losses aggregated to ₹ 15 lakhs. The company wants to borrow ₹ 20 lakh from a financial institution to improve its working and also to redeem the preference share capital. Advise. [***Hint:*** Refer to s. 80. The preference shares can be redeemed out of only two sources and no other. The borrowing from financial institution for redemption of preference shares is not provided for. The amount may, however, be borrowed for improving its working capital.]

9.4 Share Capital

It means the capital of a company, or the figure in terms of so many rupees divided into shares of a fixed amount, or the money raised by the issue of shares by a company.

As mentioned above, a public company and its subsidiary can issue only two kinds of shares, viz., preference and equity. Therefore, such a company can have only two kinds of share capital by issue of preference shares and equity shares, viz., preference share capital and equity share capital. The expression "Preference Share Capital" and "Equity Share Capital" are used in the following five different senses:

1. ***Nominal, Authorised or Registered Capital:*** This is the sum stated in the memorandum as the share capital of a company, with which it is proposed to be registered. This is the maximum amount of capital which it is authorised to raise, by issuing shares and upon which it pays stamp duty. As we shall see later, when the original amount of the authorised capital is exhausted by issue of shares, it can be increased by passing an ordinary resolution.

2. ***Issued Capital:*** It is that part of the authorised capital which, the company has issued for subscription. The amount of issued capital is either equal to or less than the authorised capital.

3. ***Subscribed Capital:*** It is that portion of the issued capital which has been subscribed for by the purchasers of the company's shares. The amount of subscribed capital is either equal to or less than the issued capital.

4. ***Called-up Capital:*** The company may not call up full amount of the face value of the shares. Thus, the called-up capital represents the total amount called-up on the shares subscribed. The total amount of called-up capital can be either equal to or less than the subscribed capital.

   Thus, uncalled capital represents the total amount not called-up on shares subscribed, and the shareholders continue to be liable to pay the amounts as and when called. However, the company may reserve all or part of the uncalled capital, which can then be called in the event of the company being wound up. For this purpose, a special resolution is

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required to be passed and then the uncalled capital is known as Reserve Capital or Reserve Liability (s.99).

5. ***Paid-up Capital:*** Paid-up capital is the amount of money paid-up on the shares subscribed.

9.4.1 Alteration of Share Capital

Section 94 provides that if the articles authorise, a company limited by share capital may, by an ordinary resolution passed in general meeting, alter the conditions of its memorandum in regard to capital so as:

1. To increase its authorised share capital by such an amount as it thinks expedient by issuing fresh shares;
2. To consolidate and divide all or any of its shares into shares of larger amount than its existing shares;
3. To convert all or any of its fully paid-up shares into stock and reconvert the stock into fully paid-up shares of any denomination;
4. To sub-divide its shares, or any of them, into shares of smaller amount than fixed by the memorandum, but the proportion paid and unpaid on each share must remain the same;
5. To cancel shares which, at the date of the passing of the resolution in this behalf, have not been taken or agreed to be taken by any person.

These clauses are now explained in detail:

1. ***Increase of Authorised Share Capital:*** A company, limited by shares, if the articles authorise, can increase its authorised share capital by passing an ordinary resolution. Within 30 days of the passing of the resolution, a notice of increase in the share capital must be filed with the Registrar. On receipt of the notice, the Registrar shall record the increase and also make any alterations which may be necessary in the company's memorandum or articles or both. If default is made in filing the notice, the company and every officer of the company who is in default shall be punishable with fine up to ₹ 500 per day during which the default continues (s.97).
2. ***Consolidation and Sub-division of Shares:*** Consolidation is the process of combining shares of smaller denomination. For instance, 10 shares of ₹ 10 each are consolidated into one share of ₹ 100. Sub-division of shares is just the opposite of consolidation, i.e., one share of ₹ 100 is divided into 10 shares of ₹ 10 each. Once a resolution has been passed, a copy of the resolution is required to be sent within thirty days to the Registrar.
3. ***Conversion of Shares into Stock and vice versa:*** Stock is simply a set of fully paid-up shares put together, and is transferable in any denomination or fraction. On the other hand, a share is transferable as a whole; it cannot be split into parts. For example, a share of ₹ 10 can be transferred as a whole; it cannot be transferred in parts. But if 10 shares of ₹ 10 each fully paid are converted into stock of ₹ 100, then the stockholder can transfer stock, say, worth ₹ 17 also.

   Section 94 empowers a company to convert its fully paid-up shares into stock by passing a resolution in general meeting, if its articles authorise such conversion. A notice is to be filed with the Registrar within thirty days of the passing of the resolution specifying the shares so converted.

   It is to be noted that stock cannot be issued in the first instance. It is necessary to first issue shares and have them fully paid-up and then convert them into stock. Also, stock can be reconverted into fully paid-up shares by passing a resolution in general meeting.

When shares are converted into stock, the shareholders are issued stock certificates. In the Register of members, the amount of stock is written against the name of a particular member in place of number of shares. The stockholder is as much a member of the company as a shareholder.

4. ***Diminution of Share Capital:*** Sometimes, it so happens that shares are issued, but are not taken up by the members of the public and, therefore, not allotted. Section 94 provides that a company may, if its articles authorise, by resolution in general meeting, cancel shares which on the date of the passing of the resolution in this behalf have not been taken or agreed to be taken by any person, and diminish the amount of the share capital by the amount of the shares so cancelled. This constitutes diminution of capital and should be distinguished from reduction of capital.

Authorised Share Capital stands increased under certain Circumstances

Section 94A empowers the Central Government to administratively increase the authorised capital of a company when an order is made under s. 81(4).

Section 81(4) provides that where any debentures have been issued to, or loans have been obtained from the government by a company, the Central Government may, if in its opinion it is necessary in the public interest to do so, by order, direct that such debentures or loans or any part thereof shall be converted into shares in that company. Such an order can be made even if the terms of issue of such debentures or the terms of such loans do not include a term, providing for an option for such conversion. Consequently, the Central Government can administratively increase the nominal capital of the company.

Also the nominal share capital of a company shall stand increased, when any public financial institution proposes to convert debentures or loans (having an option of conversion) issued to, or given to the company, when an application is made by the financial institution to the Central Government to pass orders for the increase of the authorised share capital of the company.

The consequence of the order of the Central Government will be that the conditions contained in the memorandum of the company shall stand altered and, the nominal share capital of such company shall stand increased by an amount equal to the amount of the value of the shares into which such debentures or loans or part thereof has been converted.

Where the memorandum of a company becomes altered as above, the Central Government shall send a copy of such an order to the Registrar and also to the company. On receipt of such order, the company shall file in the prescribed form, within 30 days from the date of such receipt, a return to the Registrar with regard to the increase of share capital and the Registrar shall on receipt of such order and return, carry out the necessary alteration in the memorandum of the company.

9.5 Reduction of Share Capital

Sections 100-105 provide for the reduction of share capital. A company limited by shares, if so authorised by its articles, may, by special resolution, which is to be confirmed by the court reduce its share capital:

1. By reducing or extinguishing the liability of members for uncalled capital, e.g., where a share of ₹ 10 on which ₹ 5 are paid, is treated as a share of ₹ 5 fully paid-up. In this way, the shareholder is relieved from liability on the uncalled capital;
2. By paying off or returning capital which is in excess of the wants of the company, e.g., where there is a share of ₹ 10 fully paid-up, reduce it to ₹ 5 and pay back ₹ 5 to the shareholder.

3. Pay off paid-up capital on the understanding that it may be called up again, e.g., a share of ₹ 10 is fully paid-up, on which ₹ 2.50 may be returned to the shareholder on the condition that when necessary, the company may call it up again. Thus, the difference between method (1) and this method is that the uncalled liability is not extinguished in the latter;
4. A combination of the preceding methods.
5. Write off or cancel capital which has been lost or is not represented by available assets, e.g., a share of ₹ 10 fully paid-up is represented by ₹ 7.50 worth of assets. In such a situation, reality can be re-introduced into the balance sheet of the company by writing off ₹ 2.50 per share. This is the most common method of reduction of capital. The assets side of the balance sheet may include useless assets, fictitious goodwill, preliminary expenses, discount on issue of shares and debentures, etc. These assets are either cancelled or their values are reduced to the extent they are useful. Correspondingly, share capital on the liability side is reduced.

9.5.1 Procedure for Reduction of Capital

After passing the special resolution for the reduction of capital, the company has to apply to the court by way of petition to confirm the resolution under s.101. The creditors are entitled to object where the proposed reduction of share capital involves either: (i) the diminution of liability in respect of unpaid capital; or (ii) the payment to any shareholder of any paid-up share capital, or in any other case, if the court so directs.

To enable the creditors to object, the court selects a list of such people. If any creditor objects, either his consent to the proposed reduction should be obtained or he should be paid off or his payment secured. However, the court may dispense with the consent of a creditor on the company securing payment of the debt or claim, by appropriating the full amount or that fixed by the court.

Section 102 states that if the court is satisfied that either the creditors entitled to object have consented to the reduction, or that their debts have been paid or secured, it may confirm the reduction. It may also direct that the words "and reduced" be added to the company's name for a specified period and that the company must publish the reasons for the reduction and the causes which led to it.

Section 103 provides for registration of the court's order with the Registrar. The company has also to send the minutes, giving details of the share capital as altered. The reduction of share capital takes effect only on registration of the court's order with the Registrar and not before. The Registrar will issue a Certificate of Registration, which will be a conclusive evidence that, both the requirements of the Act have been complied with and that the share capital is now as set out in the minutes. The registered minutes are deemed to be substituted for the corresponding capital clause in the memorandum, thereby altering the memorandum within the meaning of s. 40. The copies of the memorandum which will be issued subsequently must, therefore, be in accordance with the articles.

Section 104 provides that after the reduction of capital, the members cease to be liable for calls as regards to the amount, by which the nominal amount of their shares has been reduced. If, however, any creditor entitled to object to the reduction of share capital is not entered on the list of creditors, then every member at the time of the registration of the court order and minutes is liable to contribute for the payment of that debt.

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Section 105 provides for punishment with imprisonment extending to one year or with fine or both, if any officer of the company knowingly conceals the name of any creditor entitled to object to the reduction or misrepresents the nature or amount of claim or debt or abets such concealment or misrepresentation.

9.5.2 Reduction of Share Capital without the Sanction of the Court

There are some cases in which there is reduction of share capital and no confirmation by the court is necessary. These are:

1. ***Forfeiture of Shares:*** A company may, in pursuance of its articles, forfeit shares for non-payment of calls.
2. ***Surrender of Shares:*** It is a short-cut to forfeiture. It may be accepted by the company under circumstances where its forfeiture is justified. It has the effect of releasing the shareholder whose surrender is accepted from liability on shares.
3. ***Diminution of Capital:*** This has already been explained in Para 8.6. Section 94 clearly states that diminution of capital does not amount to reduction of capital.
4. ***Redemption of Redeemable Preference Shares:*** This has already been explained in Para 8.2.4 as provided by s.80.
5. ***Purchase of Shares of a Member by the Company under s.402:*** The court may order the purchase of shares of any member of the company by the company, under certain circumstances.

9.5.3 Reduction of Capital vs. Diminution of Capital

Reduction of capital involves, working off past losses against capital, cancellation of the uncalled capital or repayment of surplus capital. It may involve reduction of issued capital, subscribed or paid up share capital. Diminution of capital denotes cancellation of the authorised or issued capital (but not subscribed). Diminution of capital does not constitute a reduction of capital within the meaning of the Companies Act. The distinction between reduction and diminution of capital is as follows:

1. Diminution of capital is the reduction of the issued capital. Reduction of capital involves reduction of subscribed or paid-up capital; there is no reduction of issued capital.
2. Both require authorisation by articles but whereas 'diminution' can be effected by an ordinary resolution (if so authorised by articles), reduction of capital cannot be effected without passing a special resolution.
3. 'Reduction' requires confirmation by court (s.100) but 'diminution' needs no confirmation by the court (s.94).
4. In case of 'reduction', court may order the company to add the words 'and reduced' after its name [s.102 (3) but no such order can be passed in case of 'diminution' s.94].
5. In case of 'diminution', notice is to be given to Registrar within 30 days from the date of cancellation whereupon, the Registrar shall record the notice and make the necessary alteration in the memorandum and articles. In case of 'reduction', a more detailed procedure has been prescribed though there is no time limit as in case of 'diminution'.

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> *Task* X, Y and Z are the three shareholders in a company representing three distinct groups of shareholders. At one stage, when the company needs additional funds and therefore, seeks to issue fresh shares, Z maintains that the new shares be issued to the existing shareholder proportionately. X and Y manage to get majority shareholders to pass a special resolution to the effect that the shares shall be directly offered to the public. Can Z seek a remedy on the ground of oppression of minority? [***Hint:*** No, there is no remedy available to him as provisions of s. 81 have not been contravened.]

9.6 Reorganisation of Capital

The companies limited by shares have to issue shares to raise the necessary capital for their operations. Issue of shares may be made in three ways:

1. By private placement of shares.
2. By allotting entire shares to an issue-house, which in turn, offers the shares for sale to the public.
3. By inviting the public to subscribe for shares in the company through a prospectus.

1. ***Private Placement of Shares:*** A private company limited by shares is prohibited by the Act and the articles from inviting the public to subscribe in shares or debentures. It also need not file statement in lieu of prospectus. Its shares are issued privately, to a small number of persons known to the promoters or related to them by family connections.

   A public company can also raise its capital by placing the shares privately and, without inviting the public to subscribe to its shares or debentures. In this kind of arrangement, an underwriter or broker finds persons, normally his clients who wish to buy the shares. He acts merely as an agent and his function is simply to procure buyer for the shares, i.e., to place them. Since no public offer is made for shares, there is no need to issue any prospectus. However, under s.70, such a company is required to file with the Registrar a statement in lieu of prospectus, at least 3 days before making allotment of any shares or debentures.

   As per the guidelines issued by SEBI in June, 1992, private placement of shares should not be made by subscription of shares from unrelated investors through any kind of market intermediaries. This means a promoters' share should not be contributed by subscription of those shares, by unrelated investors through brokers, merchant bankers, etc. However, subscription of such shares by friends, relatives and associates is allowed.

2. ***By an Offer for Sale:*** Under this arrangement, the company allots or agrees to allot shares or debentures at a price to a financial institution or an issue-house for sale to the public. The issue-house publishes a document called an offer for sale, with an application form attached, offering to the public shares or debentures for sale at a price higher than what is paid by it or at par. This document is deemed to be a prospectus [s.64(1)]. On receipt of applications from the public, the issue-house renounces the allotment of the number of shares mentioned in the application in favour of the applicant purchaser who becomes a direct allottee of the shares.

3. ***By Inviting Public through Prospectus:*** This is the most common method by which a company seeks to raise capital from the public. The company invites offers from members of the public to subscribe for the shares or debentures through prospectus. An investor is expected to study the prospectus and if convinced about the prospects of the company, apply for shares.

Notes

9.6.1 Issue of Shares to existing Shareholders

The capital is also raised by issue of rights shares to the existing shareholders (s.81). In this case the shares are allotted to the existing equity shareholders in proportion to their original shareholding, e.g., one share against every two shares held by a member.

9.6.2 Public Issue of Shares

Public issue of shares means the selling or marketing of shares for subscription by the public by issue of prospectus. For raising capital from the public by the issue of shares or debentures, a public company has to comply with the provisions of the Companies Act, the Securities Contracts (Regulations) Act including the Rules made thereunder and the Guidelines and instructions issued by the concerned Government authorities, the Stock Exchange and SEBI, etc. Management of public issue involves coordination of activities and cooperation of a number of agencies such as managers to the issue, underwriters, brokers, registrars to the issue, solicitors/legal advisors, printers, publicity and advertising agents, financial institutions, auditors and other Government/ Statutory agencies such as Registrar of Companies, Reserve Bank of India, stock exchange, SEBI, etc.

It is advisable to keep in mind the guidelines issued by SEBI with regard to issue of shares termed as "Guidelines for Disclosure and Investor Protection" before issuing shares to the public.

Share application form to seek permanent account number. In respect of applications for value of ₹ 50,000 or more, the applicant or in case of applications in joint names, each of the applicant, shall mention his/her permanent account number/GIR number and income-tax circle, ward, district or the fact of non-allotment of PAN/GIR number, as the case may be and applications not complying with the provisions are liable to be rejected.

Self Assessment

8. A company must inform the registrar about redemption of preference shares within

   (a) 21 days (b) 15 days

   (c) 30 days (d) None of the above

9. The capital which is part of the uncalled capital of the company which can be called up only in the event of its winding up is called

   (a) Issued capital (b) Nominal capital

   (c) Authorised Capital (d) Reserve capital

10. XYZ Co. is a holding of XZ Pvt. Company. XZ Co. issued deferred shares. The issue is valid or void

    (a) Valid (b) Void

    (c) Situation does not arise (d) None of the above

11. What is the maximum period for redemption in case of preference shares issued by the company

    (a) 10 years (b) 15 years

    (c) 20 years (d) None of these

9.7 Voting Rights

Notes

Voting Rights of Preference Shareholders

The preference shareholders will vote only on matters directly relating to preference shares. Section 87 (2) mentions the following matters which relate to preference shares and preference shareholders can vote on them: (i) any resolution for winding up of the company; (ii) any resolution for the reduction or repayment of share capital; (iii) any resolution at any meeting, if dividend on cumulative preference shares remains unpaid for at least two years. Holders of non-cumulative preference shares shall have a right to vote on all resolutions, if their dividends are in arrear for the two financial years during a period of six years ending with the financial year preceding the meeting. [s.87(2)].

9.8 Rights Shares

The existing members of the company have a right to be offered shares, when the company wants to increase its subscribed capital. Such shares are known as "rights shares" but they are not issued free of charge.

Section 81 provides that where at any time after the expiration of two years from the date of incorporation of the company, or after one year from the date of the first allotment of shares, whichever is earlier, a public company limited by shares issues further shares within the limits of the authorised capital, its directors must first offer these shares to the existing holders of equity shares in proportion, as nearly as circumstances admit, to the capital paid up on their shares at the time of the further issue. The company must give notice to each of the equity shareholders, giving him the option to buy the shares offered to him by the company. The shareholders must be informed of the number of shares he has the option to buy. He must be given at least fifteen days to decide whether he would exercise his option or not. If the shareholder does not inform the company of his decision, he shall be deemed to have declined the offer. Unless the articles of the company otherwise provide, the directors must state in the notice of offer the fact that the shareholder has also the right to renounce the offer, in whole or part, in favour of some other person who need not be member of the company. If the shareholder declines or, is deemed to have declined or, if the person in whose favour the renunciation is made declines to buy the shares, the company's directors may dispose of those shares in such manner as they may think fit.

Task DJA Co. Ltd., is holding 40% of total equity shares in MR Co. Ltd. MR Co. Ltd. (incorporated on 1.1.2003) decided to raise the paid-up equity share capital by issuing further shares and also decided not to offer any shares to DJA Co. Ltd., on the ground that it was already holding a high percentage of shares in MR Co. Ltd. Articles of MR Co. Ltd., provides that the new shares be offered to the existing shareholders of the company. On 1.3.2006. new shares are issued to all the shareholders excepting DJA Co. Ltd. Examine the validity of decision of Board of directors of MR Co. Ltd., of not offering any further shares to DJA Co. Ltd.

Exception: However, the company may, by special resolution in general meeting, decide that the directors need not offer the shares in the further issue to the existing equity shareholders and, that they may dispose of them in any manner whatsoever. But where it has been possible to muster ordinary majority only, the directors may not offer the shares to the existing equity shareholders, if permission is obtained from the Central Government. Further, s.81 does not apply to a private company. Thus, a private company need not offer its further issue first to existing shareholders and therefore its directors are free to offer them in the manner they deem fit. Further, s.81 is not applicable in the case of issue of shares against conversion of loans or debentures.

SEBI has issued following Guidelines regarding Rights Issues, 2000:

- ***Applicability:*** These guidelines apply to rights issues made by existing listed companies whose equity share capital is listed. These guidelines are not applicable to the rights issues where the aggregate value of securities offered does not exceed ₹ 50 lacs.
- ***Appointment of Registrar:*** Appointment of Registrars to the Issue shall be compulsory.
- ***Withdrawal of a Rights Issue after Announcement:*** Where any company has withdrawn the rights issue after announcing the record date, such a company shall not be permitted to make application for listing of any of its securities for a minimum period of twelve months from the announced record date.
- ***Underwriting:*** Underwriting of rights issue is not mandatory. But, where it is underwritten, the lead manager, if any, should make a statement in the letter of offer that, in their opinion, assets of the underwriters are adequate to meet their obligation.
- ***Appointment of Merchant Banker:*** For rights issues of listed companies exceeding ₹ 50 lakhs, the issue should be managed by a category-1 merchant banker, holding a valid certification of registration issued by SEBI.
- ***Partly Paid Shares to be Made Fully paid:*** Partly paid shares, if any must either be made fully paid or forfeited.
- ***Disclosure in Letter of Offer:*** It shall be the duty of the merchant banker, acting as the lead manager, to ensure that the letter of offer contains all the matters specified by SEBI in this regard and otherwise provides a true, correct and fair view of the state of affairs of the company which are adequate for the investors to arrive at a well-informed decision.
- ***Agreement with Depository:*** A company cannot make a right issue unless:
  - It enters into an agreement with a depository for dematerialisation of securities already issued or proposed to be issued to the existing shareholders; and
  - The company gives an option to the subscribers/shareholders to receive the certificate or hold securities in dematerialised form with a depository.
- ***Filing Letter of Offer:*** The Merchant Banker, in case of rights issue exceeding ₹ 50 lakhs, shall file the letter of offer with SEBI at least 21 days prior to the filing of the letter of offer with Regional Stock Exchange. However, if within 21 days from the date of filing of draft letter of offer, SEBI specifies any changes therein, the Issuer or the Lead Merchant Banker shall carry out such changes before filing the draft letter of offer with Regional Stock Exchange.
- ***Closure of Rights Issue:*** A rights issue shall be kept open for at least 30 days but not more than 60 days.
- ***Minimum Subscription:*** SEBI requires the following clause in respect of minimum subscription to be stated in the letter of offer.

  "If the company does not receive the minimum subscription of 90% of the issue, the entire subscription will be refunded to the applicants within 42 days from the date of closure of the issue. If there is delay in the refund of the application money by more than 8 days after the company becomes liable to pay the amount, i.e., forty-two days after closure of the issue, the company will pay interest for the delayed period. @15% per annum as prescribed in sub-section (2) and (2A) of Section 73 of the Companies Act, 1956."

In case of composite issue, the Lead Merchant Banker shall ensure that the requirements of minimum subscription is satisfied both jointly and severally, i.e., independently for both rights and public issues.

- ***No Reservation in Rights Issues:*** SEBI guidelines prohibit any preferential allotment in favour of the issuing companies, permanent employees and financial institutions. If a company desires to make any preferential allotment to the employees or any identified persons it may do so independent of rights issue by complying with the guidelines in that regard.
- ***Promoters' Contribution and Lock-in-Period:*** The requirement of promoters contribution shall not be applicable in case of rights issues.
- ***Rights of FCD/PCD Holders:*** No company shall, pending conversion of FCDs/PCDs, issue any shares by way of rights unless similar benefit is extended to the holders of such FCDs or PCDs. The benefits shall be extended by making a reservation of shares in proportion to the convertible part of FCDs/PCDs. The shares so reserved may be issued at the time of conversion of such debentures on the same terms on which the rights issue was made.
- ***Restriction on Further Capital Issues:*** No company shall make any further issue of capital in any manner whether by way of issue or otherwise, during the period commencing from the submission of offer document to SEBI on behalf of the company for rights issues, till the securities referred to in the said offer document have been listed or application money refunded on account of non-listing or under-subscription, etc.
- ***Over- subscription not to be Retained:*** Over-subscription shall not be retained under any circumstances.
- ***Issue to be made Fully-Paid Up:*** The issue shall have to be made fully-paid up within 12 months, except where the issue size exceeds ₹ 500 crore.
- ***Additional Facility for Applying:*** The Lead Merchant Banker shall ensure that an advertisement giving the date of completion of dispatch of letters of offer, is released in at least one English National Daily circulated at the place where registered office of the issuer company is situated. The advertisement must be published at least 7 days before the date of opening of the issue.

Self Assessment

State whether the following statements are true or false:

12. A company can issue shares at a discount within six months of the date on which it became entitled to commence business.
13. Share premium amount can be treated as free reserves.
14. Share premium amount can be utilised for issuing fully paid bonus shares to members.
15. The maximum rate of discount on shares must not exceed 10 percent or such higher rate as the central government may permit in any special case.
16. The Companies Act 1956, does not prescribe the maximum rate of premium on shares.

Notes

Case Study

Federal Government Responsibilities against Food Industry

Governmental responsibility for food in Canada is divided among the federal, 10 provincial, three territorial, and thousands of municipal governments. Some 77 pieces of legislation govern food inspection among three levels of government. Federal responsibility centres on export and inter-provincial trade: protecting and expanding export markets for Canadian food products, and facilitating interprovincial trade. In addition, the federal government sets food safety, quality and grading standards for products sold interprovincially and internationally and administers regulations aimed at preventing the production or sale in Canada of dangerous, adulterated or misbranded products.

Provinces and municipalities are responsible for:

The intraprovincial aspects of the food industry, including local food processing, the food service industry, and the food retail industry.

They decide whether and how to inspect local operations, including restaurants and grocery stores, as well as dairies and meat plants whose products are sold within the province. (Moore and Skogstad, p. 130) The federal government of Canada faced a number of food security problems in the early 1990s, which facilitated adoption of innovative reform measures:

1. Canada's reputation for high quality food had been damaged by the "tainted tuna" scandal.
2. Resources for additional inspection of fish products were not available; resources were not only scarce but shrinking.
3. The Government wanted to reform its public service along the lines achieved in the United Kingdom and New Zealand, where separate agencies were spun off from government.
4. Developments in international trade and potential developments in interprovincial trade:
   (a) Industry and governments favoured harmonized standards and streamlined inspection to ensure the competitiveness of the Canadian food industry domestically & internationally.
   (b) Canadian producers/processors were vulnerable to trade challenges in a fragmented system.
   (c) Gaps resulting from non-inspection or non-rigorous inspection were perceived by processors as a weak link, despite the small percentage of overall production represented and assurances outlined in the Auditor General of Canada's 1994 Report.
   (d) Closer integration of the US and Canadian markets under free trade agreements made the industry anxious to reduce the costs and inefficiencies resulting from differing provincial standards e.g. fluid milk.
5. The "national treatment" principle in the North American Free Trade Agreement could be interpreted to mean that imports must meet the provincial standard of the

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Notes

province they enter rather than the standard required for inter-provincial or international trade. This could drag down Canadian food standards to the lowest common denominator.

(a) Canadian exporters were concerned about being denied access to external markets on the grounds that Canadian food safety standards and inspection systems were not equivalent to those of the markets into which they were shipping.

(b) The 1994 SPS Agreement required that countries use their food safety and animal, plant and health regulations only to the extent necessary to protect human, animal life or health, not for trade protection purposes.

6. ***Emergence of alternatives to high-cost prescriptive regulation:*** New scientific and technological tools furnished the Government with opportunities to shift additional costs and a significant degree of responsibility for food safety to the food industry itself. Risk assessment methods allowed the allocation of food inspection resources on a risk basis. One such risk-based tool, the Hazard Analysis Critical Control Point (HACCP) system, developed for the US space program, was deemed more effective than existing systems in ensuring food safety. Canada was the first government to adopt this system, for its fish inspection program. It was so well accepted internationally that Canadian meat packing plants were subsequently required to conform to US regulations requiring large American meat packing plants to implement a HACCP plan by January 1998.

7. National unity was threatened, and solutions suggested in the winning Liberal platforms in the 1993 and 1997 elections were renewal of the federation, including better coordination of services and reduction in overlap and duplication among governments.

The Government of Canada consolidated all of its food inspection and quarantine services from Health Canada, Fisheries and Oceans, and Agriculture and Agri-Food Canada into one self-standing Agency effective April 1, 1997. The Agency reports not to a deputy minister but directly to the Minister of Agriculture and Agri-Food. The Agency has separate employer status, and so can hire and fire its own employees, rather than working through the Public Service Commission. It also has a number of financial flexibilities not available to government departments, most notably the capacity to retain revenues.

Protecting the public interest is a major concern in creating alternate Service Delivery Agencies (ASDs) in Canada. Employing the Auditor General of Canada's definition of the public interest when assessing ASDs, the CFIA addressed whether there was an appropriate focus on public objectives, maintenance of public service values and adequate control over public funds and assets. On all counts the CFIA's self-assessment concluded it was serving the public interest.

The Auditor General of Canada was appointed as an external auditor under the CFIA Act, with duties to audit the CFIA's financial statements and assess the fairness and reliability of the performance information provided in the Agency's Annual Report to Parliament. The Auditor General also has authority to conduct periodic value-for-money audits of the Agency.

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Clarification of food-related roles and responsibilities of federal government departments has led to:

(a) A more integrated and comprehensive approach (gate-to-plate) to trichinosis in swine, tuberculosis in cattle and zoonotic diseases such as salmonella enteritidis in poultry.

(b) Improved capacity to respond to outbreaks of food-borne illness and threats to the food system presented by medicated feeds and antibiotic residues.

(c) Separation of health and safety standard setting from inspection, permitting new flexibilities for inspection.

(d) Separation of health risk analysis from risk management, thereby fulfilling a World Health Organization principle

(e) Reduced criticism of conflict of interest because the same department was responsible for promoting and regulating an industry (fisheries).

8. A more integrated and comprehensive approach (gate-to-plate) to trichinosis in swine, tuberculosis in cattle and zoonotic diseases such as salmonella enteritidis in poultry.
9. Improved capacity to respond to outbreaks of food-borne illness and threats to the food system presented by medicated feeds and antibiotic residues.
10. Separation of health and safety standard setting from inspection, permitting new flexibilities for inspection.
11. Separation of health risk analysis from risk management, thereby fulfilling a World Health Organization principle
12. Reduced criticism of conflict of interest because the same department was responsible for promoting and regulating an industry (fisheries).

Question

Analyse the kind of agency it is. (***Hint:*** Summarize this case)

9.9 Summary

- The right of the shareholder to transfer the shares are subject to the articles of association (For this purpose s.82 classifies shares as movable property, transferable in the manner provided in the articles).
- Section 83 requires that each share in a company having a share capital must be distinguished by its distinctive number.
- A common man uses 'share' and 'share certificate' to mean the same. It is, therefore, important to note the exact differences between the two.
- The share capital of a company is divided into a number of indivisible units of specified amount.
- If a preference share carries the right for payment of arrears of dividend from future profits, then such a share is known as cumulative preference share.
- The Companies (Amendment) Act, 1999, allowed issue of sweat equity shares subject to fulfillment of certain conditions.

9.10 Keywords

Cumulative Preference Share: If a preference share carries the right for payment of arrears of dividend from future profits, then such a share is known as cumulative preference share.

Equity Share: 'Equity share' means a share which is not a preference share (s.85). The rate of dividend is not fixed.

Non-voting Share: 'Non-voting shares' as the term suggests, are shares which carry no voting rights. These are contemplated as altogether a different class of shares which may carry additional dividends in lieu of the voting rights.

Redeemable Share: A preference share which can be redeemed upon the resolution of the board of directors, if the articles so provide, is known as redeemable preference share.

Share: A share is the share capital of a company and includes stock except where a distinction between stock and share is expressed or implied.

Stock: The term 'stock' may be defined as the aggregate of fully paid-up shares of a member merged into one fund of equal value.

9.11 Review Questions

1. Define a share.
2. What are the different types of shares which a company can issue?
3. How and subject to what conditions can loans and debentures be converted into shares?
4. How and for what purposes can a company alter its share capital?
5. Discuss the procedure for reduction of share capital.
6. A company limited by shares intends to buy some of its own shares. Advise.
7. Explain the three different ways through which issue of shares may be made by a public company.
8. Explain the provisions as regards increase of subscribed capital by a public company by allotment of further shares.
9. In what way does the Companies, Act, 1956 regulate the issue of shares at a premium? State the purpose for which the share premium so charged can be utilized. To what extent it is possible for a company to issue shares at a premium for consideration other than cash?
10. State the circumstances wherein shares of a company can be issued at a discount. What is the liability of directors for improper issue of shares at discount?
11. Explain the meaning of 'Sweat equity shares'. State the conditions a company has to fulfill for issuing such shares.
12. Comment on the following:
    (i) A company is prohibited from buying its own shares or financing the purchase thereof.
    (ii) A company cannot reduce its share capital without the sanction of the court.
    (iii) Section 81 is intended to prevent the directors from offering shares to outsiders before an offer is made of further issue of capital as a right to the existing shareholders.

Notes

(iv) Under certain situations, a company can reduce its share capital without the sanction of the court.

(v) Under certain circumstances, the authorised capital can be increased by the Central Government.

Answers: Self Assessment

1.	2(46)	2.	distinctive number
3.	same	4.	'share'
5.	'stock'	6.	(c)
7.	(a)	8.	(c)
9.	(d)	10.	(b)
11.	(c)	12.	False
13.	False	14.	True
15.	True	16.	True

9.12 Further Readings

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Unit 10: Management of Company

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Objectives

After studying this unit, you will be able to:

- Describe the legal position of director;
- Outline the qualifications and disqualifications of director;
- Explain the director remuneration;
- Elaborate upon principles of disclosure.

Introduction

A company, being an artificial person, acts through human agency. Accordingly, under the Act, it is necessary for every company to have a Board of directors. In addition to this, the following categories of managerial personnel may be appointed (s.197-A):

1. Managing Director; or
2. Manager.

Section 197A does not prohibit the employment of other managerial personnel, such as executive or whole-time directors, which do not come within the term "managing director" or "manager". Thus, it is possible for a company to make simultaneously the appointment of (i) managing director and whole time director; or (ii) manager and whole time director. Section 197A prohibits the simultaneous appointment of managing director and manager in the same company.

Notes

10.1 Directors – Definition and Meaning

Section 2 (13) defines a Director as including "any person occupying the position of director, by whatever name called." This is a definition based purely on function; a person is a director if he does whatever a director normally does. But the Act gives no further guidance on the function, duties and position of a director. In reality, directors are the persons who direct, conduct, manage or superintend a company's affairs. Section 291 has entrusted the management of the affairs of the company in their hands. They chalk out the general policy of the company within the framework of the memorandum of the company. They appoint the company's officers and recommend the rate of dividend. The directors of company are collectively referred to as the 'Board of Directors' [s. 2(6)].

Thus, it is not the name by which a person is called but the position he occupies and the functions and duties which he performs that determine whether he is a director of a company or not. In Forest of Dean Coal Mining Co. Re (1878) 10 Ch D 450, it was stated that function is everything; name matters nothing. So long as a person is duly appointed by the company to control its business and authorised by its articles to contract in its name and on its behalf, he is a director, whether named as such or not.

The articles of a company, sometimes, designate its directors as governors, members of the governing council or the board of management or may give them any other title, but so far as the law is concerned they are simply directors. For example, in the case of associations registered as companies under s. 25, the members of the executive committee or governing council or management board are directors for purpose of the Act, even when they are not designated as directors.

10.1.1 Deemed Director (s. 7).

For certain purposes, a person even when he is not a director may be deemed to be a director of a company. The Act treats as director a person in accordance with whose directions or instructions the Board of directors of a company is accustomed to act. This provision has the effect of widening the definition of the term 'director'. However, this provision merely operates to impose liabilities or prohibition on such a person who is deemed to be a director. However, a deemed director does not acquire any right or power in connection with the management of the company. He may be made liable but he cannot demand to participate in the meetings of the Board of directors or to manage the affairs of the company in any way. But for the purpose of treating a person as a deemed director and invoking his liability, it is necessary to establish that the Board of directors is accustomed to act according to his directions and instructions. Acting casually or once in a while on certain instructions by a person would not be a 'deemed director'.

A deemed director need not necessarily be an individual. The person may even be a body corporate say, a holding company.

It must be noted that the expression 'deemed director' does not include persons advising the Board of directors of a company in their professional capacity. Thus, a lawyer, accountant or other professional advisor will not come within the expression 'deemed director' when he gives professional advice or instructions and the Board is accustomed to act according to his advice or instructions, then he will not be a 'deemed director'.

Section 303(1) provides that any person with whose directions or instructions the Board of directors of a company is accustomed to act is also deemed to be a director.

A manager or any other managerial personnel is, however, not a director [Deen Dayalu v. Sri B. P. Reddy A.P. (1984) 2 Comp LJ 396].

A 'deemed director' is called as 'shadow director' under English Law.

Notes

10.1.2 Small Shareholders' Director

A public company having (a) a paid up capital of five crore rupees or more, and (b) one thousand or more small shareholders may have a director elected by such small shareholders in the manner as may be prescribed. For this purpose, "small shareholder" means a shareholder holding shares of nominal value of twenty thousand rupees or less (i.e. up to ₹ 20,000) in a public company to which this section applies. The Department of Company Affairs, has prescribed the Companies (Appointment of the Small Shareholders' Director) Rules, 2001. Such a director will be elected by the majority of the small shareholders. The tenure of such director shall be a maximum of three years and he need not retire by rotation. However, he can be re-elected for a period of three years on the expiry of his tenure. Such a director can be removed in pursuance of s. 284. A person cannot hold office as small shareholders' director in more than 2 companies. Further, the person proposed to be elected must be a small shareholder of the company. Furthermore, such a director is not eligible for appointment as whole time or managing director of the company. If he ceases to be a small shareholder, he is deemed to have vacated his office as 'small shareholders director'.

Example: The Board of directors of ABC Ltd., an unlisted company, having a paid up share capital of ₹ 6 crores consisting of equity share capital of ₹ 5 crores and preference share capital of ₹ 1 crore and also having 11,000 small shareholders holding equity shares propose to appoint a director to represent the small shareholders.

Under s. 252, a public company, if it has a paid up capital of ₹ 5 crores or more, and one thousand or more small shareholders may have a director elected by such small shareholders. It is obvious, that the appointment of such a director is not mandatory; it is discretionary for the company.

Example: In a company, there are more than one thousand small shareholders, and it has a paid up capital of more than five crore rupees. The small shareholders have exercised their right to appoint a director on the board of the company. The company wants to remove him before the expiry of his period of appointment. The company can do so under s. 284 without the consent of the small shareholders.

10.2 Legal Position of Directors

The exact position of 'Director' is hard to define, as no formal definition, either statutory or judicial, of the term has been given. However, judicial pronouncements have described them as (i) agents, (ii) trustees, or (iii) managing partners. But each of these expressions is used not as exhaustive of their power and responsibilities but as indicating points of view from which they may for the moment and for the particular purpose be considered.

10.2.1 Directors as Agents

The directors act as agents of the company and the ordinary rules of agency apply. They exercise the powers that are subject to the duties within the framework of the company's articles, and the Act. For instance, they may make contracts on behalf of the company and they will not be personally liable as long as they act within the scope of their authority. But if they contract in their own name, or fail to exclude personal liability, they also will be liable. If the directors exceed their authority, the same act may be ratified by the company. But if they do something beyond the objects clause of the company, then the act is *ultra vires* and the company cannot ratify the same. But directors are not agents for the individual shareholders; they are the agents of the company – the artificial person.

10.2.2 Directors as Trustees

The directors have also been described as trustees. But they are not trustees in the full sense of the term, in as much as no proprietary rights of the company's property are transferred to them and, therefore, they enter into contracts on behalf of the company and in the name of the company. On the other hand, in the case of a trust, the legal ownership of the trust property is transferred to the trustee and therefore, he can enter into contract in his own name, but whatever he does, he does for the benefit of the beneficiaries.

Although directors are not trustees in the real sense of the term, they occupy an office of trust and are in certain respects in the position of trustees for the company. Such cases are:

- They are trustees of money which comes to their hands or which is actually under their control. If they mis-apply company's money, they have to make good the same as if they were trustees.
- They are trustees for exercising powers conferred on them for the benefit of the company. For instance, powers to allot shares, to make calls, or to forfeit shares should be exercised bona fide in the interests of the company.
- They stand in a fiduciary relationship to the company and, therefore, whenever there is clash of his personal interests with that of the company, he should keep in mind the company's interests.

A director is in no way a trustee for individual shareholders except when the former induces the latter by mis-representation to sell the shares to him.

10.2.3 Directors as Managing Partners

The directors are also sometimes described as managing partners. In this sense, a company is considered a partnership firm. As one or more partners may manage the affairs of the firm on behalf of all the partners, similarly a few shareholders, who are elected directors by the shareholders, manage the affairs of the company. They manage the affairs of the company on their own behalf and on behalf of other shareholders who elect them.

10.2.4 Directors as Employees of the Company

The directors are not employees of the company or employed by the company, nor are they servants of the company, or members of the "company's staff". A director can, however, hold a salaried employment or an office in addition to that of his directorship which may, for these purposes, make him an employee or servant and in such a case, he would enjoy rights given to employees as such; but his directorship and his rights through that directorship are quite separate from his rights as employee. Thus, he is then entitled to remuneration and other benefits admissible to him as an employee in addition to his remuneration as director under the Act. The Act recognises situations of this nature. Sections 314 and 318, for instance, provide for a director holding an office or place of profit under a company.

10.2.5 Director as Officers of the Company

Directors are treated as officers of the company [s. 2(30)]. Also, directors are 'officers in default' (s. 5) and may become liable to certain penalties for failure to comply with certain provisions of the Act.

Notes

Self Assessment

Fill in the blanks:

1. .... defines a Director as including “any person occupying the position of director, by whatever name called.”
2. A .... need not necessarily be an individual.
3. A ‘deemed director’ is called as ‘shadow director’ under ....
4. The directors act as agents of the company and the ordinary rules of .... apply.
5. In partnership firm, the directors are also sometimes described as ....

10.3 Qualifications and Disqualifications of Directors

The Act has not prescribed any academic or professional qualifications for the directors. Also, the Act imposes no share qualification on the directors. So, unless the company’s articles contain a provision to that effect, a director need not be a shareholder unless he wishes to be one voluntarily. But the articles usually provide for a minimum share qualification. Thus, Regulation 66 of Table A provides that a director must hold at least one share in a company. Where a share qualification is fixed by the articles of a company, the Act provides (s. 270) that:

- It must be disclosed in the prospectus;
- Each director must take his qualification shares within two months after his appointment;
- The nominal value of the qualification shares must not exceed ₹ 5,000 or the nominal value of one share where it exceeds ₹ 5,000;
- Share warrants will not count for purposes of share qualification.

If a director fails to obtain his share qualification within two months, he vacates office automatically on the expiry of two months from the date of his appointment and if he acts as director after the expiry of two months without taking the qualification shares, he is liable to a fine up to ₹ 5,000 for every day until he stops acting as such (s. 272).

However, the articles of a company can neither compel a person to hold qualification shares before he is elected a director nor can they require him to obtain qualification shares within a shorter period than two months after his appointment and if any provisions to this effect is made in the articles, it shall be void.

The effect of this provision is that if the company is wound up during this period of two months, the director cannot be placed in the list of contributories, in as much as there is no express or implied contract under which he would be bound to take the qualification shares, since his name cannot be put on the register of members unless he has applied for shares and these are allotted to him [Zamir Ahmed Raz. vs. D.R. Banaji (1957) 27 Comp. Cas. 634].

Task X Co. Ltd. wants to make a contract with a partnership firm. Four of the five directors of the company are partners of such partnership. How can the contract be executed? [***Hint:*** The contract may be executed by the general body of shareholders by passing an ordinary resolution to that effect. Also see s.299.]

However, the mere acting as a director does not import any agreement to take the shares from the company; but, if in such circumstances he is put on the register by the officers of the company after the time limit for qualifying has expired (i.e. 2 months after his appointment) and he continues to act as a director, he is estopped by his conduct from repudiating the shares and will be liable to pay for them.

The appointment of a director commences from the date on which the result of poll taken to elect is announced, and the two months are calculated from that date, and not the one on which the poll was actually taken.

It may be noted that:

- The qualification shares can be held by a director even as a trustee, if that fact does not appear on the register of members, and if the company can deal with the shares as his own.
- Also, shares held jointly with any other person is sufficient share qualification. It was held in Grundy v. Briggs [1910]1 Ch. 444, that unless articles provide otherwise, shares in joint names entitles any of the joint holders to be appointed as a director. But not more than one joint holder can be appointed.
- The mortgaging of shares does not disqualify a person to be appointed as a director, unless the articles provide otherwise.
- A person who holds requisite qualification shares at the time of his appointment, a subsequent increase in the amount of share qualification cannot be made applicable to him [International Cable Co. Re, (1892) 66 LT 253].

Where a director acts without acquiring his qualification shares after the expiry of two months from the date of his appointment, the company will be bound to third parties for acts of such a director until the defect in appointment or disqualification is disclosed, and acts done by him after the disclosure by the company will not bind it. Thus a de facto director is as good a director as a *de jure* director so far as persons having no notice of the defect are concerned (s. 290).

As the provisions of s. 270 and s. 272 do not apply to a private company (s. 273), it may or may not provide in its articles any requirement of share qualification. The articles may thus provide for share qualification and the amount may be more than ₹ 5000.

Further, a private company which is not a subsidiary of a public company may, by its articles, provide additional qualifications for a director, such as, a person must be a B. Com., or holding a fixed deposit receipt in his own name issued by the company.

Section 274 has laid down certain disqualifications and therefore, the following persons are incapable of being appointed directors of any company:

1. A person found by a court to be of unsound mind;
2. An un-discharged insolvent;
3. A person who has applied to be adjudged an insolvent;
4. A person who has been convicted by a court for an offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than six months and a period of five years has not elapsed from the date of the expiry of the sentence;
5. A person who has failed to pay calls on shares held by him whether alone or jointly with others for six months from the date fixed for the payment;
6. A person who has been disqualified by court under s. 203 which empowers the court to restrain fraudulent persons from managing companies, unless the leave of the court has been obtained for his appointment;

7. Such person is already a director of a public company which, (a) has not filed the annual accounts and annual returns for any continuous three financial years; or

8. Has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend, and such failure continues for one year or more. Further, such person shall not be eligible to be appointed as a director of any other public company for a period of 5 years from the date on which such public company, in which he is a director, failed to file annual accounts and annual returns under (a) above or has failed to repay its deposits or interest or redeem its debentures on due date or pay dividend referred to in (b).

The disqualifications mentioned under (iv) and (v) above may be removed by the Central Government by a notification in the official gazette. On the other hand, a private company may provide in its articles that a person shall be disqualified for appointment as director on any other additional ground. However, a subsidiary private company or a public company cannot, by its articles, provide for any additional disqualifications.

10.3.1 Other Disqualifications

The following two provisions also provide for disqualifications of directors:

(i) Where a director has been convicted of an offence under s. 209A, he shall, on and from the date on which he is so convicted, be deemed to have vacated his office as such. On such a vacation of office, he shall be disqualified for holding the office of a director in any company for a period of five years from such date.

(ii) A director who has been removed from any managerial position by the Central Government shall not be a director of a company, for a period of five years from the date of the order of removal unless the said Government has reduced the period with the concurrence of the Company Law Board [s, 388 E].

10.3.2 Minor as a Director

In the case of a minor, though there is no provision in the Act, expressly disqualifying him, as he is not competent to contract, he cannot file either with the company or with the registrar any valid consent to act as director, as required by s.264. But as s.264 applies only to public companies; there is nothing prohibiting a minor being a director of a private company. However, from a practical point of view a minor can be an ornamental director as he can neither be party to any transaction which requires competency to contract – nor, for the same reason, can he be delegated any powers of the board. He may possibly vote on all resolutions at board meetings.

Example: Mr. Ram is a director of ABC Ltd. XYZ Ltd. and PQR Ltd. ABC Ltd. was regular in filing annual returns, but did not file annual accounts for the year ended March 31, 2007.

Further ABC Ltd. failed to pay interest on loans taken from a public financial institution from 1st January, 2007 onwards and also failed to repay the matured deposits on due date from 1st April, 2007 onwards.

Mr. Ram is proposed to be appointed as additional director of MN Ltd. on 1st June, 2008.

Also Mr. Ram wants to continue as a director of XYZ Ltd. and PQR Ltd. Further, he seeks reappointment when he retires by rotation at the AGM, of respective companies to be held in September, 2008.

As regards failure of ABC Ltd. to pay interest on term loans taken from a public financial institution, the disqualification does not apply under s. 274(1)(g)(B).

As regards failure to repay its deposits on due date and the failure continues for more than one year, Mr. Ram is disqualified. In the light of this disqualification, he is not eligible to be appointed on additional director in MN Ltd. From 1st June, 2008 onwards.

The disqualification would come into operation only at the time of appointment or reappointment of Mr. Ram as director of any public company after the default has become effective. Till such time, he can continue to hold office of director in all public companies in which he is a director. Therefore, he need not vacate the office of director in XYZ Ltd. and PQR Ltd. (either under s. 274(1)(g) or s. 283).

However, Mr. Ram cannot seek reappointment in XYZ Ltd. and PQR Ltd. when he retires by rotation at the AGMs to be held in September, 2008.

Example: Mr. A is a director of ABC Ltd. which failed to repay matured deposits from 1st April, 2007 onwards and the default continues. But ABC Ltd. is regular in filing annual accounts and annual returns. Mr. A is also a director of PQR Ltd. and XYZ Ltd.

ABC Ltd. has committed default under s. 274 (1)(g)(B) and Mr. A, being a director of ABC Ltd. becomes disqualified for his appointment or reappointment as a director in any other public company. However, he need not vacate his office of directors in PQR Ltd. and XYZ Ltd. as it is not required either by s. 274 or s. 283.

In case DEF Ltd. wants to appoint Mr. A as an additional director at the Board meeting to be held on 15 May, 2008, it cannot be done [Proviso to s. 274(1)(g)].

Further, if Mr. A had ceased to be a director of ABC Ltd. by resignation on 1st March, 2008, then the proviso to s. 274(1)(g) would not be attracted, and therefore he could be appointed as a director in DEF Ltd.

Example: The articles of association of MKP Ltd. incorporated with an authorised share capital of ₹ 50 crores divided into 5 crore equity shares of ₹ 10 each contained the following clause:

"The qualification of a director shall be the holding of at least 1,000 equity shares in the company and such a director, if not already so qualified shall have to obtain his qualification within a period of 30 days from the date of his appointment as a director."

A person appointed as a director may acquire shares for qualification within 2 months after his appointment. Therefore, the clause requiring him to obtain his qualification shares within a period of 30 days from the date of his appointment is void.

In this case, the disqualification specified in s. 274(1)(g)(A) does not apply as ABC Ltd., has not committed defaults in respect of both the matters (i.e. annual returns and annual accounts for three consecutive financial years).

Also, the clause requires him to hold at least 1,000 equity shares of ₹ 10 each. This amounts to ₹ 10,000 whereas s. 270(3) restricts the nominal value of the qualification shares to ₹ 5000 or nominal value of one share where it exceeds ₹ 5000.

Example: Mr. A, who has huge personal liabilities far in excess of his assets and properties, has applied to the court for adjudicating him as an insolvent and such application is pending. He cannot be appointed as a director of a company [s. 274(1)(c)].

Notes

Example: Mr. B was caught red handed in a shop lifting case two years ago and for embezzlement of funds and sentenced to imprisonment for a period of eight weeks. He can be appointed as a director of a company, as the disqualification given in s. 274(1)(d) is not attracted.

Example: Mr. C, a former bank executive, was convicted by a court eight years ago for embezzlement of funds and sentenced to imprisonment for a period of one year. He can be appointed as a director of a company as disqualification under s. 274(1)(d) is not attracted.

Example: Mr. D is a director of DLT Ltd. which has not filed its annual returns pertaining to the AGMs held in the calendar years 2005, 2006 and 2007. He can be appointed as a director in any other company under s. 274(1)(g), as the failure on the part of DLT Ltd. is on account of annual returns, and not in respect of filing of annual accounts.

The provisions of s. 274 regarding disqualifications of directors do not apply in the following cases:

(i) The special directors appointed on the board of a company under the Sick Industrial Companies (Special Provision) Act, 1985;

(ii) The nominee directors appointed on the board of a company by public financial institutions and companies established by the Special Acts of Parliament, like I.D.B.I., L.I.C., U.T.I.

(iii) The nominee directors appointed by the Central or State Government on a banking company.

10.3.3 Validity of acts of Directors (s. 290)

Section 290 provides that the acts done by a director shall be valid even if his appointment is discovered to be invalid because of any defect or disqualification or where his appointment had terminated by virtue of any provisions contained in the Act or in the articles. Section 290 is designed to protect persons dealing with the company such as lenders, vendors and purchasers of shares and debentures. Thus, a party entering into a contract with a company through its director may assume that the acts of the director are valid if he does not know the irregularity, if any, in the appointment of the director.

However, the acts will not be valid (or the provisions of s. 290 shall not operate) where:

(i) His appointment is illegal, or there is no appointment at all.

(ii) He continues in his office knowing that his term has expired.

(iii) He knew from the beginning that his appointment was defective.

(iv) He acted in the capacity of a managing director, manager [subject, however, to the provisions of s. 269(12)] or secretary.

(v) His acts are ultra vires the company.

(vi) Where requirement as to minimum number of directors is not satisfied.

(vii) The third party was aware of the defect in his appointment.

Notes

10.4 Appointment of Directors

The appointment of directors rests in the following hands:

1. Subscribers to the memorandum – s.254; Clause 64 (Table A);
2. Company in general meeting – Ss.255-57; 263-265;
3. Board of directors – Ss.260, 262, 313;
4. Central Government – s.408; (e) Third parties – s.255.

10.4.1 Appointment of First Directors

The first directors are usually named in the articles of a company. The articles may, however, instead of naming the first directors confer power on the subscribers, or majority of them, to appoint the directors. Where the appointment is to be made by the majority of subscribers, the majority of them (and not only the quorum fixed by the articles) should be present if the appointment is to be valid. Where there are no articles or the articles neither name them nor confer any such power on the subscribers, then Clause 64 of Table A in Schedule I to the Act confers powers on the subscribers or a majority of them to make the appointment of first directors. Furthermore, if the articles neither name them, nor do they contain a provision for their appointment by the subscribers and Table A is excluded, then the subscribers to the memorandum who are individuals are deemed to be the first directors of the company until the directors are duly appointed at a general meeting of the company in accordance with the provisions of s.255.

10.4.2 Appointment of Subsequent Directors

Sections 255 and 265 provide for three alternate schemes for the constitution of the Board of directors of a public company or a private company which is subsidiary of a public company. These schemes are: (i) all the directors retire at every annual general meeting [s.255]; or (ii) at least two-thirds of the total number of directors must be persons whose period of office is liable to determination by retirement by rotation (s.255); or (iii) at least two-thirds of the directors may be appointed by the principle of proportional representation, by a single transferable vote by a system of cumulative voting or otherwise and shall be directors for a period of three years at a time (s.265). The remaining directors in (ii) and (iii) and the directors generally of a pure private company, unless otherwise provided in the articles, must also be appointed by the company in general meeting.

Thus, a company may have two types of directors, retiring and non-retiring. The directors may retire by rotation as given in s. 256 or after a period of 3 years as given in s. 265.

Thus, every company should have a duly constituted board appointed in accordance with the provisions of s.255. A general meeting is called by the 'first' directors after the allotment of shares in the case of a company limited by shares and in the case of any other company, after its incorporation, for the specific purpose of appointment of directors.

10.4.3 Restrictions on Appointment of Directors

Section 266 states that a person cannot be appointed a director by the articles, or named as a director in the prospectus or statement in lieu of prospectus unless, before registration of the articles, publication of the prospectus, or filing of the statement in lieu of prospectus, he has:

Notes

Signed and filed with the registrar a consent in writing to act as such director; and either:

(i) Signed the memorandum for his qualification shares, if any; or

(ii) Taken his qualification shares, if any, from the company and paid or agreed to pay for them; or

(iii) Signed and filed with the registrar a written undertaking to take from the company his qualification shares, if any, and pay for them; or

(iv) Made and filed with the registrar an affidavit to the effect that his qualification shares are registered in his name.

This section does not apply to:

- A company not having a share capital;
- A private company;
- A public company which was formed as a private company;
- A prospectus issued by a company after the expiry of one year from the date on which the company was entitled to commence business.

Self Assessment

6. The agenda of the first Board Meeting of a limited company generally consists of the following items:

   (i) Election of chairman

   (ii) Approval of draft prospectus

   (iii) Appointment of officers, viz., The secretary, the manager and the accountant

   (iv) Incorporation of the company and the legal advisor to report on the same

   The correct order in which the above items of the agenda usually appear is:

   (a) (i), (ii), (iii), (iv) (b) (iv), (iii), (ii), (i)

   (c) (iii), (iv), (i), (ii) (d) (iv), (i), (iii), (ii)

7. Which one the following statements relating to a company secretary are not correct?

   (a) He is not likely to perform duties towards shareholders

   (b) He is the mouthpiece of the Board of directors

   (c) He may be considered to be the head of the administrative section of a company

   (d) He is to arrange for Board meetings.

10.5 Modes of Appointments

The Companies Act does not prescribe how directors are appointed; this is left to the companies' articles of association. Typically, directors are elected by the members at the annual general meeting of the company.

Table A which contains default articles makes provision for the appointment of directors. Thus, the present position is that the company's articles will provide for the appointment of directors, or the default position in Table A will apply unless Table A is excluded by the company's articles.

Notes

Having an express provision in the Companies Act will simplify matters as a company will not have to provide for the appointment of directors in its articles or rely on Table A, unless the company wishes to provide for a different mode of appointment. The Steering Committee received industry feedback that in practice, Table A is often excluded by the companies' articles as it is not found to be useful.

The current Singapore approach of not prescribing in legislation how directors are appointed is consistent with the position in the UK and Hong Kong. The Steering Committee considered whether the Companies Act should expressly provide for the mode of appointing directors, following the position in Australia and New Zealand.

For reasons of simplicity and greater clarity, the Steering Committee recommends that the Companies Act should provide expressly that unless the articles provide otherwise, a company may appoint a director by ordinary resolution passed at a general meeting. The mode of appointment is subject to the company's articles to give flexibility to companies.

This approach is consistent with that in Australia where the statutory provisions in the Australia Corporations Act 20017 on the mode of appointing directors are replaceable rules. It is also consistent with the approach in the New Zealand Companies Act 1993 where section 153(2) provides for the appointment of subsequent directors by ordinary resolution, unless the constitution of the company otherwise provides.

During the focus group consultation, the majority of the respondents expressed support for having such an express provision on the appointment of directors in the Companies Act. It was felt that notwithstanding that there is little dispute in practice on how directors are appointed, it would be good to clearly provide that the general meeting has power to appoint directors, subject to contrary provision in the articles.

10.6 Director Remuneration

Section 198 provides that the total managerial remuneration payable by a public company or a private company which to its directors or manager in respect of any financial year must not exceed 11 per cent of the net profit of that company for that financial year, in computing the above ceiling of 11 per cent computed in the manner laid down in section 349 and 359. The fees payable to directors for attending Board meetings is not included.

10.6.1 What is included in Remuneration?

Explanation to s.198 describes the term 'remuneration'. According to it, for the purposes of Ss. 309, 310, 311, 381 and 387, 'remuneration' includes the following:

1. Any expenditure incurred by the company in providing rent-free accommodation, or any other benefit or amenity in respect of accommodation free of charge, to any of its directors or manager;
2. Any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate to any of the persons aforesaid;
3. Any expenditure incurred by the company in respect of any obligation or service, which, but for such expenditure by the company, would have been incurred by any of the persons aforesaid; and
4. Any expenditure incurred by the company to effect any insurance on the life of, or to provide any pension, annuity or gratuity for, any of the persons aforesaid or his spouse or child.

Notes

Section 309 contemplates three kinds of directors, i.e., (i) Managing Director; (ii) Whole-time director; (iii) Director pure and simple. Further, s.309 provides that subject to the general provisions of s.198, dealing with the total managerial remuneration, the remuneration be determined by the articles, or by a resolution or, if the articles so require, by a special resolution, passed by the company in general meeting. Any remuneration paid for services in any other capacity shall not be included if: (a) the services rendered are of a professional nature; and (b) in the opinion of the Central Government, the director possesses the requisite qualifications for the practice of the profession.

A director who is neither in the whole-time employment of the company nor a managing director may be paid remuneration. (a) by way of a monthly, quarterly or annual payment with the approval of the Central Government; or (b) by way of commission, if the company by special resolution authorises such payment; or (c) by both.

Task X holds shares and directorship in a number of companies. X is proposed to be a Director of a company named Asian Ltd. State the requirements of law necessary to be complied with by him before and after he joins the Board of Asian Ltd. [***Hint:*** (i) X should resign one of the directorships, if he is already a director of more than 15 companies, (ii) He should give his consent in writing before joining the Board of Asian Ltd. (s.264) (iii) He should file his consent with the Registrar within 30 days of the date of joining. (iv) He should disclose the nature and extent of his interest in other companies (s.299). (v) He should acquire the qualification shares, if any prescribed by the Articles of Asian Ltd. in case he does not own the same already.]

However, in either of the above cases, the remuneration paid to such director, or where there is more than one such director, shall not exceed: (i) one per cent of the net profit of the company, if the company has managing or whole-time director or manager; (ii) three per cent of the net profits of the company in any other case. The company in general meeting may, however, with the approval of the Central Government, authorise the payment of a commission at a rate higher than one per cent, or as the case may be, three per cent of its net profits.

Each director is entitled to receive a sitting fee for each meeting of the Board or a committee thereof, provided the same is authorised by the articles.

A whole-time director or a managing director may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other; provided that except with the approval of the Central Government such remuneration shall not exceed 5 per cent of the net profits for one such director and if there is more than one such director, 10 per cent for all of them together. Furthermore, a managing or whole-time director who is in receipt of any commission from the company cannot receive any remuneration from any subsidiary of the company.

If any director draws or receives, directly or indirectly, by way of remuneration any sum in excess of the limits stated above, without the sanction of the Central Government, where it is required, he shall have to refund such sums to the company and until the refund is made the money will be held by him in trust for the company. The company cannot waive the recovery of any sum refundable to it, unless permitted by the Central Government.

The provisions of s.309 will not apply to a private company unless it is a subsidiary of a public company.

10.6.2 Increase in Remuneration

Notes

Section 310 provides that every increase in the remuneration of any director including a managing or whole-time director granted or provided by any amendment in his term of appointment which has the effect of increasing, whether directly or indirectly, the amount payable to him would not be operative unless the same has been approved by the Central Government. But no approval of the Central Government would be required if the increase in remuneration made is in accordance with the conditions specified in Schedule XIII. Also no approval of the Central Government is necessary, if the increase in the remuneration is only by way of fee for each meeting of the Board or a committee of the Board attended by any such director and the amount of the fee after such increase does not exceed such sum as may be prescribed. The Central Government has laid down differential scale of sitting fee according to the paid-up capital of the companies.

10.7 Remuneration Payable to a Manager

Section 387 provides that he may receive remuneration either by way of a monthly payment or by way of a specified percentage of the 'net profits' of the company, or partly by one way and partly by the other. Such remuneration, however, must not exceed in the aggregate 5 per cent of the net profits except with the approval of the Central Government.

10.7.1 Managerial Remuneration vis-à-vis Schedule XIII

A public company is entitled to appoint its managerial personnel and fix their remuneration so long as the same is in accordance with the conditions laid down in Schedule XIII without seeking the prior approval of the Central Government. Schedule XIII, provides as follows:

1. ***Remuneration Payable by Companies Having Profits:*** Subject to the provisions of s.198 and s.309, a company having profits in a financial year may pay any remuneration, by way of salary, dearness allowance, perquisites, commission and other allowances, which shall not exceed 5 per cent of its net profits for one such managerial person and if there are more than one such managerial persons, 10 per cent for all of them together.

2. ***Remuneration payable by companies having no profits or inadequate profits:*** Where in any financial year during the currency of tenure of the managerial person, a company has no profits or its profits are inadequate, it may pay remuneration to a managerial person, by way of salary, dearness allowance, perquisites and other allowance, not exceeding ceiling limit of ₹ 24,00,000 per annum or ₹ 2,00,000 per month calculated on the following scale:

Where the effective capital of the company is	Monthly remuneration payable shall not exceed (₹)
Less than ₹ 1 crore	75,000
₹ 1 crore or more but less than ₹ 5 crores	1,00,000
₹ 5 crore or more but less than ₹ 25 crores	1,25,000
₹ 25 crore or more but less than ₹ 50 crores	1,50,000
₹ 50 crore or more but less than ₹ 100 crores	1,70,000
₹ 100 crores or more	2,00,000

In addition to the above, certain perquisites like contribution to provident fund, gratuity, leave encashment may be paid. Non-resident Indians may also be paid children education allowance,

Notes

holiday passage for children studying outside India or family staying abroad, leave travel concession. These additional benefits shall be subject to the limits laid down in Schedule XIII.

The expression 'effective capital' shall mean the aggregate of the paid-up share capital (excluding share application money or advances against shares); amount, if any, for the time being standing to the credit of share premium account, reserves and surplus (excluding revaluation reserve); long term loans and deposits repayable after one year (excluding working capital loans, overdrafts, interest due on loans unless funded, bank guarantee, etc. and other short term arrangements) as reduced by the aggregate of any investments (except in case of investments by an investment company whose principal business is acquisition of shares, stock, debentures or other securities), accumulated losses and preliminary expenses not written off.

Sitting Fee (s.310)

The sitting fee payable to a director for each meeting of the Board of Directors or a committee thereof shall not exceed ceiling prescribed by the Central Government (presently, ₹ 5,000). Any increase in the sitting fee payable to a director shall not require the prior approval of the Central Govt. if it falls within the prescribed limits.

10.8 Disclosure

Disclosure of interest by directors, Section 299 provides as follows:

1. A director of a company who is in any way concerned or interested in a contract or arrangement by or on behalf of the company must disclose such concern or interest at the board meeting at which the contract is discussed. However if the director was not interested in the contract at the date of the meeting, then he must disclose his interest at the next board meeting held after he became interested.
2. However, if a director gives a general notice to the board that he is a director or member of a specified company or firm and is to be regarded as interested in any contract which is made with, it then this is a sufficient declaration or disclosure of interest. Such a general notice must, however, be given once every financial year and that too at the board meeting.
3. Non-compliance by a director with the aforesaid requirements will render him liable to a fine up to ₹ 50,000.
4. However, there is an exclusion clause. All contracts and arrangements between two companies where the interest of a director or director of one company in the other does not exceed a shareholding of two percent of the paid-up share capital of the other are excluded from the provisions of s.299.

Section 299 is in accordance with the principle of law that an agent cannot put himself into a position where his duty and his interest conflict.

10.8.1 Interested Directors not to Participate or Vote in Board's Proceedings

Section 300 provides as follows:

"An interested director must not participate in the discussions or exercise his vote on the particular contract or arrangement in which he is interested. If he does vote, his vote shall be void, nor his presence count for the purposes of quorum".

Notes

However, these restrictions do not apply to:

1. A private company which is neither a subsidiary nor a holding company of a public company;
2. A private subsidiary company in respect of contracts or arrangements entered into by it with the holding company;
3. Any contract of indemnity against any loss which any director(s) may suffer by reason of becoming or being a surety or sureties for the company;
4. A company in which the director had only his qualification shares and he was nominated as a director by the other company with which the contract is entered into;
5. A company in which the director is a member holding not more than two per cent of the paid-up share capital of the company.

A director who knowingly contravenes the provisions of s.300 is liable to be fined up to ₹ 50,000.

10.8.2 Register of Contracts in which Directors are Interested

To ensure that the provisions of sections 297-300 are complied with, s.301 provides as follows:

1. Every company must keep one or more registers in which must be entered separately particulars of all contracts or arrangements in which directors and their relatives are interested, and also particulars of firms and companies in which directors are interested as partners, members or directors. The particulars to be entered in the register are:
   (i) The date of the contract or arrangement;
   (ii) The names of the parties thereto;
   (iii) The principal terms and conditions thereof;
   (iv) The date on which the contract was placed before the board, where it is required to be placed;
   (v) The names of the directors voting for and against the contract or arrangement; and
   (vi) The names of directors who remained neutral.
2. The aforementioned particulars must be entered in the register within seven days of the approval of the board, where approval is required.

   In case of any other contract or arrangement, the particulars must be entered in the register within seven days of the receipt at the registered office of the company of the particulars of such other contract or arrangement or within 30 days of the date of such contracts or arrangements whichever is later.

   The register is required to be placed before the next meeting of the board and is then to be signed by all the directors present at the meeting.
3. The register aforesaid shall also specify, in relation to each director of the company, the names of the firms and bodies corporate of which notice has been given by him under s.299.
4. Exemption has been granted to contracts for the sale or purchase or supply of goods, etc. not exceeding ₹ 1000 in value in any year, and also to contracts by banking companies for collection of bills in the ordinary course of business, and transactions of banking and insurance companies in the ordinary course of business with any director, relative, partner, etc.

Notes

5. If default is made in complying with the above provisions of s.301, then the company, and every officer of the company who is in default, shall, in respect of each default, be punishable with fine which may extend to ₹ 5000.

6. The above register shall be kept at the registered office of the company, and it shall be open to inspection. Extracts may be taken from the register and any member of the company may demand copies thereof. The provisions of s.163 which apply to the register of members shall apply to the register in which directors are interested.

Task The total strength of the Board of directors of a company is ten. How many directors are liable to retire by rotation at the next annual general meeting? [*Hint:* Three] (s. 255,256)

10.8.3 Disclosure of Director's Interest in Contract Appointing Manager, or Managing Director

Section 302 states that where a company appoints or varies the terms of appointment of a manager, managing director, or whole-time director, and any director is directly or indirectly interested or concerned in the matter, then an abstract of the matter and of the director's interest therein should be circulated by the company to its members within 21 days of the date of the contract or its variation. These contracts must be kept at the registered office of the company, and must be available for inspection by the members. If the appointment or variation is made by a resolution of the board, the above provisions will apply to the same.

If default is made in complying with these provisions, then the company, and every officer of the company who is in default, shall be punishable with fine which may extend to ₹ 10,000.

Further, all contracts entered into by a company for the appointment of a manager, managing director shall be kept at the registered office of the company and shall be open to the inspection of the members of the company. Extracts may be taken from the register and copies thereof may be demanded by any member. The provisions of s.163, which applies to the register of members become applicable here also.

Summary of provision of Section 297 with respect to interested directors:

Particulars	Persons in which director is said to be interested	Approvals required
Contracts with the company	1. Director or relative 2. A firm in which a director or his relative is a partner. 3. Any other partner in such a firm 4. A private company of which the director is a director or a member.	1. Approval of the board. 2. In case the PUC of the company is ₹ 1 crore or more, then approval of the board and prior approval of the central government.

Example: R is the managing director of a public company with a paid up capital of ₹ 200 lac. He is also a partner of the firm in which the other partners are his wife and two sons. The company proposes to enter into a contract with the firm for the sale of its products of the value of ₹ 5 lac on credit.

As per s.297 such a contract can be entered only if (i) the consent of board of directors is obtained, and (ii) the previous approval of the central government is obtained (since the paid up capital is more than ₹ 1 crore).

Example: P is the managing director of a public company with a paid up capital of ₹ 150 lac. The company proposes to enter into a contract for the sale of its products of the value of ₹ 5 lakhs on credit with a private company in which the wife of P and his two sons S and T are members.

The facts of this case do not attract the restriction for entering into contract with an interested director. P is neither a director nor a member of the private company.

Example: The articles of a company states that a director shall not vote in respect of a contract in which he is interested. In a resolution put up for approval of the shareholders, a shareholder (even if he is a director), may vote as he pleases even when his interests are different from or opposed to those of the company. As a shareholder, he is not a trustee for the company or for any one else. Hence, the director can exercise his voting rights at a general meeting in favour of a contract in which he is interested.

Example: Company Y with a paid-up capital of ₹ 50 lakhs entered into a contract with company Z which has paid up capital of ₹ 5 lakhs. A director of a company Y is holding equity shares of the nominal value of ₹ 50,000 in Z company. The director does not disclose his interest at the board meeting under s. 299. The holding of the director is less than two percent of ₹ 5 lakhs. Therefore, the director is not liable to disclose his interest under s. 299(6).

10.9 Service Contract

Directors not to Hold Office or Place of Profit

Section 314 imposes certain restrictions on the holding of office or place of profit in a company by the directors and their associates. Following is the summary of restrictions so provided:

1. ***Section 314 (1) (a):*** No director of a company shall hold any office or place of profit (carrying any remuneration) under the company or its subsidiary except with the consent of the company by a special resolution. It shall, however, be sufficient if the special resolution is passed at the first general meeting held after such appointment.
2. ***Section 314 (1) (b):*** Except by passing a special resolution, and the approval of the central government the following persons shall not hold any office or place of profit carrying a total monthly remuneration of such sum as may be prescribed (presently ₹ 10,000 per month):
   - A partner or relative of a director or manager;
   - A firm in which such director or manager, or relative of either, is a partner;
   - A private company of which such a director or manager, or relative of either, is a director or member.

   Again, special resolution may be passed at the first general meeting after the appointment made. Where, however, the aforesaid appointment is made without the knowledge of the director, the consent of the company may be obtained either in the general meeting aforesaid or within three months from the date of the appointment, whichever is later.

   However, a director or any of his associates may be appointed as managing director, manager, banker or trustee for the debenture-holders of the company without sanction of special resolution, if the remuneration received from such subsidiary in respect of such office or place of profit is paid over to the company or its holding company.

For the aforesaid appointment of a director or his associates, special resolution shall not only be necessary at the time of first appointment but also for every subsequent appointment on a higher remuneration not covered by the special resolution except where an appointment on a time-scale has already been approved by the special resolution.

It may be noted that the aforesaid restrictions do not apply where a relative of a director or a firm in which such relative is a partner holds any office or place of profit under the company or a subsidiary thereof having been appointed to such office or place before such director became a director of this company [s. 314(1A)].

3. ***Section 314(1)(B):*** (i) no partner or relative of a director or manager; (ii) no firm in which such director or manager, or relative of either is a partner; (iii) no private company of which such a director or manager, or relative of either, is a director or member, shall hold an office or place of profit in the company carrying a total monthly remuneration of not less than such sum as may be prescribed (presently, ₹ 50,000 per month) except by passing a special resolution and the approval of the Central Government.

4. ***Section 314(2)(C):*** If any director or his associate holds an office or place of profit in contravention of the aforesaid provisions, then: (i) he shall be deemed to have vacated such office or place of profits as such on and from the date next following the date of the general meeting; (ii) he shall be liable to refund to the company any remuneration received or the monetary equivalent of the perquisites or advantage enjoyed by him. The company cannot waive the recovery of any sum refundable to it as above unless, permitted to do so by the Central Government.

These provisions will neither affect the director's office as such nor shall he be liable to refund remuneration received in the capacity of a director, e.g; if some commission or monthly remuneration is payable to all the directors, the same will not be refundable, but if a director receives something in addition to other directors that he will be bound to pay to the company. Thus, for the purposes of this section, an office and place of profit is to be deemed to be one of profit if in case it is held by a director, such director over and above his remuneration as a director, and in case it is held by any other person, firm or private company or a body corporate, obtains anything from the company by way of remuneration, whether as salary, fees, commission, or perquisites, right to occupy any premises rent-free as a place of residence or otherwise.

Section 629 (A) also provides for a fine of ₹ 5,000 and a further fine of ₹ 500 for every day during the period in which contravention continues.

Section 314 (2A) makes it obligatory for every individual, firm, private company, or other body corporate proposed to be appointed to any office or place of profit to which this section applies to declare in writing before or at the time of appointment, whether he or it is or is not connected with any director of the company in any of the ways referred to in s.314 (1).

The aforesaid restrictions do not apply to a person who being the holder of any office of profit in the company is appointed by the Central Government, under s.408, as a director of the company. [s. 314(4)].

10.10 Removal of Directors

A director may be removed by:

1. Shareholders
2. Central Government
3. CLB

10.10.1 Removal by Shareholders

Notes

Section 284 provides that a company may, by ordinary resolution passed in general meeting after special notice, remove a director before the expiry of his term of office. On receipt of the special notice, the company must forthwith send a copy thereof to the director concerned to enable him to make a representation. If he makes a representation in writing and requests the company to notify it to the members, the company must, unless it is received by it too late for it to send to the members, state the fact of the representation in any notice of the resolution given to the members. It should also send a copy of the representation to every member of the company to whom notice of the meeting is sent. If the representation is not sent as aforesaid, the company must at the instance of the director concerned read it out at the meeting. The director is also entitled to be heard on the resolution at the meeting.

The special notice given by the member(s) must specify the reasons for removal of the director.

However, the copy of the representation of the director sought to be removed, need not be circulated nor the concerned director be allowed the right to have the representation read out in the general meeting (where the same was not circulated earlier because of late receipt), if the company or any other person claiming to be aggrieved, has made an application to CLB to prevent such circulation or reading out on the ground that such circulation or reading out would amount to abuse of the right on the part of the concerned director to secure needless publicity for defamatory matters, and CLB, being satisfied, orders accordingly.

The vacancy caused by the removal of a director may be filled at the same meeting and if so filled, the person appointed thereto will only hold office for the residual period of the removed director. If the vacancy is not filled by the company in general meeting, the Board of directors may fill it as if it were a casual vacancy in accordance with s.262, but the board cannot appoint the removed director.

A removed director may claim compensation for loss of office as a director, or claim damages for the termination of any other office on account of the removal, or may continue to hold the additional office.

But the following directors cannot be removed by the company in general meeting:

- A director appointed by the Central Government under s.408.
- A director of a private company holding office for life on April 1, 1952.
- A director elected by the principle of proportional representation under s.265.
- A director appointed by the Central Government under Industries (Development and Regulation) Act, 1951.
- A director appointed under Sick Industrial Companies (Special Provisions) Act, 1985.
- A director appointed by financial institutions under their statutory powers.
- A nominee director.
- A director appointed by CLB (s. 402).

It is to be noted that s.284 is not exhaustive as it is stated therein that nothing in s.284 shall be taken as derogating from any power to remove a director which may exist apart from the section. The articles of a company may provide for the removal of a director.

Thus it is to be noted that the power to remove a director is not an absolute or unrestricted one.

Notes

Example: The shareholders of X Co. Ltd. sought to remove a director at a meeting. The concerned director alleged that this could not be done as no special notice was given to pass a resolution to remove him. As such he was deprived of his right to make a representation. The shareholders' contention that the sending of the special notice and the right of the director to make a representation were only a formality was not tenable. [Queen Kuries and Loans (P) Ltd. v. Sheena Jose, (1993) 76 Comp. Cas 821 Ker]. The contention of the director was held to be correct.

Example: If in the above example, one shareholder holding ten equity shares of ₹ 10 each fully paid up had given a special notice for the removal of the director, but did not state any reasons for the removal. Even in such a case, the director cannot be removed, as the disclosure of the ground for removal is a matter of substance and not of form because the director concerned is entitled to make a representation in writing against his removal. How can he make the representation, if he does not know the reasons of his removal.

10.10.2 Removal by the Central Government

The provisions of s. 203 and s. 204 prohibit certain persons from acting or being appointed as directors, and provide for their removal only if they were convicted for offences involving moral turpitude. In all those cases, conviction or finding of guilt by the court is the prerequisite for bringing about vacation of office. Strict proof of guilt in a criminal case is essential and very often such persons may go scot-free in spite of malpractices. The findings of the CLB will enable the Central Government to take quick action against persons involved in cases of fraud, etc. For this purpose, s.388B to 388E have been inserted in the Act.

Under s.388B, the Central Government has the power to make a reference to the CLB against any managerial personnel. The power can be exercised where, in the opinion of the Central Government, there are circumstances suggesting:

1. At the personal level, that any person concerned in the conduct and management of the affairs of a company is or has been guilty of fraud, misfeasance, persistent negligence of default in carrying out his obligations and functions under the law, or breach of trust in connection therewith; or
2. At the company level. that the business of the company is not or has not been conducted and managed by such person in accordance with sound business principles or prudent commercial practices; or
3. At the industry level, that the business of the company is or has been conducted or managed by such person in a manner which is likely to cause or has in fact caused, serious injury or damage to the interest of trade, industry or business to which such company pertains; or
4. At the community level, that the business of the company is or has been conducted and managed by such person with an intent to defraud its creditors, members, or any other person or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest.

The reference may be made by stating a case against the person aforesaid, with a request that, the CLB may inquire into the case, record finding as to whether or not such person is a fit and proper person to hold the office of director or any other office connected with the conduct and management of any company.

The statement of the case by the Central Government should be in the form of an application presented to the CLB and the person against whom such case is stated and referred should be joined as a respondent to the application. The application should contain a concise statement of such circumstances and materials as the Central Government may consider necessary for purpose of inquiry to be made by the CLB. The application must be signed and verified in the same manner as a complaint in a suit by the Central Government under the Code of Civil Procedure.

Thereafter, the CLB will hear the case against the respondent. At any stage of the proceedings, the CLB may allow the Central Government to alter or amend the application in such a manner and on such terms as may be just and all such alterations and amendments shall be made as may be necessary for the purpose of determining the real question in the inquiry (s.388B).

If during the pendency of the case the CLB finds it necessary, in the interest of the members or creditors of the company, it may, either on the application of the Central Government or of its own motion, direct that the respondent shall not discharge any of the duties of his office until further orders and appoint in his place another suitable person to discharge the duties of the respondent. This person, who is temporarily appointed to discharge the duties in place of the respondent will be regarded as a public servant within the meaning of s.21 of the Indian Penal Code (s.388C).

At the conclusion of the hearing of the case, the CLB shall record its findings, stating therein specifically as to whether or not respondent is a fit and proper person to hold the office of director or any other office connected with the conduct and management of any company (s.388-D).

On the basis of the aforesaid findings, the Central Government may, by order, notwithstanding any other provisions contained in the Act, remove the delinquent respondent from his office (s.388E(1)).

An order under s.388E must not be passed against any person unless he has been given a reasonable opportunity to show cause against the order. However, no matter can be raised by such a person before the Central Government, which has already been decided by the CLB (s.388E(2) and proviso thereto).

After the delinquent person has been, by order, removed, he shall neither hold any office for a period of 5 years from the date of the order of removal nor will he be paid any compensation for loss of office as a result of removal. The time-limit may, however, be relaxed by the Central Government with the previous concurrence of the CLB, and the Central Government may accordingly permit such person to hold the office of a director or any other office connected with the conduct and management of the affairs of the company even before the expiry of the period of 5 years. On the removal of the person, the company may, with previous approval of the Central Government, appoint another person to that office in accordance with the provisions of the Act.

10.10.3 Removal by Company Law Board

Section 402(b) empowers the CLB to remove some managerial personnel when an application to it is made for prevention of oppression and mismanagement under Ss. 397 and 398. Under this section, if the CLB finds that, the relief ought to be granted, it may terminate, set aside or modify any agreement between the company and the managing director or any other director or the manager. When appointment of a managerial personnel is so terminated or set aside, he can neither sue the company for damages or compensation for the loss of office, nor can he be appointed, except with the leave of the CLB, in any managerial capacity in the company for a period of 5 years from the date of the order terminating or setting aside his contract with the company. Also the removed director shall not be entitled to claim any compensation from the company for loss of his office.

Notes

A Director of a private company is appointed as its managing director on a monthly salary of ₹ 10,000. There is an objection to this on the ground that a director cannot be appointed to an office of profit. Advise.

10.11 Retirement of Director

The directors due to retire by rotation vacate office at the latest on the last day on which an annual general meeting could have been held under s. 166, and therefore, if this meeting is not held, the directors cannot claim to continue after the date on which the meeting should have been held. The reasons for not allowing directors to continue after the date on which the AGM should have been held is that as it is the duty of the directors to call the AGM within the prescribed time, they cannot be allowed to take advantage of their own default and by that means to continue in office for the extended period [B.R. Kundra v. Motion Pictures Assn. (1976) 46 Comp Cas. 339 Del].

10.12 Appointment of a Director other than a Retiring Director

Section 257 provides for the procedure of appointment of a person other than the retiring director. If any person, (whether a member of the company or not) other than the retiring director wishes to stand for directorship, he must signify his intention to do so by giving 14 days' notice to the company before the meeting and the company must inform the members not later than seven days before the meeting either by individual notices or by advertisement of this fact in at least two newspapers circulating in the place where its registered office is situated, of which one must be in English and the other in the regional language of the place. Also, the candidate or the member who intends to propose him as director has to deposit a sum or ₹ 500 which shall be refunded to such person or as the case may be, to such other member, if the candidate succeeds in being elected. In case such person is not elected as director, he or the member, as the case may be, will not be entitled to the refund of ₹ 500 and the amount deposited shall stand forfeited to the company. Also s.264 requires every person proposed as a candidate for the office of a director to sign and file first with the company his consent to act as a director, if appointed and then with registrar within 30 days of his appointment.

Example: The BOD of XYZ Ltd. appoints Mr. A as a director in the vacancy caused by resignation of Mr. B. Now at the ensuing AGM, Mr. A is to vacate his office. The company is contemplating to reappoint him as a director, treating him as a retiring director.

The company cannot treat A as a retiring director under s. 257. Therefore, he cannot be deemed to have been reappointed. The procedure given in s. 257 will have to be followed for his appointment.

10.13 Power and Fiduciary Duties

10.13.1 Powers of the Board of Directors

Section 291 provides for general powers of the Board of directors.

"Subject to the provisions of the Act, the Board of directors of a company shall be entitled to exercise all such powers and to do all such acts and things, as the company is authorised to exercise and do"

Notes

However, the Board cannot exercise any power or do any act or thing which is directed or required, whether by this or any other Act or by the memorandum or articles of the company or otherwise, to be exercised or done by the company in general meeting. In exercising any such power or doing any such act or thing, the board will be subject to the provisions contained in that behalf in this or any other Act, or in the memorandum or articles of the company, or in any regulations not inconsistent therewith and duly made thereunder, including regulations made by the company in general meeting.

Thus, the Board may exercise all powers of the company and can do all such acts and things that the company can do. But the exercise of such powers of the Board shall be in conformity with the provisions of the Companies Act or any other Act and memorandum, articles and resolutions of the company in general meetings. Thus, a general meeting may, by amending the articles, restrict the powers of the board. But the meeting cannot invalidate any act validly done by the board except in the following cases: (1) where the directors are either unable or unwilling to act [Barron vs. Potter (1914) 1 Ch. 895]; (2) when the directors act for their own personal interests in complete disregard to the company [Marshall's Value Gear Co. Ltd. vs. Manning Wardle & Co. Ltd (1909) Ch. 267]; (3) when the Board has become incompetent to act e.g. where all the directors constituting the Board are interested in a dealing or where none of the directors was validly appointed [B.N. Vishwanathan vs. Tiffins B.A. and Ltd. AIR (1953) Mad 510].

10.13.2 The Mode or Manner of Exercise of Board's Powers

Section 292 provides that the Board of directors of a company shall exercise the following powers on behalf of the company and it shall do so only by means of resolutions passed at meeting of the Board:

(i) The power to make calls on shareholders in respect of money unpaid on their shares;

(ii) The power to buyback its shares under s. 77A;

(iii) The power to issue debentures;

(iv) The power to borrow money otherwise than on debentures;

(v) The power to invest funds of the company (subject to sections 293 and 372A); and

(vi) The power to make loans. (subject to sections 293 and 372 A).

The Board may, however, by a resolution passed at a meeting delegate to any committee of directors, the managing director, the manager or any other principal officer of the company, the powers specified in clauses (iv), (v) and (vi) on such conditions as the Board may prescribe.

Besides the powers specified in s.292, there are certain other powers also which can be exercised only at the meeting of the Board. These are:

1. The power of filling casual vacancies in the Board (s.262);
2. Sanctioning of a contract in which a director is interested [s.297];
3. The power to recommend the rate of dividend to be declared by the company at the Annual General Meeting, subject to the approval by the shareholders.

In the following cases, not only that the powers be exercised at the Board's meeting but also that every director present and entitled to vote must consent thereto:

1. The power to appoint a person as managing director or manager, who is already managing director or manager of another company (Ss.316 and 386).
2. The power to invest in any shares and debentures of any other body corporate (s.372).

Notes

10.13.3 Restrictions on Powers of Directors

Section 293 provides that, the Board of directors of a public company or a private company which is a subsidiary of a public company cannot exercise the following powers without the consent of the shareholders in general meeting:

1. Sell, lease or otherwise dispose of the whole, substantially the whole, of the undertaking of the company, or where the company owns more than one undertaking, of the whole or substantially the whole, of any such undertaking.

   However, this restriction does not apply to the case of a company whose ordinary business is to sell or lease property.

2. Remit or give time for the re-payment of any debt due by a director except in the case of renewal or of continuance of an advance made by a banking company to its director in the ordinary course of business.

3. Invest, otherwise than in trust securities, the amount of compensation received by the company in respect of compulsory acquisition of any fixed assets of the company.

4. Borrow money exceeding the aggregate of the paid-up capital of the company and its free reserves. 'Borrowing' does not include temporary loans obtained from the company's bankers in the ordinary course of business.

   The expression 'free reserves' mean reserves not set apart for any specific purpose.

   Further, every resolution passed by the company in general meeting shall specify the total amount up to which moneys may be borrowed by the board. Furthermore, the expression 'temporary loans' means loans repayable on demand or within six months from the date of the loan such as short term, cash credit arrangement, the discounting of bills and the issue of other short term loans of a seasonal character, but does not include loans raised for the purpose of financing expenditure of a capital nature.

5. Contribute in any year, to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amount exceeding ₹ 50,000 or 5% of its average net profit for the last three financial years, whichever is greater.

However, contributions to National Defence Fund or any other fund approved by the Central Government for the purpose of national defence are exempted from the above provisions. Any amount may be contributed without obtaining the sanction of the company in general meeting. However, the amount contributed to these funds must be disclosed in the profit and loss account of the company for the year in which the contribution was made.

The Companies Act does not expressly empower companies to borrow money. Therefore, most of the companies expressly provide for such borrowing powers in the memorandum. In such a case, where memorandum authorises the company to borrow, the articles provide as to how and by whom these powers shall be exercised. It may also fix up the maximum which can be borrowed by the company.

Example: The paid up share capital and free reserves of XYZ Ltd. is ₹ 100 crore as on April 1, 2008. The shareholders of the company at their general meeting held on April 4, 2008, by a resolution authorised the board of the company to borrow money 'exceeding the paid-up share capital and free reserves of the company, to the extent required by the board of directors." The board, as a result, borrowed money to the extent of ₹ 130 crore, including ₹ 20 crore as short term loan and ₹ 25 crore as a temporary loan for financing the construction of a building of the company.

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The borrowing made by the board violates the provisions of the Act because (i) it exceeds the paid up capital and free reserves even after excluding short term loan of ₹ 20 crore assuming that the loan is obtained from the companies bankers in the ordinary course of business. (ii) the resolution passed in the general meeting enabling the board to borrow in excess of its paid up capital and free reserves without specifying the total amount up to which money may be borrowed by the board.

Example: The position would be different in case the company's paid up share capital and free reserves increased to ₹ 150 crore and the board borrow money to the extent of ₹ 140 crore which neither include any short-term loan nor temporary loan for financing of the construction of a building for the company. As the board could raise up to ₹ 150 crores, but in fact has raised ₹ 140 crore only, there is no contravention of the provision of the Act.

Self Assessment

8. Minimum no. of Directors in case of a public company is
   (a) 1 (b) 2
   (c) 3 (d) 4
9. Minimum no. of Directors in case of private company is
   (a) 1 (b) 2
   (c) 3 (d) 4
10. Age limit of Directors in case of public company is
    (a) 65 (b) 70
    (c) 60 (d) 55
11. Age limit of Directors in case of private company is
    (a) 65 (b) 70
    (c) 75 (d) No limit

10.14 Duties of Director in Relation to Good Corporate Governance

Duties of directors may be divided under two heads: (1) Statutory duties; and (2) Duties of a general nature. The statutory duties are the duties and obligations imposed by the Companies Act. These have been discussed at appropriate places. Important among them are:

1. ***To file Return of Allotments:*** Section 75 charges a company to file with the Registrar, within a period of 30 days, a return of the allotments stating the specified particulars. Failure to file such return shall make directors liable as 'officer in default'. A fine up to ₹ 500 per day till the default continues may be levied.
2. ***Not to Issue Irredeemable Preferences Shares or Shares Redeemable after 10 years:*** Section 80 forbids a company to issue irredeemable preference shares or preference shares redeemable beyond 10 years. Directors making any such issue may be held liable as 'officer in default' and may be subject to fine up to ₹ 1,000.
3. ***To Disclose Interest [Ss.299-300]:*** A director who is interested in a transaction of the company must disclose his interest to the Board. The disclosure must be made at the first meeting of the Board held after he has become interested. This is because a director stands

Notes

in a fiduciary capacity with the company and therefore, he must not place himself in a position in which his personal interest conflicts with his duty. Interest should be such which avoids conflicts with the duties of the director towards the company.

Notice, however, that the Companies Act does not debar a company from entering into a contract in which a director is interested. It only requires that such interest be disclosed. An interested director should not take part in the discussion on the matter of his interest. His presence shall not be counted for the purpose of quorum. He shall not vote on that matter. If he does vote, his vote shall be void. Non-disclosure of interest makes the contract voidable and not void. Where the whole Board of directors is aware of the facts, a formal disclosure is not necessary (Venkatachalapathi vs. Guntur Mills AIR 1929 Mad 353). In this case, a loan was advanced by the wife of a director creating a mortgage on the property of the company. The director did not disclose his interest and he even voted on the matter. The company later sued to have mortgage set aside.

Held: the fact was known to all directors and a formal disclosure was not necessary. As regards voting by the interested director, it was held that the voting would not render the contract void or voidable unless in the absence of that vote, there would have been no quorum qualified to contract.

4. ***To disclose receipt from transferee of property:*** Section 319 provides that any money received by the directors from the transferee in connection with the transfer of the company's property or undertaking must be disclosed to the members of the company and approved by the company in general meeting. Otherwise the amount shall be held by the directors in trust for the company. This money may be in the name of compensation for loss of office but in essence may be on account of transfer of control of the company. But if it is bona fide payment of damages for a breach of contract, then it is protected by s.321(3).

5. ***To disclose receipt of compensation from transferee of shares:*** If the loss of office results from the transfer (under certain conditions) of all of the shares of the company, its directors would not receive any compensation from the transferee unless the same has been approved by the company in general meeting before the transfer takes place (s.320). If the approval is not sought or the proposal is not approved, any money received by the directors shall be held in a trust for the shareholders who have sold their shares.

Section 320 further provides that in pursuance of any agreement relating to any of the above transfers, if the directors receive any payment from the transferee within one year before or within 2 years after the transfer, it shall be accounted for to the company unless the director proves that it is not by way of compensation for loss of office.

Section 321 further provides that, if the price paid to a retiring director for his shares in the company is in excess of the price paid to other shareholders or any other valuable consideration has been given to him, it shall also be regarded as compensation and should be disclosed to the shareholders.

Some other statutory duties are: to attend the Board meetings; to convene and hold general meetings; to prepare and place before AGM financial accounts; to make declaration of solvency.

The general duties of directors are as follows:

1. ***Duty of good faith:*** The directors must act in the best interest of the company. Interest of the company implies the interests of present and future members of the company on the footing that the company would be continued as a going concern.

   A director should not make any secret profits. He should also not exploit to his own use the corporate opportunities. In Cook vs. Deeks (1916) AC 554, it was observed that "Men who assume complete control of a company's business must remember that they are not at liberty to sacrifice the interest which they are bound to protect and while ostensibly acting for the company, direct in their own favour business which should properly belong to the company they represent." In this case, there was an offer of a contract to the company. Directors who were the holders of shares of 3/4 of the votes resolved that the company had no interest in the contract and later entered the contract by themselves.

Held: The benefit of the contract belonged in equity to the company.

2. ***Duty of Care:*** A director must display care in performance of the work assigned to him. He is, however, not expected to display an extraordinary care but that much care only which an ordinary prudent man would take in his own case. Justice Romer in Re City Equitable Fire Insurance Company [1925 Ch. 407] observed, "His (director's) duties will depend upon the nature of the company's business, the manner in which the work of the company is distributed between the directors and other officials of the company. In discharging these duties a director must exercise some degree of skill and diligence. But he does not owe to his company the duty to take all possible care or to act with best care. Indeed, he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. It is, therefore, perhaps, another way of stating the same proposition that directors are not liable for mere errors of judgement."

   Similar view was expressed in Langunas Nitrate Co. vs. Lagunas Nitrate Syndicate (1899) 2 Chi. 392, in the following words: "If directors act within their powers, if they act with such care as is to be reasonably expected of them having regard to their knowledge and experience and if they act honestly for the benefit of the company they discharge both their equitable as well as legal duty to the company."

   Section 201 states that, a provision in the company's articles or in any agreement that excludes the liability of the directors for negligence, default, misfeasance, breach of duty or breach of trust, is void. The company cannot even indemnify the directors against such liability. But if a director has been acquitted from such charges, the company may indemnify him against costs incurred in defense. Section 633 further states that, where a director may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust but if he has acted honestly and reasonably and having regard to all the circumstances of the case, he ought fairly to be excused, the court may relieve him either wholly or partly from his liability on such terms as it may think fit.

3. ***Duty to attend Board Meetings:*** A number of powers of the company are exercised by the Board of directors in their meetings held from time to time. Although a director is not expected to attend all the meetings but if he fails to attend three consecutive meetings or all meetings for a period of three months, whichever is longer, without permission, his office shall automatically fall vacant.

4. ***Duty not to Delegate:*** Director, being an agent, is bound by maxim 'delegatus non protest delegare' which means a delegate cannot further delegate. Thus, a director must perform his functions personally. A director may, however, delegate in the following cases: (a) where permitted by the Companies Act or articles of the company; (b) having regard to the exigencies of business certain functions may be delegated to other officials of the company.

Some other duties are to convene statutory; annual general meeting and also extraordinary general meeting when required by the shareholders of the company; to prepare and place at the AGM along with the balance sheet and profit and loss account, a report on the company's affairs; to make a declaration of solvency in the case of a member's voluntary winding up.

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The duties of the directors are usually regulated by the company's Articles. While performing their duties, they must display reasonable care, honesty, good faith, skill and diligence. As they stand in a fiduciary relationship to the company and they are agents and trustees in certain respects, they are bound to exercise in the performance of their duties a reasonable degree of skill and care.

Self Assessment

State whether the following statements are true or false:

12. The board of directors can make political contribution by passing a resolution at its meeting only.
13. The board of directors can fill a casual vacancy in the office of a director by passing a resolution by circulation.
14. The board of directors can appoint an additional director by passing a resolution either at a meeting or by circulation.
15. The board of directors can enter into a joint venture agreement by passing a resolution either at a meeting or by circulation.
16. The board of directors can invest in another body corporate by passing a resolution at its meeting.

Case Study

Reliance Industries

Reliance Industries, the largest shareholder in Reliance Energy, has voted in favour of entrusting itself with the power to appoint the majority of directors on the REL board.

Earlier these powers were vested with Mr. Anil Ambani, REL Chairman and Managing Director.

According to sources, RIL was among the 97.24-per cent REL shareholders who voted in favour of the changes to its Articles of Association, a set of rules that govern day-to-day workings of a company, through a postal ballot. The result of which was announced.

The altered Article envisages that so long as the Reliance Group of Companies holds 26 per cent or more of REL's paidup voting equity share capital, it will have the right to appoint majority of REL's directors on the board of the company.

Reliance Industries had earlier said that it had not sought in any withdrawal of powers conferred on Mr. Anil Ambani. It had also said that RIL had not been consulted by REL before the proposed re-amendment of the relevant articles of association. The move to alter the articles of association was seen as part of the ongoing differences between the Ambani brothers over control of the ₹ 99,000-crore Reliance Group, of which REL is a subsidiary.

REL had, by way of a special resolution, asked shareholders to mail their votes through postal ballot for a change in its Articles of Association.

The company had sought permission to change Article 131 (a), 131 (a) (ii) and 131 (aa), which allowed Mr. Anil Ambani the power to appoint one-third or majority of the total

Contd...

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directors on REL's board, choose the Vice-Chairman of the company and even decide the tenure of the Chairman, Vice-Chairman and the directors appointed by him.

REL sought to vest these powers with its prime shareholder, Reliance Industries.

Question

Why does Reliance want alteration in Reliance Energy's articles? (***Hint:*** due to the conflict between the Ambani brothers)

10.15 Summary

- Section 2 (13) defines a Director as including "any person occupying the position of director, by whatever name called."
- The articles of a company, sometimes, designate its directors as governors, members of the governing council or the board of management or may give them any other title, but so far as the law is concerned, they are simply directors.
- A deemed director need not necessarily be an individual. The person may even be a body corporate say, a holding company.
- The directors act as agents of the company and the ordinary rules of agency apply.
- The directors are also sometimes described as managing partners.
- Directors are treated as officers of the company [s. 2(30)].

10.16 Keywords

Deemed Director: For certain purposes, a person even when he is not a director may be deemed to be a director of a company.

Director: Any person occupying the position of director, by whatever name called director.

Legal Position of Director: The exact position of 'Director' is hard to define, as no formal definition, either statutory or judicial, of the term has been given. However, judicial pronouncements have described them as (i) agents, (ii) trustees, or (iii) managing partners.

Statutory Duties: The statutory duties are the duties and obligations imposed by the Companies Act.

10.17 Review Questions

1. Define 'Director'. What is his legal position in a company?
2. To what extent can the directors of a company be considered as trustees, agents or managing partners of the company? Explain your answer with reasons.
3. Who can be a director? What qualifications, if any, must a person possess in order to become a director of a company?
4. How are the directors of a company appointed?
5. What are the disqualifications of a director?
6. Can the directors of a company be appointed by the Board of directors?
7. State the powers of the Board of directors which can be exercised only with the approval of the members in a general meeting of the company.

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8. Enumerate the powers which can be exercised by the Board of directors only at its meetings.
9. What do you understand by an office or place of profit held by a director under the company? In this regard, discuss the restrictions placed by the Companies Act, 1956.
10. State in relation to a public company:
    (a) When additional directors can be appointed and for what period?
    (b) When an alternate director can be appointed and for what period?
    (c) How is the office of a director filled in case of a casual vacancy, and for what period?
    (d) When can directors be appointed by the principle of proportional representation and for what period?

Answers: Self Assessment

1. Section 2 (13)
2. deemed director
3. English Law
4. agency
5. managing partners
6. (d)
7. (a)
8. (c)
9. (b)
10. (a)
11. (d)
12. True
13. False
14. True
15. True
16. True

10.18 Further Readings

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Unit 11: Corporate Governance

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CONTENTS

Objectives

After studying this unit, you will be able to:

- Define corporate governance;
- Describe corporate manager as trustee;
- Explain corporate governance in the Indian scenario.

Introduction

Corporate governance became a dominant business topic in the wake of the spate of corporate scandals of midyear 2002-Enron, Worldcom and Tyco, to name a few. Interest in corporate governance is not new, but the severity of the financial impact of these scandals undermined the confidence of both the institutional and the individual investor and heightened concerns about the ability and resolve of private enterprises to protect their stakeholders. The crisis in confidence in the corporate sector contributed to the downward pressure on stock prices worldwide and particularly in the United States. In the first six months of 2002, the S&P 500 fell 16 percent, the technology heavy NASDAQ fell 36 percent. The U.S. government intervened, and new legislation required CEOs to personally attest to the accuracy of their firms' accounts and report results more quickly. Simultaneously, corporate America increased the level of self-regulation.

11.1 Corporate Governance

Corporate governance consists of the set of processes, customs, policies, laws and institutions affecting the way people direct, administer or control a corporation. Corporate governance also

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includes the relationships among the many players involved (the stakeholders) and the corporate goals. The principal players include the shareholders, management, and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

'Corporate governance' is a term that refers to the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. The term may also describe the company's compliance with applicable codes (corporate governance guidelines), its investment technique based on active ownership (as in corporate governance funds) or a field in economics, which studies the many issues arising from the separation of ownership and control.

Corporate governance is also inclusive of the relationships of the stakeholders, and the goals for which the corporation is governed. Corporate governance is an international business issue. In the US, corporate governance became a high profile issue as a result of corporate scandals and business failures, such as Enron and WorldCom. However, internationally, similar scandals have made corporate governance an issue that all organizations have made a business priority.

A key component of corporate governance is accountability, to shareholders, customers, employees and others. Corporations must not only comply with federal regulations and exercise fiscal responsibility but governance must extend to ethical responsibilities as well. In its simplest view, corporations should seek to comply with codes to the overall good of all constituents.

Corporate governance is used to monitor whether outcomes are in accordance with plans; and to motivate the organization to be more fully informed in order to maintain or alter organizational activity. Primarily though, corporate governance is the mechanism by which individuals are motivated to align their actual behaviors with the overall corporate good (i.e. maximum aggregate value generated by the organization and shared fairly amongst all participants).

Corporate governance in the broadest sense, defines the operating rules of a company. Those rules will encompass the laws of the land, fiduciary or economic responsibility, ethical behavior, fraud prevention, risk mitigation and in general good corporate citizenry. Everyone in a corporation from the boardroom to the front line has a role in corporate governance.

11.1.1 Need of Corporate Governance

The success of modern enterprises depends on the adoption and implementation of good management practices to protect the interests of stakeholders. Sound corporate governance practices help companies to improve their performance and attract investment while enabling them to realize their corporate objectives, protect shareholder rights, meet legal requirements, and demonstrate to a wider public how they are conducting their business. These practices have become critical to worldwide efforts to stabilize and strengthen global capital markets and protect investors.

Good corporate governance helps an organisation to achieve its outcomes and obligations through sound planning and risk management. It provides a means to assist in decision making and to improve accountability. It also helps to provide a framework for establishing responsibility to the organisation's members, the people served by the organisation and other stakeholders.

11.1.2 Features of Good Corporate Governance

There are some key features of good governance that you need to consider when assessing the governance of your organisation. These features should be central to an organisation's corporate governance framework and should be included in governance related documentation which

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may include organisational plans, business plans, marketing plans, policy and procedures manuals, risk management reviews and/or quality assurance manuals. The features are:

- Strategy setting and planning
- Risk management
- Consultation
- Roles and responsibilities
- Skills, independence and resources
- Conduct and ethics
- Performance
- Succession planning
- Financial and operational reporting
- Audit committees.

Good corporate governance is important to professional investors. Major institutions rank corporate governance on par with the firm's financial indicators when evaluating investment decisions. A McKinsey study found that professional investors are even prepared to pay large premiums for investments in firms with high governance standards. Premiums ranged from an average of 13 percent in North America and even Western Europe to 20 or 25 percent in Asia and Latin America and even higher in Easter Europe and Africa. On average when moving from poorest to best on corporate governance, firms could expect an increase of 10 to 12 percent in market value.

A number of bodies have published guidelines for good corporate governance. One found very useful was the organization for Economic Co-operation and Development's 1999 publication "OECD Principles for Corporate Governance," which defined corporate governance as "providing the structure for determining organizational objectives and monitoring to ensure that objectives are attained". The OECD emphasized that "there is no single model of good corporate governance," but it noted that in many countries corporate governance is vested in a supervisory board that is responsible for protecting the rights of shareholders and other stakeholders (employees, customer, creditors, and so on). The board, in turn, works with a senior management team to implement governance principles that ensure the effectiveness of organizational processes.

Corporate and Key Asset Governance

A framework for linking corporate and IT governance is proposed. The top of the framework (Figure 11.1) depicts the board's relationships. The senior executive team, as the board's agent, articulates strategies and desirable behaviors to fulfill board mandates.

Strategy is viewed as a set of choices. Who are the targeted customers? What are the products and service offerings? What is the unique and valuable position targeted by the firm? What core processes embody the firm's unique market position?

Task In the US, corporate governance became a high profile issue as a result of corporate scandals and business failures, such as Enron and WorldCom. However, internationally, similar scandals have made corporate governance an issue that all organizations have made a business priority. Discuss.

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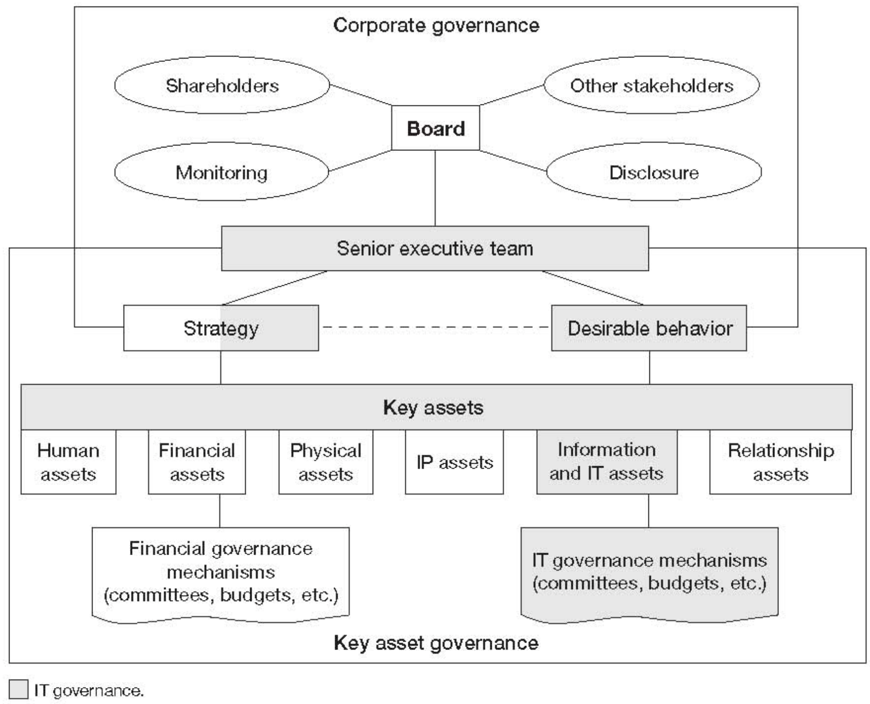
Desirable behaviors embody the beliefs and culture of the organization as defined and enacted through not only strategy but also corporate value statements, mission statements, business principles, rituals, and structures. Desirable behaviors are different in every enterprise. Behaviors, not strategies, create value. For example, Johnson & Johnson relied on autonomous business units to create shareholder value for nearly a hundred years. Eventually, however, customers insisted that they wanted to deal with J&J not a set of individual J&J operating companies. Accordingly, J&J's well-known corporate credo has evolved to specify desirable behaviors such as lowering the cost of its products to customers, creating mechanisms for better understanding the unique needs of individual customers, and transferring employees across J&J companies to enhance individual careers and help them identify with the corporation.

Figure 11.1: Corporate and Key Asset Governance



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The lower half of Figure 11.1 identifies the six key assets through which enterprises accomplish their strategies and generate business value. Senior executive teams create mechanisms to govern the management and use of each of these assets both independently and together. The key elements of each asset include the following:

- ***Human Assets:*** People, skills, career paths, training, reporting, mentoring, competencies, and so on.
- ***Financial Assets:*** Cash, investments, liabilities, cash flow, receivables, and so on.
- ***Physical Assets:*** Buildings, plant, equipment, maintenance, security, utilization, and so on.
- ***IP Assets:*** Intellectual Property (IP), including product, services, and process know-how formally patented, copy righted, or embedded in the enterprises people and systems.

- ***Information and IT Assets***: Digitized data, information, and knowledge about customers, processes performance, finances, information systems, and so on.
- ***Relationship Assets:*** Relationships within the enterprises as well as relationships, brand, and reputation with customers, suppliers, business units, regulators, competitors, channel partners, and so on.

Governance of the key assets occurs *via* a large number of organizational mechanisms. Some mechanisms are unique to a particular asset (for example, the IT architecture committee) and others cross and integrate multiple asset types ensuring synergies between key assets. Maturity across the governance of the six key assets varies significantly in most enterprises today with financial and physical assets typically the best governed and information assets among the worst.

At the bottom of figure 11.1 are the mechanisms used to govern each of the six key assets. It is contended that enterprises with common mechanisms across multiple assets perform better. For example, if the same executive committee governs both financial and IT assets, a firm can achieve better integration and create more value. Some mechanisms will always be unique to each asset the audit committee for financial assets and the IT architecture committee for example, but some common mechanisms lead to better coordination of the six assets.

As a sobering exercise, quickly jot down the list of mechanisms used in your enterprise to govern each of the six assets. Could you complete the lists? How many of the mechanisms were common across more than one asset more than two assets? Coordinating the six key assets of an enterprise is not easy. The average assessment of a group of forty-two CIOs on how well their enterprises integrated IT governance with the governance of the other key assets was less than three on a five point scale. Creating common governance mechanisms across the assets will not increase integration but the resulting smaller number of mechanisms will be simpler to communicate and implement. Education of the senior management team about how governance mechanisms combine to work for the enterprise is an essential and ongoing task for effective governance. We contend that many tangible benefits await better IT governance.

Self Assessment

Fill in the blanks:

1. Corporate governance includes the relationships among the many players involved and the ....
2. .... is used to monitor whether outcomes are in accordance with plans; and to motivate the organization to be more fully informed in order to maintain or alter organizational activity.
3. A McKinsey study found that .... are even prepared to pay large premiums for investments in firms with high governance standards.
4. .... are different in every enterprise.

11.2 Corporations as Social Entity

A corporation, though producing and distributing goods and services, is not just an economic and legal entity. No doubt, society is dependent upon corporations for the supply of goods and services but they cannot ignore the social consequences of their overall activities. In fact, a corporation, in addition to being an economic entity, is also a social entity. This fact is nowadays recognized beyond doubt and social implications of working of corporations are studied with keen interest. Every business corporation operates within a certain kind of social environment.

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No business corporations however humble, is purely a private or personal office of its promoters and/or its managerial personal; it has to function with a certain kind of social control imposed both from within and without.

No business corporation can be regarded as a purely profit making organization. The establishment of any business corporation is attended with not only legal and economic consequences but with many social consequences. Therefore, the corporate managers have to treat the corporations not only as important economic institutions but also as a major force for bringing about and managing social change.

11.3 Corporate Managers as Trustees

The corporate managerial personnel stand in a fiduciary relationship towards the corporation for which they are working. This relationship is based on the premise that they have a privilege to control the resources of the corporation. They have powers – both financial and non-financial. They are vested with discretionary powers in a number of situations. They are vested with discretion, in relation to management and superintendence of the corporation's affairs. They are not mere employees of the corporation. They can no longer conform themselves to the employee-employer relationship. They are not only employees but also agents and trustees for the corporation.

As an agent, a manager firstly, should not make use of the corporate opportunities for his personal gain. Secondly, he should carry out his duties with as much skills as possible.

A manager should also realize that he is a trustee for the corporation for which he is working. He is however, not a trustee in the strict sense of the term in as much as no ownership or property is vested in him in his capacity as a manager. Nevertheless, in certain respects, he is in the position of trustee for the corporation. Firstly, he is a trustee of resources, which come into his hands or which are actually under his control, he will be held liable to make good money. In the second place, a manager is in the position of a trustee for the corporation as regards the exercise of all powers which he is authorized to exercise, on behalf of the corporation. In the third place, a manager's position partakes of the fiduciary character of trusteeship, so that he is precluded from allowing the interest of the corporation to clash with his own interest.

11.4 Corporate Managers as Protectors of Interests

The fact that a manager occupies a fiduciary position in relation to his corporation raises a few more questions. Is a manager not in a position of trust in relation to consumers of the products of his corporation? Is he not in a position of trust in relation to the employees of the corporation? What is his position vis-à-vis suppliers, dealers competitors, etc? How does he stand in relationship to the community in which the corporation exists? These questions are a subject of considerable debate and the consensus is in favour of answering these questions in the affirmative. The managers owe responsibilities to employees, consumers and the community at large. As a corporation has social implications, it may be called a 'public' institution. In this sense, managers are public trustees. Therefore, the managers have to keep in mind all interests whether internal or external which are affected by the operations of the corporation.

Consequently, social consciousness and duty to the society must become an integral part of the norm of manager's responsibilities. All this carries the manager much beyond the scope of a mere commercial manager. He has to manage the corporation to include social good. The managers are the administrators of a community system and the wealth of the country is controlled by them. This gives the managers the economic power to affect the lives of the masses with every position of power, law implies certain responsibilities. Therefore, the managers

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have responsibilities to the various segments of the society. The responsibilities of the managers are co-extensive with the sphere of corporate influence. They owe a duty to the employees in the corporation in that their conditions of service are proper. They owe duty to the consumers in providing quantity goods and services at reasonable prices. They owe a duty to society, to keep the environment free of pollution. The managers have to accept these realities of life and fulfill the obligations to the various sections of the society.

Once the corporations are considered public institutions, their managers become public trustees. From the point of view of both the general public and the government, the standards of duties of managers have changed. New ethical standards have come up in which the interests of the various segments of the society are given due consideration.

11.5 Corporate Governance in the Indian Scenario

Many factors in the Indian socio-economic environment have added significance to the concept of corporate governance. Firstly, the Indian government is committed to remove poverty and bring about a socialist society in which private interest will be subordinated to the national considerations. The constitution of India provides for economic and social justice for all. Our country, being welfare state, has therefore, enacted many laws in order to make corporations feel responsible to the various segments of the society. Many amendments have been carried out in the recent past to the Companies Act, 1756, the Consumer Protection Act, 1986 and other laws which suggest a fresh look at the economic and social values implicit in the existing legal provisions.

One could safely hope and predict that the new concept of the company formally projected in the Indian Corporate Legislation will be the dominant factor in the shaping of corporate policy in the years ahead of us.

Secondly, the financial institutions and banks are contributing a great deal towards the financial needs of the corporate sector. The financial institutions and the banks require the borrowing corporations to conform to the declared social and economic policy of the government. This is ensured by nominating representatives on the Board of Directors of the borrowing companies.

Thirdly, the ethical aspect of business relates back to some of our ancient teaching, and is deeply enshrined in the thoughts and workings of some of our great national leaders. In the modern context, one has to refer to Mahatma Gandhi, who aimed at throughout his life, the promotion and development of the concept of trusteeship in almost every field-political, social, and economic. According to Gandhi, all life is trust and all power carries with it obligations.

Task Why do the financial institutions and banks require the borrowing corporations to conform to the declared social and economic policy of the government? Discuss.

Corporate governance may thus, be defined as a conscious effort by the corporate management to balance judiciously the interests of its different stakeholders. Some of the stakeholders are shareholders, employees, consumers, society, government, suppliers, creditors, etc.

In 1999, the Securities and Exchange Board of India (SEBI) appointed a committee to promote and raise the standards of corporate governance of India. It was headed by Mr. Kumara Mangalam Birla, and, as such the committee came to be known as Kumara Manglam Committee on corporate governance. The agenda of the committee was three-fold, i.e.,

1. (a) To suggest suitable amendments to the Listing Agreement executed by the stock exchanges with the companies

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(b) To suggest any other measures to improve the standard of corporate governance in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of non-executive directors.

2. To draft a code of Corporate Best Practices.

3. To suggest safeguards that be installed within the companies to deal with inside trading.

The committee identified three constituents which have a key role to play in improving the standard of corporate governance. These are the shareholders, the board of directors, and the managerial personnel of the company. The responsibilities of these constituents were identified to ensure effective corporate governance. Some of the recommendations of the committee are:

1. The Board of directors should have at least 50% non-executive directors. Further, the Board should have at least 1/3 of the members as independent directors where the chairman is non-executive, and at least 1/2 of the Board should be independent in case the chairman is an executive.

2. The Board should constitute (a) an 'Audit Committee'; and (b) a 'remuneration Committee' to determine remuneration package for executive directors.

3. The Board meetings should be held at least four times in a year, with a maximum gap of four months between any two meetings.

4. The corporate governance section of the Annual Report should make disclosures on remuneration paid to directors in all forms.

5. There should be a separate section on corporate governance in the Annual Report, with details on the levels of compliance by the company of the mandatory recommendations of the committee.

6. A separate section on compliance with the mandatory recommendations of clause 49 of the Listing Agreement should form part of the report and the details of non-compliance should be highlighted.

Self Assessment

State whether the following statements are true or false:

5. Society is dependent upon corporations for the supply of goods and services but they cannot ignore the social consequences of their overall activities.

6. Business corporations can be regarded as a purely profit making organization.

7. Social consciousness and duty to the society must become an integral part of the norm of manager's responsibilities.

8. The Indian government is committed to remove poverty and bring about a socialist society in which private interest will be subordinated to the national considerations.

9. The financial institutions and banks are not contributing a great part of the financial needs of the corporate sector.

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Case Study

Why Intervention is effective in Emerging Markets

On 2nd and 3rd December 2004, the BIS hosted a meeting of Deputy Governors of central banks from major emerging market economies to discuss foreign exchange market intervention. While few developed countries have actively intervened within the last decade, the outstanding exception being Japan, intervention has been commonplace in the emerging market community.

There are several reasons why developed countries no longer actively intervene. One is that research and experience suggest that the instrument is only effective (at least beyond the very short term) if seen as foreshadowing interest rate or other policy adjustments. Without a durable and independent impact on the nominal exchange rate, intervention is seen as having no lasting power to influence the real exchange rate and thus. competitive conditions for the tradable sector. A second reason is that large-scale intervention can undermine the stance of monetary policy. A third reason is that private financial markets have enough capacity to absorb and manage shocks - so that there is no need to "guide" the exchange rate.

Yet emerging market countries do intervene - presumably because they believe the instrument to be an effective tool in the circumstances and for the situations they face. The difference in view is brought home by the unprecedented scale of foreign exchange reserve accumulation by the emerging market group in recent years. Between the end of 2001 and the end of 2004, global foreign exchange reserves grew by over US$ 1600 billion, reflecting reserve accumulation by emerging market economies in Asia. Many observers from developed economies have publicly attributed the comparatively weak appreciation of Asian currencies against a rapidly depreciating US dollar to such intervention. Hence there does seem to be a common belief that intervention by emerging market economies has significantly altered the path of the real exchange rate for long enough to matter – even if such a view runs counter to received wisdom about intervention in the markets for major currencies.

This meeting threw some new light on these issues. Some flavour of the discussion can be gleaned from the central bank papers reproduced in this volume, along with overview papers prepared by BIS staff. Four central questions are outlined below; it will be clear that many important issues remain to be resolved.

Is intervention more effective in emerging markets?

The wide range of different objectives behind intervention in practice makes assessment difficult - especially empirical assessment that uses data from different episodes and different countries where policy objectives may vary. In flexible exchange rate cases, the objectives of intervention are particularly varied, a point which emerges clearly from the Moreno paper and the individual country papers in this volume. Reasons for intervention cited by central banks that do not target the exchange rate include: to slow the rate of change of the exchange rate; to dampen exchange rate volatility (in some cases to satisfy an inflation target); to supply liquidity to the forex market; or to influence the level of foreign reserves. The paper from South Africa provides an example of objectives that are both subsidiary to the main objective and conditional on prevailing circumstances (in this case, the process of reserve accumulation being used to help dampen volatility when that is convenient). Other country papers show that varying mixtures of objectives are quite commonplace.

Contd...

Notes

Many central banks would argue that their main aim is to limit exchange rate volatility rather than to meet a specific target for the level of the exchange rate. Yet others would counter that it is better to abstain from intervention in the foreign exchange market: such a stance would, they contend, make investors more aware of the need to hedge their own exposures, and this would help the market in hedging instruments to develop. The papers from Israel, Mexico, Poland and Thailand are particularly relevant in this regard. There is indeed some evidence that exchange rate volatility has fallen a lot in some countries where the central bank has not intervened in recent years. The papers from Korea and Peru highlight the existence of a policy trade-off where there are reasons to intervene to dampen volatility yet intervention may involve moral hazard with respect to market development.

The survey reported in Mihaljek's paper shows that many emerging market central banks view intervention as effective in influencing the exchange rate consistent with their objectives. Part of this may be attributable to cases in which fixed or targeted exchange rate regimes are in place: under such a regime, monetary policy actions are primarily dictated by what is needed to achieve and maintain the exchange rate target, intervention in the foreign exchange market is automatic or nearly so, and the exchange rate peg has proved reasonably durable. The papers from Hong Kong SAR and Saudi Arabia illustrate the point.

Formal econometric research has usually thrown doubt on the conclusion of effectiveness of intervention in flexible exchange rate cases although, as noted, such research often conflates interventions for different purposes. In addition, the effectiveness of intervention is likely to depend on the specific circumstances - studies of effectiveness on average do not answer the question of when intervention is likely to be successful.

Disyatat and Galati's paper surveys the available empirical evidence, and presents new evidence for the Czech koruna (the methodology requires detailed daily data on intervention and option prices, which were only available for the Czech Republic). The authors' new estimates tentatively suggest the existence of a cumulative effect from repeated intervention (although the mechanism is not clear). In the group of countries surveyed, there are several examples of repeated interventions over lengthy periods. In this connection, the paper from Venezuela makes the interesting point that intervention might have diminishing power with repetition.

It remains possible that greater apparent effectiveness of intervention in emerging market cases simply reflects different structural characteristics. Emerging market economies tend to have less substitutability of assets across currency boundaries, and the authorities tend to have greater financial - and certainly regulatory - weight relative to their private markets. Mihaljek's paper shows clearly that emerging market economies typically hold very large reserves compared with market turnover, even if interventions are not in general large relative to turnover. And several of the country papers describe the application of regulatory measures to obtain influence over the exchange rate.

Questions

1. What do you think intervention is effective for emerging market. (***Hint:*** Yes)
2. What is the effect of intervention on global economy. (***Hint:*** It provides more opportunities)

Source: BIS paper no 24

11.6 Summary

- A corporation, though producing and distributing goods and services, is not just an economic and legal entity.
- A manager should also realize that he is a trustee for the corporation for which he is working.
- As a corporation has social implications, it may be called a 'public' institution.
- The responsibilities of the managers are co-extensive with the sphere of corporate influence.
- The financial institutions and the banks require the borrowing corporations to conform to the declared social and economic policy of the government.
- Corporate governance may be defined as a conscious effort by the corporate management to balance judiciously the interests of its different stakeholders.
- A reasonable or rational purpose of governance might aim to assure, (sometimes on behalf of others) that an organization produces a worthwhile pattern of good results while avoiding an undesirable pattern of bad circumstances.

11.7 Keywords

Complaint: Any allegation in writing by a complainant with a view to obtaining any relief under the Act.

Consumer: Any person who buys any goods for consideration which has been paid or promised or partly paid and partly promised.

Corporate Governance: A conscious effort by the corporate management to balance judiciously the interests of its different stakeholders.

11.8 Review Questions

1. Explain the concept of corporate governance and its relevance in the present day corporate world.
2. What disclosures are required to be made under the provisions of clause 49 of the Listing Agreement?
3. What is the role of Audit Committee in relation to corporate governance?
4. Explain the different provisions of the Companies Act, 1956 concerning corporate governance.
5. "Corporate governance is an international business issue." Discuss.
6. "Corporate governance is used to monitor whether outcomes are in accordance with plans; and to motivate the organization to be more fully informed in order to maintain or alter organizational activity." Explain.
7. How corporate governance means to assist in decision making and to improve accountability? Explain.
8. Describe the features of good corporate governance.

9. "Society is dependent upon corporations for the supply of goods and services but they cannot ignore the social consequences of their overall activities." Explain.

10. "The managers are the administrators of a community system and the wealth of the country is controlled by corporate governance". Explain.

Answers: Self Assessment

1. corporate goals
2. Corporate governance
3. professional investors
4. Desirable behaviors
5. True
6. False
7. True
8. True
9. False

11.9 Further Readings

Books

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S S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.

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Unit 12: Company Meetings and Proceedings

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe provisions relating to statutory meetings;
- Explain provisions relating to annual general meetings;
- Explain extraordinary meeting;
- Describe voting and poll.

Notes

Introduction

A company is an artificial person and therefore, cannot act itself. It must act through some human intermediary. The various provisions of law empower shareholders to do certain things. They are specifically reserved for them to be done in company's general meetings. Section 291 empowers the Board of directors to manage the affairs of the company. In this context meetings of shareholders and of directors become necessary. The Act has made provisions for the following different types of meetings of shareholders: (i) Statutory Meeting; (ii) Annual General Meeting; (iii) Extraordinary General Meeting; and (iv) Class Meetings.

12.1 Statutory Meeting (S.165)

Some of the most important legal provisions regarding the statutory meetings are:

1. It is required to be held only by a public company having a share capital. A private company or a public company registered without share capital is under no obligation to hold such a meeting.

2. It must be held within a period of not less than one month and not more than six months from the date at which the company is entitled to commence business.

3. At least 21 days before the day of meeting, a notice of the meeting is to be sent to every member stating it to be a statutory meeting.

4. The Board of directors should also get a report, called the statutory report, sent to each member along with the notice of the meeting. If the statutory report is forwarded later, it shall be deemed to have been duly forwarded if it is so agreed to by all the members entitled to attend and vote at the meeting. A copy of the statutory report should also be sent to the Registrar after the same is sent to the members.

   The statutory report contains (a) the total number of shares allotted – fully paid-up and partly paid-up; allotted for cash and for consideration other than cash; (b) the total cash received by the company in respect of all allotments; (c) an abstract of receipts and payments up to a date within seven days of the date of the report and the balance of cash in hand; (d) any commission or discount paid on the issue of shares or debentures; (e) the names, addresses and occupations of directors, auditors, managers and the secretary of the company; (f) the extent to which any underwriting contract has not been carried out; (g) the arrears due on calls from every director; (h) the particulars of any commission or brokerage paid to any director or manager on the issue of shares and debentures.

   The statutory report is required to be certified as correct by at least two directors, one of whom shall be the managing director, where there is one. Also, the auditors of the company shall certify that part of the statutory report which relates to the shares allotted, cash received thereon and the receipts and payments and the balance of cash in hand.

5. The members present at the meeting may discuss any matter relating to the formation of the company or arising out of the statutory report without previous notice having been given.

6. The meeting may adjourn and the adjourned meeting has the same powers as the original meeting. The adjourned meeting, therefore, may do anything which could have been done by the original meeting.

7. If default is made in complying with the provisions of s.165, the following consequences may follow: (a) Every director or other officer of the company who is in default shall be punishable with fine up to ₹ 5,000. (b) The Registrar or a contributory may apply to the

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court for the winding up of the company [s.439]. However, the court may, instead of passing an order for winding up, give directions for the holding of the meeting for filing of the statutory report.

8. It should be remembered that this meeting is required to be held only once in the life time of a public company, having a share capital.

12.2 Annual General Meeting (AGM) (SS.166-168)

As the name signifies, this is an annual meeting of a company. The provisions relating to this meeting are:

1. Every company, whether public or private, having a share capital or not, limited or unlimited must hold this meeting.

2. The meeting must be held in each calendar year and not more than fifteen months shall elapse between two meetings. However, the first AGM may be held within eighteen months from the date of its incorporation and if such general meeting is held within that period, it need not hold any such meeting in the year of its incorporation or in the following year. The maximum gap between two such meetings may be extended by three months by taking permission of the Registrar, who may so allow for any special reason.

   The Company Law Department has expressed the view that the Registrar can grant extension of time, for special reasons, up to a maximum period of 3 months, even if such extension allows the company to hold its AGM beyond the calendar year. However, the said extension shall be granted only if the application therefor is made to the Registrar before the expiry of the period as per s.166 (1).

3. The meeting must be held (i) on a day which is not a public holiday, (ii) during business hours, (iii) at the registered office of the company or at some other place within the city, town or village in which the registered office is situated. [s.166(2)].

4. The business to be transacted at such a meeting may comprise of (s.173):

   (i) Ordinary business which relates to the following matters: (a) consideration of accounts, balance sheet and the reports of the Board of directors and auditors; (b) declaration of dividend; (c) appointment of directors in the place of those retiring; and (d) appointment of auditors and fixation of their remuneration.

   (ii) Any business other than ordinary business transacted at the meeting will be deemed to be special business. With regard to all special business, an Explanatory Statement is required to be annexed to the notice.

5. What about a situation where annual accounts are not ready for being placed before the AGM? In case annual accounts are not ready for laying at the appropriate AGM, it is open to the company concerned to adjourn the said AGM to a subsequent date when the annual accounts are expected to be ready for approval in the AGM. Since consideration of annual accounts is only one of the matters to be dealt with at an AGM, directors are under a statutory obligation to hold the meeting. The proper course shall be to hold the meeting and then adjourn it to a suitable date for considering the accounts. The adjourned meeting must, however, be held within the maximum time limit allowed under s.166.

6. The combined reading of Ss.166 and 210 requires compliance with the following: (a) There must be one meeting held in each calendar year. (b) Not more than 15 months must elapse between one general meeting and another. (c) The period of 15 months may be extended to 18 months by the Registrar. (d) Except in the case of the first AGM, the accounts must relate to a period beginning with the day immediately after the period for which they

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were submitted and ending with a day which must not precede the day of the meeting by more than 6 months; or 6 months and the extension granted by the Registrar, i.e., a maximum period of 9 months.

7. The company must give twenty-one days notice to all the members of the company and the auditor. A shorter notice may be held valid if consent is accorded to, by all the members entitled to vote at the meeting (s.171). Such a consent may be given before the meeting is held or after the resolutions are passed. A copy of Directors' report on the company's position for the year together with copy of the audited accounts and auditors' report must accompany the notice. Also a proxy form must be attached with the notice, on which it shall be specifically mentioned that a member entitled to vote is entitled to appoint proxy, and such proxy need not be a member of the company.

   The notice must specify the place and the day and hour of the meeting and shall contain a statement of the business to be transacted thereat [s.172(1)].

   If the time of holding the meeting and other essential particulars required by the section are not specified in the notice, the meeting will be invalid and all resolutions passed thereat will be of no effect.

   The notice must be given to every member, legal representative of a deceased member or assignee of an insolvent member and to auditor or auditors [s.172(2)].

8. If default is made in holding the meeting, the Central Government may, on the application of any member of the company, call or direct the calling of the meeting. If the company fails to hold the meeting either originally or when directed to do so by the Central Government, then the company and every officer of the company who is in default shall be punishable with fine up to ₹ 50,000; and in the case of a continuing default, with a further fine of ₹ 2500 per day during the continuance of default (s.168).

12.2.1 Certain Typical Issues in Respect of AGM

1. ***Whether AGM can be called on a Public Holiday***: Section 166(2), *inter alia*, provided that, every AGM shall be called on a day that is not a public holiday. The Department of Company Affairs has opined that, it is a mandatory provision.

   However, Bank holidays (for purposes of closing) though declared as public holidays under the Negotiable Instruments Act, 1881 shall not be treated as public holidays for the aforesaid purpose. Thus, 31st March and 30th Sept. shall not be considered as public holidays.

   In the following cases, however, AGM may be held on a public holiday: (i) Section 2(38) provides that, if any day is declared by the Central Government to be a public holiday after the issue of the notice convening such a meeting, it shall not be deemed to be a public holiday in relation to the meeting. (ii) Where a public company or its subsidiary has by its Articles fixed the time of its AGM and the day turns out to be a public holiday [Proviso (a) to s.166(2)]. (iii) Where a public company or its subsidiary has, by a resolution passed in one AGM fixed the time for its subsequent AGM and the day turns out to be a public holiday [Proviso (a) to s.166(2)]. (iv) A private company which is not a subsidiary of a public company may also [like a public company or its subsidiary under (ii) and (iii) above] by a resolution agreed to all the members thereof fix the time as well as the place of its AGM and the same shall be valid if the day happens to be a public holiday [Proviso (b) to s.166(2)]. (v) A company to whom a license is granted under s. 25 is exempted from the provisions of s.166(2). (vi) Where the AGM is adjourned because of lack of quorum, it is to be held on the same day in the next week at the same time and place (s.174). In case the day comes to be accidentally a public holiday, it shall not amount to contravention of s.166(2).

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2. ***Whether it is not obligatory to advertise notice of meetings in the newspapers:*** However, as an abundant precaution, the company may advertise in the newspapers to avoid objection from such of the shareholders as reside outside India and who incidentally may not receive the notices served through post.

3. ***Voting Rights of Members:*** It shall be determined as at the date of the meeting and not as they would have been if the meeting had been held within the prescribed time.

4. M***eeting Beyond Statutory Time:*** It cannot be said to be void or illegal. If the central government does not extend the date of holding the AGM u/s 167, the directors shall be subjected to increasing penalty but the meeting shall be a valid meeting. Otherwise, the position in law would become impossible.

5. ***Power to Cancel or Postpone:*** The Board of directors has the power to cancel or postpone a meeting convened, though it cannot be exercised except *for bona fide* and proper reasons.

Task A company served a notice of a general meeting to its members. The notice stated that a resolution to increase the share capital of the company would be considered at such meeting. A shareholder complains that the amount of the proposed increase was not specified in the notice. Is the notice valid?

Self Assessment

Fill in the blanks:

1. .... is required to be held only by a public company having a share capital.

2. In statutory meeting the Board of directors should also get a report, called the ....

3. The statutory report is required to be certified as correct by at least two directors, one of whom shall be the managing director, and other ....

4. .... meeting must be held in each calendar year and not more than fifteen months shall elapse between two meetings.

12.3 Extraordinary Meeting (EGM) (S.169)

Every general meeting (i.e. meeting of members of the company) other than the statutory meeting and the annual general meeting or any adjournment thereof, is an extraordinary general meeting. Such meeting is usually called by the Board of Directors for some urgent business which cannot wait to be decided till the next AGM. Every business transacted at such a meeting is special business. An explanatory statement of the special business must also accompany the notice calling the meeting. The notice should also give the nature and extent of the interest of the directors or manager in the special business, as also the extent of the shareholding interest in the company of every such person. In case approval of any document has to be done by the members at the meeting, the notice must also state that the document would be available for inspection at the Registered Office of the company during the specified dates and timings.

The Articles of Association of a Company may contain provisions for convening an extraordinary general meeting. E.g., it may provide that "the board may, whenever it thinks fit, call an extraordinary general meeting" or it may provide that "if at any time there are not within India, directors capable of acting who are sufficient in number to form a quorum, any director or any two members of the company may call an extraordinary general meeting".

Notes

12.3.1 Extraordinary General Meeting on Requisition

The members of a company have the right to require the calling of an extraordinary general meeting by the directors. The board of directors of a company must call an extraordinary general meeting if required to do so by the following number of members:

- Members of the company holding at the date of making the demand for an EGM not less than one-tenth of such of the voting rights in regard to the matter to be discussed at the meeting.
- If the company has no share capital, the members representing not less than one-tenth of the total voting rights at that date in regard to the said matter.

The requisition must state the objects of the meetings and must be signed by the requisitioning members. The requisition must be deposited at the company's registered office. When the requisition is deposited at the registered office of the company, the directors should within 21 days, move to call a meeting and the meeting should be actually be held within 45 days from the date of the lodgement of the requisition. If the directors fail to call and hold the meeting as aforesaid, the requisitionists or any of them meeting the requirements at (a) or (b) above, as the case may be, may themselves proceed to call meeting within 3 months from the date of the requisition, and claim the necessary expenses from the company. The company can make good this sum from the directors in default. At such an EGM, any business which is not covered by the agenda mentioned in the notice of the meeting cannot be voted upon.

Clause 47 of Table A (Schedule I) provides that, all general meetings other than AGMs shall be called the EGMs. The legal provisions as regards such meetings are:

1. EGM is convened for transacting some special or urgent business that may arise in between two AGMs, for instance, change in the objects or shift of registered office or alteration of capital. All business transacted at such meetings is called special business. Therefore, every item on the agenda must be accompanied by an 'Explanatory Statement'.
2. An EGM may be called: (i) by the directors on their own accord; (ii) by the directors on requisition; (iii) by the requisitionists themselves; (iv) by the Company Law Board. The board of directors may call a general meeting of the members at any time by giving not less than 21 days notice. A shorter notice may, however, be held valid if consent is accorded thereto by members of the company holding 95% or more of the voting rights (s.171). The board of directors must convene a general meeting upon request or requisition if the following conditions are satisfied (s.169):

   The requisitionists must be such number of members who, at the date of the deposit of the requisition, are the holders of 1/10th of total voting power. Thus, in case of a company having a share-capital they should hold at least 1/10th of such of the paid-up capital that carries right to vote in regard to that matter. Preference shareholders have voting power only as regards matters relating to the preference shareholders. They have no voting right and therefore, no right to requisition in respect of other matters. If the company does not have a share capital, they should at least hold 1/10th of the total voting power of the company in regard to that matter. The requisition must state the objects of the meeting, i.e., it must set out the matters for the consideration of which the meeting is to be called. Further, requisition must have been deposited at the registered office of the company. The requisition must be signed by the requisitionists. In case all the aforesaid conditions are satisfied, the board of directors must within 21 days of the receipt of the requisition call the meeting giving at least 21 days notice fixing the meeting within 45 days of the receipt of the requisition.

Where the resolution proposed is a special resolution then the requirements of s.189(2) must be complied with, viz., it should be so described and explanatory statement be annexed.

If the board of directors does not/fails to call the meeting as aforesaid (i.e., at least 21 days notice fixing the date of the meeting within 45 days of the deposit of a valid requisition), the meeting may be called by the requisitionists themselves: (a) In case of a company having share capital, by one or more requisitionists as represent: (i) a majority in value of the paid-up share capital held by all the requisitionists; or (ii) at least 1/10th of the paid-up share capital carrying voting rights in respect of that matter, whichever is less; or (b) in case of a company not having a share capital, by one or more requisitionists who represent at least 1/10th of the total voting power of the company in regard to the matter of the requisition.

Where the Articles, in accordance with the provisions of s.180, provide that members who have not paid calls on their shares would not be entitled to vote, then they cannot requisition a meeting, nor vote at it and if they do so, the proceedings would be invalid.

The requisitioned meeting must be held within 3 months of the date of the deposit of the requisition. Further, where two or more persons hold any shares or interest in a company jointly, a requisition, or a notice calling a meeting, signed by one or only some of them shall, for the purposes of this section, have the same force and effect as if it had been signed by all of them.

Any reasonable expenses incurred by the requisitionists, as aforesaid, shall be repaid to them by the company and the same shall be recouped from directors at fault.

A meeting by the requisitionists must be held in the same manner as nearly as possible, in which the meetings are to be called by the board of directors. However, where the registered office is not made available to them for holding the meeting, they may hold the meeting elsewhere [R. Chettair vs. M. Chettair (1951) 21 Comp. Cas. 93].

Powers of the Company Law Board (s.186).

If for any reason it is impracticable to call a meeting of the company, other than an AGM, the Company Law Board may direct the calling of the meeting: (a) on its own motion; (b) on an application of any director; (c) on an application of any member entitled to vote at that meeting.

For the aforesaid meeting, the Company Law Board may give directions in respect of the place, date and the manner in which the meeting be held and conducted. It may also give such ancillary or consequential directions as it thinks expedient, including a direction that one member present in person or proxy shall be deemed to constitute a meeting.

Example: Superclean Industries Pvt. Ltd. is a company in which there are three shareholders and all of them are directors of the company. Mr. Superman holds 60 percent of the paid up share capital while the balance 40 percent of shares is held equally by the remaining two directors. Because of some rift among them, the two directors holding 40 percent share capital have aligned and started preventing the holding of any meetings of the company. The articles of the company provide for a minimum of two directors/members as quorum for board meetings as well as general meetings.

Mr. Superman is a majority shareholder, but he is helpless, as no meeting can be held because of no quorum. He would apply to CLB under s. 186 for convening of the general meeting. The CLB, if satisfied, will order a meeting to be held with the presence of one member as sufficient quorum. Mr. Superman, being the majority shareholder is entitled to exercise his statutory right to participate in the decision-making process, which cannot be frustrated by the quorum requirement. [Opera Photography Ltd. Re, 1989 B CLC 763 CLD]

Notes

Self Assessment

5. Which of the following are included in the 'Statutory Books' for the purpose of company audit?

   (i) Register of charges

   (ii) Minutes Books for the Board meetings

   (iii) Articles of Association

   (iv) Minutes Book for the shareholder's meeting

   (v) Register of members

   (vi) Memorandum of Association

   Select the correct answer using the codes given below:

   Codes

   (a) (i), (ii), (iv) and (v) (b) (ii), (iii), (iv) and (vi)

   (c) (i), (iii), (v) and (vi) (d) (ii), (iii), (v) and (vi)

6. Consider the following statements: A statutory auditor of a public limited company claims that he has the following legal rights in relation to his duties:

   (i) Right to refuse to make a report

   (ii) Right of access to books of accounts and registers

   (iii) Right to seek explanation from directors and officers

   (iv) Right to make statement in the general meeting.

   Of the above statements:

   (a) (i), (ii) and (iii) are correct (b) (i), (ii) and (iv) are correct

   (c) (i), (iii) and (iv) are correct (d) (ii), (iii) and (iv) are correct

12.4 General Meeting for Shareholders

When it is proposed to alter, vary or affect the rights of a particular class of shareholders (e.g., where accumulated dividends on cumulative preference shares are to be cancelled) and it is not possible to obtain the consent in writing, of the holders of 3/4th of the issued shares of that class, a meeting of the holders of those shares may be called. Such a meeting is commonly known as a 'class meeting'. It should be noted that all resolutions in a class meeting must be passed as special resolutions.

The holders of at least 10% of the issued shares of that class who did not consent in favour of the resolution may apply to the court within 21 days to have the resolution cancelled and where such application is made, the resolution shall not have effect unless and until it is confirmed by the court.

Task A meeting was properly convened and was subsequently adjourned by the chairman. No fresh notice is given for the adjourned meeting which is held subsequently. State whether the adjourned meeting is valid. [***Hint:*** The adjourned meeting in question is valid as per s.174.]

12.5 Requisites of a Valid Meeting

12.5.1 Notice of Meeting

Every member of the company is entitled to a notice of every general meeting. A notice of not less than 21 days must be given in writing to every member. However, a shorter notice for AGM will be valid if all members entitled to vote give their consent. In case of other meetings, a shorter notice will be valid if consent is given by members holding at least 95% of the paid-up capital carrying voting rights, or representing at least 95% of the voting power.

The notice may be given to members either personally, or sending by post to him at his registered address. A notice of a meeting may also be given by advertising the same in a newspaper circulating in the neighbourhood of the registered office of the company.

The secretary should see that proper notice of meeting must be given to all persons who are entitled to receive it. An improper or insufficient notice, as well as absence of notice, may affect the validity of a meeting and render the resolutions passed at the meeting ineffective. Also the notice should make a full and frank disclosure to the members of the fact on which they would be expected to vote.

12.5.2 Agenda of the Meeting

The word 'agenda' indicates the business to be transacted at a meeting. It is prepared for all kinds of meetings in order that the meeting may be conducted systematically. The agenda is generally prepared by the secretary in consultation with the chairman. It is drafted in such a manner as to help the chairman to conduct the meeting smoothly. In drafting the agenda, the secretary should bear in mind the following: (i) the agenda should be clear and explicit; (ii) it should be drafted in a summary manner; (iii) all items of routine business should be put down first and the contentious matters later; and (iv) all items of similar nature should be placed in a continuous order.

The foregoing points are important because when a copy of the agenda is sent to a member, he is in a position to form a definite opinion of the subject matter to be discussed at the meeting. While preparing the agenda, care should be taken for the order of the matters to be discussed, as the order of the agenda cannot be altered except with consent of the meeting. Sometimes, the agenda is drafted in such a manner that it can serve the purpose of minutes later on. Some space is left opposite each agenda item and the secretary writes it up during the meeting; this practice is very common in the preparation of agenda for Board meetings.

Sometimes, companies maintain an Agenda Book, wherein the agenda items are entered. It is placed before the chairman of the meeting and is regarded as the agenda. Those placed before the members or other directors are copies only. Later, the agenda book becomes a permanent record for future reference.

12.5.3 Proxy

In the case of a company, every member of the company entitled to attend and vote at a meeting has the right to appoint another person, whether a member or not, to attend and vote for him. The term 'proxy' is applied to the person so appointed. Also, it refers to the instrument by which a member of a company appoints another person to attend the meeting and vote on his behalf. However, the proper term for this document is 'proxy form' or 'proxy paper'. The following points about proxies are to be noted: (i) A proxy has no right to speak at the meeting. (ii) A proxy

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need not be a member of the company. (iii) The instrument appointing a proxy must be in writing and signed by the appointor. (iv) The proxy form must bear the date of the meeting. (v) No company can make it compulsory for anyone to lodge proxies earlier than 48 hours before the meeting. (vi) A proxy may be revoked before the person appointed has voted. (vii) A proxy can demand a poll. (viii) A proxy cannot vote against the wishes of his appointor.

Secretarial work as regards proxies

(a) Scrutinise the proxy forms to see whether they comply with the provisions of the Act, and the bye-laws and rules of the company. (b) Any proxies received after the stipulated time limit must be returned with a note that they cannot be accepted. (c) Any irregularities in proxy forms should be reported to chairman of the meeting, as he is the final authority to accept or reject them. (d) Each correct proxy form is countersigned by the secretary. (e) Enter the correct proxy forms in the register of proxies. (f) Return the proxy form to the member together with an admission card in the name of the proxy.

12.5.4 Voting and Poll

Unanimity on all matters before a meeting is always not obtained. In the absence of unanimity, the chairman wants to know the wishes of the persons present therein. This is known as ascertaining the sense of the house and for this purpose; he has to put the matter before the house to the members. There are various methods which can be adopted by the chairman to put the matter to vote in order to ascertain the wishes of the members.

In the case of a company, the Act prescribes two methods to ascertain the wishes of the members. These are:

(i) ***By Show of Hands:*** Under this method, the chairman asks all those in favour of the resolution to raise their right hand and when that number is noted, asks all those against to do likewise. The chairman then declares the result of the voting indicating whether the proposal has been carried or lost.

(ii) ***By Poll:*** In company meetings, voting by poll is according to the number of shares held by a member. Under this method, every person present records his vote on a ballot paper and deposits it in the ballot box provided for that purpose. The counting of ballots cast for and against the motion reveals the results. This method ensures secrecy in casting votes. The voting by show of hands may not always reflect the opinion of members upon a value basis. Also, there may be a number of proxies who can vote only by poll and not by show of hands.

Rules in respect of voting

As per the provisions of the Act, rules regarding voting may be noted as follows:

1. Every holder of equity shares shall have a right to vote [s. 87(1)].

2. Right of an equity shareholder to vote cannot be prohibited on the ground that, he has not held his shares for any specified period before the meeting or on any other ground (s.182). In Ananthalakshmi vs. H. I. & F. Trust, AIR 1951 Mad. 927, a provision in the Articles of a company that only those shareholders would be entitled to vote whose names have been there on the register for two months before the date of the meeting was held to be in contravention of the Act.

   The only ground on which the right to vote may be excluded is non-payment of calls by a member or other sums due against a member or where the company has exercised the right of lien on his shares (s.181).

3. A preference shareholder shall have the right to vote only on resolutions which directly affect the rights attached to his preference shares [s.87(2)].

   Where the directors proposed to increase the shares of the company (i) by issue of further equity shares, or (ii) by capitalising an amount standing to the credit of the company's reserve account and applying the same in paying-up the new equity shares and distributing the same as fully paid among the equity shareholders, the proposed resolution was held to affect the rights of the preference shareholders and could, therefore, be only carried out with their sanction [Re John Smith's Tadcaster Brewery Co. Ltd. (1952) 2 All ER 751].

4. Voting rights of a member are not affected by the fact that his shares have been attached or pledged or a receiver has been appointed [Balkrishnan Gupta vs. Swadeshi Polytex Ltd. (1985) 58 Comp Cas. 563].

5. Voting by show of hands in the first instance. Section 177 provides that, at any general meeting, a resolution put to vote shall, unless a poll is demanded under s.179, be decided on a show of hands. A declaration by the chairman that on a show of hands, a resolution has or has not been carried either unanimously or by a particular majority and an entry to that effect in the minutes book of the company, shall be conclusive evidence of the fact. No proof of the number or proportion of the votes cast in favour of or against such resolution shall be required (s.178).

Demand for Poll

Section 179 provides that before or on declaration of the result of the voting on any resolution on a show of hands, a poll may be ordered to be taken by the Chairman of the meeting of his own motion and shall be ordered to be taken by him on a demand made in that behalf by the person or persons specified below:

(a) In the case of a public company having a share capital, by any member or members present in person or by proxy and holding shares in the company: (i) which confer a power to vote on the resolution not being less than 1/10th of the total voting power in respect of the resolution; or (ii) on which an aggregate sum of not less than fifty thousand rupees has been paid-up;

(b) In the case of a private company having a share capital, by one member, present in person or by proxy if not more than seven members are personally present and by two members present in person or by proxy, if more than seven members are personally present;

(c) In the case of any other company, by any member or members present in person or by proxy and having not less than 1/10th of the total voting power in respect of the resolution.

The chairman of the meeting may regulate the manner in which the poll should be taken. He must appoint two scrutinisers to scrutinise the votes given on the poll and to report thereon to him. Then the chairman will declare the result.

Voting by companies, and Government as members (Ss.187-187-A). Where a company or a corporation is a member of another company, it may attend the meetings of the other company through a representative. The representative must be appointed by a resolution of the Board of directors or the other governing body. Where the Central Government or a State Government is a member, the President or the Governor of the State, as the case may be, has the power to appoint representatives to attend meetings of the company. The person nominated shall hold the position of a proxy.

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Self Assessment

7. Can a Company hold an AGM on public holiday?

   (a) Yes (b) No

   (c) (a) and (b) both are correct (d) None

8. Audit of a public company will be counted for the limit of audits

   (a) Yes (b) No

9. Statutory meeting must be held in case of a public company

   (a) Yes (b) No

10. Statutory meeting must be held in case of a private company

    (a) Yes (b) No

12.6 Resolutions

Decisions of a company are taken by resolution of its members, passed at their meetings. Also, the Board of directors takes certain decisions at its meeting by passing certain resolutions after due deliberations.

The term 'motion' indicates a proposition made at a meeting by any member. Such a motion may be passed without any change or modification. But if some members feel that the motion in the form proposed needs some change or modification, they may move an amendment. A motion when passed with or without amendment is called a resolution.

A motion should always be in writing and before it is brought before the meeting, the necessary notice must be given. A person proposing a motion is called the mover and the motion should be signed by him.

Once the motion has been put to the members and they have voted in favour of it, it becomes a resolution. In the case of a company, there are three kinds of resolutions:

1. Ordinary resolution;
2. Special resolution;
3. Resolution requiring special notice.

Task One general meeting was called by a company in December, 2004. This meeting was adjourned to March, 2005 and then held. Subsequent meeting was held in February; 2006. Is the company liable for any irregularity?

12.6.1 Ordinary Resolution [s.189(1)]

When a motion is passed by a simple majority of the members voting at a general meeting, it is said to have been passed by an ordinary resolution. In other words, votes in favour of the resolution are more than 50%. Still in other words, a resolution shall be an ordinary resolution where the votes cast in favour of the resolution are more than the votes cast against the resolution. According to s.189(1), "A resolution shall be an ordinary resolution when at a general meeting of which the notice required under the Act has been duly given, the votes cast (whether on show

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of hands, or on poll, as the case may be), in favour of the resolution (including the casting vote, if any, of the chairman) by members who, being entitled to do so, vote in person or where proxies are allowed, by proxy, exceed the votes, if any, cast against the resolution by members so entitled and voting."

All matters which are not required either by the Act or the company's Articles to be done by a special resolution can be done by means of an ordinary resolution. Some of the cases in which only ordinary resolution is required are: alteration of authorised capital, declaration of dividend, appointment of auditors, election of directors.

12.6.2 Special Resolution [s.189 (2)]

A resolution is a special resolution in regard to which: (a) the intention to propose the resolution as a special resolution has been specifically mentioned in the notice calling the general meeting; (b) 21 days notice has been duly given for calling the meeting; (c) the number of votes cast in favour of the resolution is three times the number cast against it.

Some of the cases in which a special resolution is necessary: alteration of objects clause; change of registered office from one State to another; alteration of the Articles; changes in the name of the company; reduction of share capital.

12.6.3 Resolution Requiring Special Notice (s.190)

Some resolutions require special notice. The object of special notice is to give the members sufficient time to consider the proposed resolution and also to give the Board of directors an opportunity to indicate views, on the resolution if it is not proposed by them but by some other shareholders. Under this, a notice of intention to move the resolution should be given to the company not less than 14 days before the date of the meeting at which it is proposed to be moved. The company in turn must immediately give notice by advertisement in a newspaper or in any other mode allowed by the Articles, but not less than seven days before the meeting. Some of the cases in which a special notice is necessary are: appointing an auditor, a person other than a retiring auditor; moving a resolution that a retiring auditor will not be re-appointed; removing a director before his term expires.

Section 192 requires that a printed or a type written copy of each special resolution should be sent to the registrar within 30 days of passing thereof.

12.6.4 Passing of Resolutions by Postal Ballot (s.192A)

Section 192A contains the following provisions for passing of resolution by postal ballot:

(i) A listed company may and in the case of resolution relating to such business as the Central Government may, by notification, declare to be conducted only by postal ballot, shall, get any resolution passed by means of a postal ballot, instead of transacting the business in general meeting of the company.

(ii) Where a company decides to pass any resolution by resorting to postal ballot, it shall send a notice to all the shareholders, along with a draft resolution explaining the reasons therefor, and requesting them to send their assent or dissent in writing on a postal ballot within a period of 30 days from the date of posting of the letter.

(iii) The notice shall be sent by registered post acknowledgement due, or by any other method as may be prescribed by the Central Government in this behalf and shall include with the notice, a postage pre-paid envelope for facilitating the communication of the assent or dissent of the shareholder to the resolution within the said period.

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(iv) If a resolution is assented to by a requisite majority of the shareholders by means of postal ballot, it shall be deemed to have been duly passed at a general meeting convened in that behalf.

(v) If a shareholder sends under (ii) above his assent or dissent in writing on a postal ballot and thereafter any person fraudulently defaces or destroys the ballot paper or declaration of identity of the shareholder, such person shall be punishable with imprisonment for a term which may extend to 6 months or with fine or with both.

(vi) If a default is made in complying with provisions in (i) to (iv), the company and every officer of the company, who is in default shall be punishable with fine which may extend to ₹ 50,000 in respect of each such default.

12.6.5 Circulation of Members' Resolution (s.188)

When some members of a company want (i) to propose a resolution at the company's next AGM; or (ii) desire to circulate to members any statement with respect to the matter referred to in any proposed resolution or any business to be dealt with at any general meeting, the Act allows them to use the administrative machinery of the company for the purpose.

If the requisite number of members make a requisition as aforesaid, the company shall be bound to: (i) give a notice of the resolution intended to be moved at the next AGM; (ii) circulate the statement among the members entitled to notice of any general meeting. However, before the obligation of the company in respect of the above may arise, the following conditions shall have to be satisfied:

- The requisition must have been signed by at least: (a) members having 1/20th of the total voting rights of all the members having the right to vote on the resolution; or (b) members, numbering 100 (having the right to vote at the resolution) and commanding a paid-up share capital of ₹ 1 lakh or more.
- The requisition must have been deposited at the registered office of the company: (a) at least 6 weeks before the meeting in case of a requisition requiring notice of a resolution; and (b) at least 2 weeks before the meeting in case of any other requisition.
- The statement to be circulated should not contain more than 1000 words.
- The requisitionists must have deposited with the company a sum reasonably sufficient to meet the expense of the requisition.

Self Assessment

State whether the following statements are true or false:

11. Every Public Limited Company having a share capital must hold a statutory meeting.
12. A company required to hold a statutory meeting must hold the meeting within one month of obtaining the certificate to commence business.
13. The first AGM of a company must be held within 18 months of the date of incorporation.
14. If a company fails to call or hold an AGM within the prescribed time, the central government may direct the calling and holding of the meeting on a petition of any member.
15. The statutory report is required to be certified as correct by at least two directors, one of whom shall be the managing director, if any.

Notes

Case Study

Winding up Company

Salomon carried on business as a leather merchant. He sold his business for a sum of £ 30,000 to a company formed by him along with his wife, a daughter and four sons. The purchase consideration was satisfied by allotment of 20,000 shares of £ 1 each and issue of debentures worth £ 10,000 secured by floating charge on the company's assets in favour of Mr. Salomon. All the other shareholders subscribed for one share of £ 1 each. Mr. Salomon was also the managing director of the company. The company almost immediately ran into difficulties and eventually became insolvent and winding up commenced. At the time of winding up, the total assets of the company amounted to £ 6,050; its liabilities were £ 10,000 secured by the debentures issued to Mr. Salomon and £ 8,000 owing to unsecured trade creditors.

The unsecured sundry creditors claimed the whole of the company's assets, viz. £ 6,050 on the ground that the company was a mere alias or agent for Salomon.

Question

Do you agree to the claims of the unsecured trade creditors? Comment. (***Hint:*** Yes Please follow the case).

12.7 Summary

- The Board of directors should also get a report, called the statutory report, sent to each member along with the notice of the meeting.
- The statutory report is required to be certified as correct by at least two directors, one of whom shall be the managing director, where there is one.
- The meeting may adjourn and the adjourned meeting has the same powers as the original meeting.
- The Company Law Department has expressed the view that the Registrar can grant extension of time, for special reasons, up to a maximum period of 3 months, even if such extension allows the company to hold its AGM beyond the calendar year.
- Whether AGM can be called on a public holiday. Section 166(2), *inter alia*, provided that, every AGM shall be called on a day that is not a public holiday.
- EGM is convened for transacting some special or urgent business that may arise in between two AGMs, for instance, change in the objects or shift of registered office or alteration of capital.

12.8 Keywords

Agenda: The word 'agenda' indicates the business to be transacted at a meeting.

Motion: The term 'motion' indicates a proposition made at a meeting by any member. Such a motion may be passed without any change or modification.

Proxies: In the case of a company, every member of the company entitled to attend and vote at a meeting has the right to appoint another person, whether a member or not, to attend and vote for him.

Notes

Statutory Report: The Board of directors should also get a report, called the statutory report, sent to each member along with the notice of the meeting.

12.9 Review Questions

1. What are the different kinds of general meetings of a company?
2. Define statutory meeting of a public company.
3. Give the contents of a statutory report.
4. Summarise the provisions as regards Annual General Meeting.
5. What are the provisions of the Companies Act, 1956 in respect of an Extraordinary General Meeting to be held on requisition?
6. Define Extraordinary General Meeting.
7. Write a short note on the powers of Company Law Board to call meetings.
8. Discuss the requisites of a valid meeting.
9. Discuss the provisions of the Companies Act, 1956 relating to resolution requiring special notice mentioning the matter for which special notice is required.
10. Explain the procedure for ascertaining the sense of general meeting of a company.
11. Write short notes on:
    (a) Notice of a meeting
    (b) Proxy
    (c) Voting by poll
    (d) Resolutions

Answers: Self Assessment

1.	statutory meeting	2.	statutory report
3.	the auditors of the company	4.	AGM
5.	(b)	6.	(d)
7.	(b)	8.	(a)
9.	(a)	10.	(b)
11.	True	12.	False
13.	True	14.	True
15.	True		

12.10 Further Readings

Notes

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Notes

Unit 13: Borrowing and Debentures

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain investment;
- Define borrowing;
- Describe *ultra vires* borrowing;
- Elaborate upon provisions for prevention of oppression and mismanagement.

Introduction

A condition requiring or binding an applicant for shares in or debentures of a company to waive compliance with any of the requirements of this section (S.56), or purporting to affect him with notice of any contract, document or matter not specifically referred to in the prospectus, shall be void.

No one shall issue any form of application for shares in or debentures of a company, unless the form is accompanied by memorandum containing such salient features or a prospectus as may be prescribed which complies with the requirements in connection with a *bona fide* invitation to a person to enter into an underwriting agreement with respect to the shares or debentures; or in relation to shares or debentures which were not offered to the public. If any person acts in contravention of the provisions of this sub-section, he shall be punishable with fine which may extend to five thousand rupees.

13.1 Investments

13.1.1 Meaning of Investment

The Act does not define the term 'investment' though it uses the same in a number of sections which are discussed below. In common parlance, it includes any property or right in which money is put. However, the word 'investment' in the following sections is confined to the act of a company in buying securities, viz., shares and debentures of another company.

13.1.2 Investments to be in Company's Own Name (s.49)

All investments made by a company on its own behalf shall be made and held by it in its own name. There are, however, certain exceptions to this rule. These exceptions are as follows:

1. If any other law, for the time being in force, permits, the investments of the company may be made and held by it in any other name.
2. Where the company has a right to appoint any person or persons as a director or directors of any other body corporate, shares in such other body corporate, up to an amount not exceeding the nominal value of the qualification shares, may be registered or held by the body corporate jointly in the names of the company itself and of each such person or nominee or in the name of each such director.
3. A company may hold any shares in its subsidiary in the name or names of any nominee or nominees of the company to ensure that the number of members of any subsidiary is not reduced, where it is a public company, below seven and where it is a private company, below two.
4. If the investments are made by a company, whose principal business consists of the buying and selling of shares or securities, the company may hold its investments in any other name. Securities include stock and debentures.
5. A company may deposit with a bank, being the bankers of the company, any shares or securities for the collection of any dividend or interest payable thereon.
6. A company may deposit, or transfer to, or hold in the name of, the State Bank of India or a Scheduled Bank, being the bankers of the company, shares or securities, in order to facilitate the transfer thereof. The company can do so only for a period of 6 months. If the transfer of such shares or securities does not take place within 6 months, the company shall, as soon as practicable after the expiry of that period of 6 months, have the shares or securities re-transferred to it from the State Bank of India or the Scheduled Bank or, as the case may be, and again hold the shares or securities in its own name.
7. A company may deposit with, or transfer to, any person any shares or securities, by way of security for the repayment of any loan advanced to the company for the performance of any obligation undertaken by it.

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The certificate or letter of allotment relating to the shares or securities in which investments have been made by a company shall, except in cases (4) to (7) referred to above, be in the custody of the company or with the State Bank of India, or a Scheduled Bank, being the bankers of the company.

13.1.3 Register of Investments not Held in the Company's Own Name

Where any shares or securities in which investments have been made by a company are not held by it in its own name, the company shall enter in a register maintained by it for the purpose: (a) the nature, value and such other particulars as may be necessary fully to identify the shares or securities in question; and (b) the bank or person in whose name or custody the shares or securities are held. The register shall be open to the inspection of any member or debenture holder of the company. If any inspection of the register is refused, the Central Government may, by order, direct an immediate inspection of the register.

If default is made in complying with s.49, the company and every officer of the company who is in default, shall be punishable with fine which may extend to ₹ 50,000.

Self Assessment

Fill in the blanks:

1. .... includes any property or right in which money is put.
2. All investments made by a company on its own behalf shall be made and held by it in its ....
3. A company may deposit, or transfer to, or hold in the name of, the State Bank of India or a Scheduled Bank, being the bankers of the company, ..., in order to facilitate the transfer thereof.
4. Securities include .... and debentures.

13.2 Borrowing

13.2.1 Power of a Company to Borrow

Every trading company has an implied power to borrow but it is wise to include an express power to borrow in the objects clause of the Memorandum. Non-trading companies, however, must be expressly authorised to borrow by their Memorandum.

A power to borrow, whether express or implied, includes the power to charge the assets of the company by way of security to the lender.

The Companies Act does not expressly empower companies to borrow money. Therefore, most of the companies expressly provide for such borrowing powers in the Memorandum. In such cases, where Memorandum authorises the company to borrow, the Articles provide as to how and by whom these powers shall be exercised. It may also fix up the maximum amount which can be borrowed by the company.

Exercise of Borrowing Powers

A public company cannot exercise its borrowing powers until it secures the certificate to commence business [s.149 (1)]. A private company may, however, exercise the borrowing powers immediately after its incorporation.

The power to borrow money is generally exercised by the directors but Articles normally provide for certain restrictions on their power to borrow. Section 293 also limits the directors' power to borrow, to the aggregate of the paid-up capital of the company and its free reserves apart from temporary loans obtained from the company's bankers in the ordinary course of business.

Task The loan of the Debenture-holders was secured by a floating charge on the assets of the company. The company had the power to sell the whole of its undertaking as per a clause in its Memorandum. The company sold the undertaking. The Debenture-holders insisted that their floating charge had been crystallised by the act of the sale of the undertaking. Is their contention correct? [***Hint:*** The contention of Debenture-holders is not correct as none of the conditions for the conversion of the floating charge into a fixed charge has been satisfied].

13.2.2 Ultra Vires Borrowing

Borrowing by a company shall be deemed to be *ultra vires* where the company borrows in spite of no power to borrow, or borrows beyond the limit fixed by the Memorandum or Articles. Any such loan to the company is null and void and does not create an actionable debt. However, the following remedies shall be available to such a lender:

1. ***Injunction and Recovery:*** If the money, assets, property, etc., purchased with such money is identifiable and are still in the possession of the company, the lender can obtain an injunction to restrain the company from parting with them and seek a tracing order to trace and recover them.

2. ***Subrogation:*** If the borrowed money was applied in payment of lawful creditors of the company, the lender can subrogate to the rights of those creditors, i.e., he will step into the shoes of the old creditors for the purpose of recovering his money [Sinclair vs. Brougham (1914) A.C. 398]. However, he shall not have any priority over other creditors even if the debts paid off had priority [Re. Wirexhan Mold & Cohmah's Quau Rly. (1899) 1Ch. 440].

3. ***Suit against the Directors:*** The lender may claim damages from the directors and sue them personally for a breach of warranty of authority [Firbank's Executors vs. Humphreys (1866) 18 O.B.D.64]. But if the fact that, the company has no powers to borrow was apparent upon reference to the company's Memorandum or Articles, the lender shall not be entitled to claim damages from directors upon this ground as he was not misled because he is deemed to have knowledge of these public documents [Ranshdall vs. Ford (1866) E.R.Q. Fq Cas. 750].

13.2.3 Borrowing Intra Vires the Company but Ultra Vires the Directors

If the borrowing is in excess merely of the power of directors but not of the company, e.g., where the Articles provide that the directors shall have power to borrow only up to ₹ 2,00,000 and, for borrowing beyond this amount prior approval of the shareholders in general body meeting must be obtained, any borrowing beyond ₹ 2,00,000 without shareholders' approval (i.e., *ultra vires* the directors) can be ratified and rendered valid by the company. If ratified, the loan shall become perfectly valid and binding upon the company. However, even where the company refuses to ratify the directors' act, the 'Doctrine of Indoor Management' shall protect a lender provided he can establish that he advanced the money in good faith. The company may in turn proceed against the directors and claim indemnity.

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13.2.4 Other Restrictions on the Borrowing Powers of the Board

The Board can exercise the following powers, *inter alia*, only by means of resolutions passed at Board meeting and not by the circulation of resolution: (i) the power to issue debentures; (ii) the power to borrow money otherwise, than on debentures. The Board may, however, by a resolution passed at a meeting, delegate the power in (iii) above, to any committee of directors, the managing director, the manager or any other principal officer of the company, mentioning therein the limit up to which amount can be borrowed by the delegate. Also, the Act empowers the company in general meeting to impose restrictions and conditions on the powers of the Board to issue debentures and borrow money.

13.2.5 Procedure for Delegating Powers to Borrow Money otherwise than on Debentures

Section 292 empowers the Board to borrow money on behalf of the company by means of resolution passed at the meeting of the Board. However,

1. Section 292 (1) permits the Board to delegate, by means of a resolution passed at a meeting, to a committee of directors, the manager or any other principal officer of the company, the power to borrow money otherwise than on debentures.
2. Section 292 (2) further provides that, every resolution delegating the power referred to above, relating to the power to borrow money otherwise than on debentures must specify the total amount outstanding at anyone time up to which money may be borrowed by the delegate. In case a company has a branch office, the power to borrow as referred to above may be delegated to the principal officer of such branch.

The company thus, should follow the following procedure for delegating its power to borrow money otherwise than on debentures:

1. Convene a meeting of the Board of directors.
2. Ensure that every director gets the proper notice of the meeting along with the agenda.
3. Pass a resolution in the board's meeting delegating the stated power to the desired official of the company.
4. Ensure that the resolution does state the maximum amount that the official shall be allowed to borrow.

13.3 Prevention of Oppression and Mismanagement

13.3.1 Rule of Majority

The principle of rule by majority is made applicable to the management of affairs of the company. The shareholders pass resolutions on various subjects either by simple majority or by three-fourths majority. Once a resolution is passed, then it is binding on all the members of the company. As a resultant corollary, the court will not intervene to protect minority against the resolution, as on becoming a member, the shareholder agrees to submit to the will of the majority of the members. Thus, if a wrong is done to the company, it is the company which is legal entity having its own personality, which can institute a suit against the wrongdoer; and shareholders do not have a right to do so. This rule was laid down in the leading case of Foss v. Harbottle the facts of this case were as follows:

F and T brought an action on behalf of themselves and all other shareholders against the defendants who consisted of 5 directors, a solicitor and an architect of the company alleging that by concerted and illegal transactions they had caused the company's property to be lost to the company. It was also alleged that there was no qualified Board. F and T claimed damages from the defendants to be paid to the company. The Court held, that the action could not be brought by the minority shareholders. The wrong done to the company was one which could be ratified by the majority of members. The company was the proper plaintiff for wrongs done to the company and the company can act only through its majority shareholders. The majority of the members should be left to decide whether to commence proceedings against the directors. The principle of majority rule has since then been applied to a number of cases.

In Rajahmundry Electric Supply Co. v. Nageshwara Rao, AIR (1956) S. C. 213, the Supreme Court observed that: The Courts will not, in general, intervene at the instance of shareholders in matters of internal administration and will not interface with the management of the company by its directors so long as they are acting within the powers conferred on them under articles of the company. Moreover, if the directors are supported by the majority shareholders in what they do, the minority shareholders can, in general, do nothing about it.

One may notice that the aforesaid decisions are essentially a logical extension of the principle that a company is a separate legal person from the members who compose it. Once it is admitted that a company is a separate legal person, it follows that 'if a wrong is done to it, the company is the proper person to bring an action. This is a simple rule of procedure which applies to all wrongs, viz., only the injured party may sue. If, for instance, X intentionally pushes Y down the stairs and Y breaks his leg in consequence, C, who has seen the whole incident can not bring an action against X. C has not been hurt; he is not the injured party; he is the wrong plaintiff. The right plaintiff is Y.

The rule, as applied to companies, however, appears a little more complicated. After all, the directors who have been fraudulent have injured the company. The company is composed of members. Losses to the company affect all the members, not simply the majority or the minority or any particular member. Why then, should an individual member not sue, since he has been injured?

The answer is that injury is not enough. The plaintiff must show that the injury has been caused by a breach of duty to him. In the course of existence a person suffers many injuries for which no action can be brought, for no duty owned to him has been broken. The individual shareholders or even the minority shareholders who try to show that the directors owe a duty to them personally in their management of the company's assets will definitely fail. The directors own no duty to the individual members, but only to the company as a whole. A company is a person and if it suffers injury through breach of duty owed to it, then the only possible plaintiff is the company itself acting, as it must always act, through its majority.

It should, however, be noted that the aforesaid principle of Foss v. Harbottle applies only where a corporate right of a member is infringed. The rule doesn't apply where an individual right of a member is denied. The shareholder, by his contract with company undertakes with respect to his rights which his membership carries to accept as binding upon him the decisions of the majority of shareholders, if arrived at in accordance with the law and the articles; these membership rights are referred to as corporate membership rights. Other rights of the shareholder, such as right to vote, or right to receive dividend are his personal or individual rights and cannot be taken away by the majority and if the company refuses to record his vote or pay him the dividend, he can sue in his own name and this right of action is unaffected by any decision of the majority.

The BOD of a Pvt. Co. has borrowed money for long-term purposes in excess of the aggregate of the paid-up capital and free reserves. Is it binding on the company?

Notes

Exceptions to 'The Majority Rule' (Protection of Minority Rights)

In the following cases, the rule of Foss v. Harbottle does not apply, i.e., the minority the shareholders may bring an action to protect their interest:

1. ***Where the act done is illegal or ultra-vires the company:*** A shareholder is entitled to bring an action against the company and its officers in respect of matters which are illegal or ultra-vires the company since no majority of shareholders (not even the entire body of shareholders) can sanction such matters. [Burland v. Earle (1902) A.C.83].

2. ***Breach of fiduciary duty:*** When a director is in breach of fiduciary duty, every shareholder may be regarded an authorised organ to bring the action [Santya Charan Lal v. Rameshwar Prasad Bajoria (1950) S.C.R. 394]. In Blakesly v. Johnson (1980), a U.S. case, the President Director of a corporation who was also the majority stockholder did not make adequate disclosure to the minority shareholder of facts concerning the sale of the business and as a result the latter allowed his stock to be redeemed by the corporation for an inadequate price. Held, the president was guilty of breach of fiduciary duty.

3. ***Where the act complained of constitutes a fraud on the minority:*** Where the majority of a company's members use their power to defraud or oppress the minority, their conduct is liable to be impeached even by a single shareholder. Justice Evershed, M.R. in Greenhalgh v. Ardene Cinemas Ltd. (1951) said, "a special resolution would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and minority shareholders, so as to give the former an advantage of which the latter were deprived."

   Thus, where the majority of members of company 'A', who were also members of company 'B', passed a resolution to compromise an action against company 'B'. The resolution was charged to be favourable to company 'B' but unfavourable to company 'A'. Held, the minority of company 'A' could get the compromise set aside (Menier v. Hooper's Telegraph Works Ltd.)

4. ***Where an act which requires special resolution to be effective but has, in fact, been done by a simple majority:*** An action by minority shall be maintainable where it is bought to restrain the company from doing an act for which a special resolution is required and such a resolution has not properly been passed or passed by means of a trick.

5. ***Where the personal rights of an individual member have been infringed:*** As already noted, the principle of majority rule is applicable only to the corporate membership rights of a member. Infringement of a member's individual rights like right to vote, right to receive dividends, etc., entitles him to proceed in his own name.

6. ***Protection under the Companies Act:*** The Companies Act, 1956, vide certain specific provisions, extends protection to the minority shareholders by conferring certain rights on them:

   (i) *Variation of Class Rights:* Where the share capital of a company is divided into different classes of shares, the rights attached to the shares of any class can be varied as provided in the memorandum or articles of the company with the consent of the 3/4th majority of the shareholders of that class. Where this is done and the rights are varied by the requisite majority vote, the holders of not less than 10 per cent of the issued shares of that class who had not assented to the variation may apply to the Court for the cancellation of the variation under s.107.

   (ii) *Scheme of Reconstruction and Amalgamation:* Section 394 provides for schemes of reconstruction and gives protection to minorities. No compromise or arrangement in connection with a scheme for the amalgamation of the company shall be sanctioned

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by the court unless it has received a report from the Registrar that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest.

(iii) *Oppression and Mismanagement:* The principle of majority rule does not apply to cases where Ss.397 and 398 are applicable for prevention of oppression and mismanagement. A member, who complains that the affairs of the company are being conducted in the manner oppressive to some of the members including himself, may apply to the Court by petition under s.397. In O.P. Gupta v. Shiv General Finance (p) Ltd. (1977), the Delhi High Court held, that a member's right to move the Court under s.397 was a statutory right and cannot be affected by an arbitration clause in the Articles of Association of a company.

(iv) *Rights of dissentient shareholders at the time of takeover bids:* When an offer for the purchase of all the shares is received and the offer is accepted by the holders of 90 per cent of the shares, the party making the offer may, on the same terms acquire the remaining shares also. But a notice is to be given to the dissenting shareholders who have a right to apply to the court praying that their shares should not be allowed to be acquired, on the terms of the scheme. On hearing the parties concerned, the court makes an order as it may think fit.

Self Assessment

5. Debenture which are repayable only on the happening of an event of winding up is called

   (a) Redeemable (b) Irredeemable

   (c) Perpetual (d) Both (b) and (c)

6. For the purpose of debt equity ratio Fully Convertible Debentures are classified as

   (a) Debt (b) Equity

   (c) Both (a) and (b) (d) None of the above

7. In case of Partly Convertible Debentures nonconvertible portion is classified as

   (a) Debt (b) Equity

   (c) Both (a) and (b) (d) None of the above

8. Amount due on redemption including interest should be claimed with in how much time.

   (a) 10 year (b) 9 year

   (c) 8 year (d) 7 year

13.3.2 Powers of Company Law Board for Prevention of Mismanagement and Oppression (Ss. 397-399 and 402)

Section 397 provides that any member of a company who complains that its affairs are being conducted in a manner oppressive to any member or members (including any one or more of themselves) may apply to the Company Law Board under this section. With a view to bring an end the matters complained of, the Company Law Board may make such order as it thinks fit under this section, if it is of opinion that– (i) the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members; and (ii) to wind up the company would unfairly prejudice the members who have lodged the

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complaint, but the court would be prepared to make a winding up order on the ground that it is just and equitable that the company should be wound up.

An application may also be made under s.398 to the Company Law Board by any members of a company who complain that– (i) the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner prejudicial to the interest of the company; or (ii) a material change has taken place in the management or control of the company and that by reason of such change, it is likely that the affairs of the company will be conducted in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company.

After hearing the petition, the Company Law Board may pass such order as it thinks fit.

Persons Entitled to Complain

Section 399 specifies the persons who are entitled to apply to the Company Law Board, for relief in cases of oppression and mismanagement complained of in pursuance of Ss.397-398. The numbers necessary to make such application is: (i) in the case of a company having a share capital, 100 members or 10 per cent of the total number of its members whichever is less, or members holding 10 per cent of the issued share capital; (ii) in the case of a company not having a share capital, 20 per cent (one fifth) of the total number of its members. The Central Government is empowered in an appropriate case to authorise any lesser number of members to make such application to the Company Law Board.

Power of CLB to Provide Relief

Section 402 provides for the relief that can be provided by the Company Law Board and the CLB's order may include:

1. The regulation of the conduct of the company's affairs in future;
2. The acquisition of the shares or interests of any members by other members or by the company;
3. The consequent reduction of the share capital in case of (b) above;
4. Termination, setting aside or modification of any agreement, however arrived at, between the company and the manager, managing director or any other director;
5. Termination, setting aside or modification of any agreement between the company and any other person with the latter's consent;
6. Setting aside of any transfer, delivery of goods, payment, execution or other act relating to the property made or done by or against the company within three months of the application which would amount to fraudulent preference in case of an individual's insolvency;
7. Any other matter for which, in the opinion of the company law board, it is just and equitable that provision should be made.

ABC Ltd realised on 2 May, 2006 that particulars of charge created on 12 March, 2006 in favour of a bank were not filed with ROC for registration. What procedure should the company follow to get the charge registered with the ROC? Would the procedure be different if the charge was created on 12 February, 2006 instead of 12 March, 2006?

Powers of Central Government to Prevent Oppression or Mismanagement

Section 408 empowers the Central Government to prevent oppression or mismanagement by nominating directors on the Board of directors of a company.

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Investigation

Besides the aforesaid provisions, to prevent oppression or mis-management by those who control the affairs of the company, the Act contains certain provisions under the head 'Investigation'.

Self Assessment

State whether the following statements are true or false:

9. A resolution passed by the shareholders empowering the directors to borrow beyond the aggregate of paid-up capital and free reserves is void.
10. An entry has to be made in the register of investments within seven days of making the inter-corporate investment.
11. A public company has paid up capital and free reserves of ₹ 250 crores and ₹ 50 crores respectively. For making the inter-corporate investment, it must pass a special resolution and obtain approval of the central government.
12. Investments made by a company on its own behalf must be held by it in its own name.
13. An investment company need not hold its investments in its own name.

Case Study

Patents

A closely held private company consists of family members as its shareholders. One Mr. A held some 50% of the shareholding while his brother and his group held the remaining 50% shareholding in the Company. Mr. A was not concentrating on the affairs of the Company thinking that his rights and interest are secured to mandatory corporate regulations to be followed. Mr. A was living abroad and had to travel abroad very frequently due to health problems. Suddenly, Mr. A has found that the very valuable property of the Company is sold for a throw away price to a third party. Mr. A challenged the sale transaction, but, the third party who has purchased the property has started even developmental activity as there was no restraint from the Board or as Mr. A could not convince the Board for getting a restraint order like injunction. The case is pending before the Board for years and the majority group engages competent and costly lawyers and they keep on filing applications and now it is really difficult for the Hon'ble Company Law Board to read all the papers, find-out all the proceedings and passing final orders in the matter. Mr. A has a clear case to prove that the property is sold illegally and in violation of Articles of Association and the provisions of Law, but, still he could not get his rights secured and is hoping that his rights will be preserved and protected when the Company Petition under section 397/398 is finally disposed of.

Question

What is the nature of remedy available under the provisions meant to prevent the continuing oppression and mismanagement? Give your own views in detail.

Notes

13.4 Summary

- All investments made by a company on its own behalf shall be made and held by it in its own name.
- If the investments are made by a company, whose principal business consists of the buying and selling of shares or securities, the company may hold its investments in any other name.
- A company may deposit with, or transfer to, any person any shares or securities, by way of security for the repayment of any loan advanced to the company for the performance of any obligation undertaken by it.
- A power to borrow, whether express or implied, includes the power to charge the assets of the company by way of security to the lender.
- The power to borrow money is generally exercised by the directors but Articles normally provide for certain restrictions on their power to borrow.
- Section 292 empowers the Board to borrow money on behalf of the company by means of resolution passed at the meeting of the Board.

13.5 Keywords

Borrowing: A power to borrow, whether express or implied, includes the power to charge the assets of the company by way of security to the lender.

Investment: The Act does not define the term 'investment' though it uses the same in a number of sections.

Rule of Majority: The principle of rule by majority is made applicable to the management of affairs of the company.

Suit against the Director: The lender may claim damages from the directors and sue them personally for a breach of warranty of authority

13.6 Review Questions

1. What are the conditions imposed by section 372A of the Companies Act, 1956 as regards investments of a company?
2. Discuss the provisions of the Companies Act, 1956 relating to inter-corporate investments.
3. What are the provisions of the Companies Act, 1956 as regards purchase by a company of shares of other companies?
4. Discuss the law and state the procedure relating to inter-corporate loans.
5. What are the legal requirements which a company must comply with while borrowing?
6. What is *ultra vires* borrowing? What remedies, if any, are open to a lender if a company resorts to *ultra vires* borrowing?
7. What are the restrictions imposed on the borrowing powers of the Board of directors?
8. What is a floating charge? Distinguish it from a fixed charge.
9. Comment on the characteristics of a floating charge. When does such a charge crystallise into a fixed charge?

Notes

10. What charges are registered under the Companies Act, 1956? What is the effect of non-registrable of a registrable charge?

Answers: Self Assessment

1.	Investment	2.	own name
3.	shares or securities	4.	stock
5.	(d)	6.	(b)
7.	(a)	8.	(d)
9.	True	10.	True
11.	True	12.	True
13.	True		

13.7 Further Readings

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Notes

Unit 14: Winding Up of Companies

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the modes of winding up;
- Evaluate the consequences of winding up;
- Describe voluntary winding up;
- Explain the general powers of the court in relation to winding up.

Introduction

For the purposes of jurisdiction to wind up companies, the expression "registered office" means the place which has longest been the registered office of the company during the six months immediately preceding the presentation of the petition for winding up. (S.10)

The memorandum of a company limited by guarantee shall also state that each member undertakes to contribute to the assets of the company in the event of its being wound up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company, or of such debts and liabilities of the company as may have been contracted before he ceases to be a member, as the case may be, and of the costs, charges and expenses of winding up, and for adjustment of the rights of the contributories among themselves, such amount as may be required, not exceeding a specified amount. (S. 13)

14.1 Winding Up

Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator, called a 'liquidator', is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights. In simple words, winding up means applying the assets of a company in the discharge of its liabilities and returning any surplus to those entitled to it, subject to the cost of doing so. The statutory process by which this is achieved is called 'liquidation'. Winding up of a company differs from insolvency of an individual in as much as a company cannot be made insolvent under the insolvency law. Besides, even a solvent company may be wound up.

14.2 Modes of Winding Up (S. 425)

A company may be wound up in any of the following three ways:

1. Compulsory winding up under an order of the court.
2. Voluntary winding up.
3. Voluntary winding up under the supervision of the court.

14.2.1 Winding Up by the Court

Court having jurisdiction. For the purpose of filing the petition for compulsory winding up, the following courts have jurisdiction:

(a) High court having jurisdiction in relation to the place at which the registered office of the company is situated. The expression 'registered office' means the place which has longest been the registered office of the company during the six months immediately preceding the presentation of the petition for winding up.

(b) A District court, subordinate to the High Court on which jurisdiction has been so conferred. However, it shall necessarily be a High Court in 'respect of a company having a paid up capital of ₹ 1 lakh or more (s. 10].

Example: X Ltd has its registered office in Mumbai. Mr. Y is a creditor of the company and he resides in Chennai. He files a petition in the High Court at Chennai. The paid up capital of the company is ₹ one crore.

The High Court at Chennai does not have the jurisdiction to entertain the petition. It is the High Court at Mumbai to which the petition for winding up should be made.

Winding up by the court, also called compulsory winding up, may be ordered in cases mentioned in s.433. The court will make an order for winding up on an application by and of the persons enlisted in s.439.

Notes

Grounds for Compulsory Winding Up [s.433(3)]

A company may be wound up by the court on the following grounds:

1. ***Special Resolution:*** The company may by special resolution, resolve that it be wound up by the court. The resolution may be passed for any cause whatsoever. However, the court may not order winding up if it finds it to be opposed to public interest or the interest of the company as a whole.

2. ***Default in Holding Statutory Meeting:*** If default is made in delivering the statutory report to the Registrar or in holding the statutory meeting, the company may be ordered to be wound up. Petition on this ground can be presented either by the Registrar or by a contributory. If it has to be filed by any other person, it should be filed before the expiration of 14 days after the last day on which the statutory meeting ought to have been held [s.439 (7)].

3. ***Failure to Commence Business:*** If a company does not commence business within a year from incorporation or suspends business for a whole year, it may be ordered to be wound up. Failure to commence or to carry on business is not treated as a ground for compulsory winding up unless the company has no intention of carrying on business or it has become impossible to do so.

4. ***Reduction in Membership:*** If the number of members is reduced below the statutory minimum of 7 in a public company or 2 in a private company, the company may be ordered to be wound up.

5. ***Inability to Pay Debts:*** The Court may order a company to be wound up if it is unable to pay its debts. According to s.434, a company shall be deemed to be unable to pay its debts if: (a) a creditor for more than one lakh rupees has served on the company at its registered office a demand under his hand requiring payment and the company has for three weeks thereafter neglected to pay or secure or compound the sum to the reasonable satisfaction of the creditor; or (b) execution or other process issued on a judgement or order of any court or court in favour of a creditor of the company is returned unsatisfied in whole or in part; or (c) it is proved to the satisfaction of the court that, the company is unable to pay its debts, taking into account its contingent and prospective liabilities.

   Though a contingent and prospective liability is not a debt, the provision that, the court is to take into account the company's contingent and prospective liabilities is important. A company which has to date paid all its debts as they fell due may still be ordered to be wound up if a consideration of its assets and liabilities shows that, it will or may shortly be unable to do so. Inability is to be seen in the commercial sense of a running enterprise and not in the sense of liquidation, i.e., if the company cannot meet its current demand, even though its assets, when realised, would exceed its liabilities, it will be deemed to be unable to pay its debt and may be wound up.

   But the important condition to be fulfilled is that, the creditor should have a complete title to the debt and the debt – a determined or definite sum of money – must have become payable immediately. Where there is a bona fide dispute regarding the debt, the company cannot be charged to have neglected to pay it.

   The application money due to be refunded to an applicant who applied for shares, but his application was not accepted, is not a debt. Also, the interest due on such an amount is not a debt.

   Also wages or salary which is due by the company to an employee is not a debt.

The petition on the ground of a company's inability to pay its debts can be made by a creditor (including a secured creditor) a debenture holder, and a trustee for debenture holders. Even a contingent creditor, such as a holder of bill of exchange may make a petition. The company itself can file a petition. The registrar has a limited right to file a petition for winding up of a company.

6. ***Just and Equitable***: The court may also order for the winding up of a company if it is of the opinion that, it is just and equitable that, the company should be wound up. In exercising its power on this ground, the court shall give due weight to the interest of the company, its employees, creditors and shareholders and the interest of the general public. The relief based on the just and equitable clause is in the nature of a last resort when other remedies are not efficacious enough to protect the general interests of the company. While in the above five cases definite conditions should be fulfilled but in the 'just and equitable' clause the entire matter is left to the 'wide and wise' direction of the court. The winding up must be just and equitable not only to the persons applying but also to the company and to all its shareholders. [Hind Overseas Pvt. Ltd. vs. R.P. Jhunjhunwala (1977) ASIL. XIII] A few of the examples of 'just and equitable' grounds on the basis of which the court may order the winding up are given below:

   (i) *When the substratum of the company has gone*: The substratum of a company is deemed to be gone where its objects have failed or become impossible of achievement.

   Some tests to ascertain whether the substratum of the company is gone were laid down in In re Kaithal and General Mills Co. Ltd. (1951.) 31 Comp Cas 46 These are:

   (a) Where the only subject matter of the company is gone; or

   (b) The object for which it had been incorporated has substantially failed; or

   (c) It is impossible for the company to continue except at a loss; or

   (d) The existing liabilities are far in excess of existing and possible assets.

   (ii) *When there is a complete deadlock in the management:* A company will be wound up on this ground even though it is making good profits. In re Yenidje Tobacco Co. Ltd. [1916]2 Ch 426, A and B, the only shareholders and directors of a Private Limited company became so hostile to each other that neither of them would speak to the other except through the secretary. Held: There was a complete deadlock and consequently the company was ordered to be wound up.

   (iii) *Where the company was formed for fraudulent or illegal purposes:* For this purpose, fraud in the prospectus or in the manner of conducting company's business is not sufficient. It must be shown that, the original object of creating the company was fraudulent or illegal [re T.E. Brismead & Sons Ltd. (1897)1 Ch.45].

   (iv) *Where the principal shareholders have adopted an aggressive or oppressive policy towards the minority:* [R. Sabapathy Rao vs. Sabapathy Press Ltd. AIR (1925) Mad. 489] However, the court will order winding up only when it is satisfied that it is impossible for the business of the company to be carried on for the benefit of the company as a whole because of the way in which voting power is held and used.

   (v) *When the company is a 'bubble':* This means it never had any real business [re London and Country Coal Co. (1867) L.R. 3 Eq. 365].

   (vi) *Where the business of the company cannot be carried except at loss*: But, mere apprehension on the part of some shareholders that loss instead of gain will result has been held to be no ground [Re Mahamandal Shastra Prakashik Samiti Ltd. (1917) 15 All L.T. 193]. Similarly, in re Shah Steamship Navigation Co. [(1901) 10 Bom. L.R. 107], it was

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held that 'the Court will not be justified in making winding up order merely on the ground that the company has made losses and it was likely to make further losses.

(vii) *Where a private company is in essence or substance a partnership:* It may be ordered to be wound up if such circumstances exist under which it would be just and equitable for the Court to order for the dissolution of the partnership firm. In Re Davis & Coltett Ltd. [(1935) Ch. 693] one member improperly excluded the other, who held half the shares, from taking part in the company's business. Held, the company be wound up.

In this context, some guiding principles for the application of just and equitable ground for winding up were laid down in Ebrahimi v. Westbourne Galleries Ltd. [1972] 2 All ER 492. These are:

(a) The company was formed based on personal relationship and mutual confidence;

(b) An agreement or understanding that all or some of the shareholders will participate in the conduct of the business as in the case of a partnership concern; and

(c) Restrictions on the transfer of a members' interest in the private company.

However, the fact that an existing partnership firm was converted into a private company does not necessarily imply that the company retains the features of a partnership firm [Official Liquidator v. Ram Swarup (1997) Cas 569.]

(viii) *Requirements for Investigation:* Where Directors were making allegations of dishonesty against each other in respect of defalcations of the funds of the company, the company was ordered to be wound up on the ground that, it was a case in which the conduct of some of the officers of the company required an investigation which could only be obtained in a winding up by the Court [Re Varieties Ltd. (1893) 2 Ch. 235].

Task Company was incorporated for the purpose of manufacturing machinery tools, implements, etc. It spent a substantial part of its subscribed capital on fixed assets. It borrowed a sum of ₹ 30 Lakhs from a bank for providing working capital. As the company was unable to pay back this loan, the bank obtained a decree from a court. The stock-in-trade, plant and machinery and all the fixed assets of the company were sold out in execution of the decree, leaving no surplus for the company.

Would it be just and equitable to wind up the company in the circumstances?

[***Hint*:** The company in question may be wound up on just and equitable grounds since its subject matter is gone.]

Self Assessment

Fill in the blanks:

1. .... of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members.

2. The statutory process by which this is achieved is called ....

3. If a company does not commence business .... from incorporation or suspends business for a whole year, it may be ordered to be wound up.

Notes

4. The Court may order a company to be wound up if it is unable to pay its ....
5. .... or salary which is due by the company to an employee is not a debt.

14.3 Procedure for Winding Up Order

1. The winding up petition must be presented to the court.
2. ***After the presentation of the petition but before the hearing, application may be made to the court by either the company, creditor or contributories:*** to appoint a provisional liquidator to safeguard the assets pending the hearing. Before making such appointment, however, the court must give notice to the company so as to enable it to make its representation in the matter unless, for reasons to be recorded in writing, it thinks fit to dispense with such notice. The powers of the provisional liquidator are the same as those of a liquidator unless limited by the court (s.450).
3. ***On hearing a winding up petition, the court may [s.443(1)]:*** (i) dismiss it, with or without costs; or (ii) adjourn the hearing conditionally or unconditionally; or (iii) make any interim order that it thinks fit; or (iv) make an order for winding up the company with or without costs, or any other order that it thinks fit.

   The court cannot, however, refuse to make a winding up order on the ground only that, the assets of the company have been mortgaged to an amount equal to or in excess of those assets or that the company has no assets. "Where the petition is presented on the ground that, it is just and equitable that the company should be wound up, the court may refuse to make an order of winding up if it is of the opinion that, some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy." [s.443 (2)].

   Where the petition is presented on the ground of default in delivering the statutory report to the Registrar or in holding the statutory meeting, the court may: (a) instead of making a winding up order, direct that the statutory report shall be delivered or that a meeting shall be held; and (b) order the costs to be paid by persons who, in the opinion of the Court, are responsible for the default [s.443 (3)].

   In all matters relating to the winding up of a company, the court may have regard to the wishes of creditors or contributories of the company as proved to it by any sufficient evidence and for the purpose may direct that their meetings may be held or conducted as directed by the Court (s.557).

14.4 Consequence of Winding Up Order

The consequence of the winding up order by the court are as follows:

1. The court must, as soon as the winding up order is made, cause intimation thereof to be sent to the official liquidator and the Registrar (s.444).
2. The petitioner and the company must also file with the Registrar within 30 days a certified copy of the order [s.445(1)]. The Registrar should file with himself a certified copy of the winding up order of the court when he himself is a petitioner under s.439. If default is made in filing the certified copy of the order, the petitioner, or the company and every officer of the company who is in default, shall be punishable with fine upto ₹ 1,000 for every day during which the default continues (s.445).
3. The Registrar should then make a minute of the order in his books relating to the company and notify in the official gazette that such an order has been made [s.445(2)].

Notes

4. The order for winding up is deemed to be a notice of discharge to the officers and employees of the company, except when the business of the company is continued [s.445(3)].
5. The order operates in the interests of all the creditors and all the contributories, no matter who in fact asked for it (s.447).
6. The official liquidator, by virtue of his office becomes the liquidator of the company and takes possession and control of the assets of the company (s.449).
7. All actions and suits against the company are stayed, unless the court gives leave to continue or commence proceedings (s.446).
8. All the powers of the Board of directors cease and the same are then exercised by the liquidator [Ss.491 & 505].
9. On the commencement of winding up, the limitation ceases to run in favour of the company.
10. Any disposition of the property of the company and any transfer of shares in the company or alteration in the status of members made after the commencement of winding up shall, unless the court otherwise orders, be void [s.536(2)].
11. Any attachment, distress or execution put in force, without leave of the court, against the estate or effects of the company after the commencement of the winding up shall be void [s.537 (a)] but not for dues payable to Government [s.537(2)].
12. Any sale held, without leave of the court, of any of the properties or effects of the company after the commencement of winding up shall be void [s.537(b)].
13. Any floating charge created within 12 months preceding the commencement of winding up is void unless it is proved that, the company after the creation of the charge was solvent, except as to, any cash advanced at the time of or subsequent to the creation of the charge or to any interest on that amount @ 5% or such other rate notified by the Central Government (s.534).

Example: A company created a floating charge of its current assets in favour of a bank to secure a current account, which was in debit of ₹ 5 lakhs and also to secure further working capital facilities provided by the bank. The charge created on January 1, 2007 was duly registered with ROC. The bank advanced ₹ 10 lakh subsequent to the creation of the charge. The company has gone into creditors voluntary liquidation pursuant to a resolution passed on September 1, 2007. There is no case of a fraudulent preference.

As it is a creditors voluntary winding up, the floating charge is void being made within 12 months of winding up resolution, unless the charge is against cash advanced at the specified rate of interest (s. 534).

Example: If in the above example, if it was a members' voluntary winding up, then the floating charge is valid.

The secured creditor is outside the winding up and can realise his security without the leave of the court.

14.4.1 Statement of Affairs to be made to the Liquidator (s.454)

When a winding up order is made by the court, the directors of the company must make to the liquidator a statement as to the affairs of the company, stating the following particulars: (i) the debts and liabilities of the company; (ii) the assets of the company, showing separately the cash in hand and in bank, if any; (iii) the name, residence and occupation of each creditor stating separately the amount of secured debts and unsecured debts; (iv) the debts due to the company and the name, residence and occupation of each person from whom the sum is due and the amount likely to be realised there from.

The object of such a statement is to give the liquidator an idea as to the financial affairs and liabilities of the company. The creditors and contributories of the company can inspect the statement. The statement should be made within 21 days (or such extended time not exceeding 3 months as the official liquidator or Tribunal may for special reasons allow) after the relevant date. The relevant date is the date of the winding up order by the court or where a provisional liquidator is appointed, the date of his appointment. The statement must be submitted and verified by affidavit by one or more of the persons who, at the relevant date are the directors and by the person who at that time is the manager, secretary or other chief officer of the company. Defaulter shall be punishable with imprisonment up to 2 years or with fine up to ₹ 1,000 for every day during which default continues or with both.

14.4.2 Committee of Inspection

The court may, at the time of making an order of winding of a company or at any time thereafter, direct that there shall be appointed a committee of inspection to act with the liquidator. In such a case the liquidator must, within 2 months from the date of such direction convene a meeting of the creditors of the company for the purpose of determining who are to be members of the committee. Within 14 days from the date of the creditors meeting (or such further time as the Court in its direction may grant for the purpose), the liquidator should convene a meeting of the contributories to consider the decision of the creditors' meeting with respect to the membership of the committee. It is open to the meeting of the contributories to accept the decision of the creditors' meeting with or without modifications or to reject it. The liquidator must apply to the court for directions as to what the composition of the committee shall be and who shall be members thereof. However, it will not be necessary to seek directions in this regard where the meeting of the contributories accept the decision of the creditors' meeting in its entirety.

Section 465 provides: (i) a committee of inspection cannot have more than 12 members; (ii) the committee shall have the right to inspect the accounts of the liquidator at all reasonable times; (iii) it must meet at such times as it may from time to time appoint and the liquidator or any member of the committee may also call a meeting of the committee as and when he thinks necessary; (iv) the quorum for the meeting of the committee shall be 1/3rd of the total number or two whichever is higher; (v) a member of the committee may resign by notice in writing. But where a member of the committee is adjudged an insolvent or compounds or arranges with his creditors, or is absent from five consecutive meetings of the committee without the leave of the members, he shall cease to remain a member.

Notes

Self Assessment

6. Match list-I and list-II.

List-I		List-II	
A.	Special resolution	1.	If a company does not commence business within a year from incorporation or suspends business for a whole year, it may be ordered to be wound up.
B.	Default in holding statutory meeting	2.	The company may, by special resolution, resolve that it be wound up by the court.
C.	Failure to commence business	3.	If default is made in delivering the statutory report to the Registrar or in holding the statutory meeting, the company may be ordered to be wound up.
D.	Reduction in membership	4.	If the number of members is reduced below the statutory minimum of 7 in a public company or 2 in a private company, the company may be ordered to be wound up.

Codes:

	A	B	C	D
(a)	2	4	3	1
(b)	2	3	1	4
(c)	3	4	1	2
(d)	4	1	3	2

7. Match the list-I and list-II

	List-I		List-II
A.	The powers of the provisional liquidator are the same as those of a liquidator unless limited by the court	1.	s 443(2)
B.	In all matters relating to the winding up of a company, the court may have regard to the wishes of creditors or contributories of the company as proved to it by any sufficient evidence and for the purpose may direct that their meetings may be held or conducted as directed by the Court	2.	(s.444).
C.	Where the petition is presented on the ground that, it is just and equitable that the company should be wound up, the court may refuse to make an order of winding up if it is of the opinion that, some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy	3.	(s.450)
D.	The court must, as soon as the winding up order is made, cause intimation thereof to be sent to the official liquidator and the Registrar	4.	(s. 557)

Codes:

	A	B	C	D
(a)	2	4	3	1
(b)	2	3	1	4
(c)	3	4	1	2
(d)	4	1	3	2

14.6 General Powers of the Court

The general powers of the court are as follows:

1. ***Power of Court to Stay Winding Up (s.446):*** The court may at any time after making a winding up order (on the application either of the official liquidator of any creditor or contributor and on proof to the satisfaction of the court that, all proceedings in relation to the winding up order be stayed) make an order staying the proceedings either altogether or for a limited time, on such terms and conditions as the court thinks fit.

2. ***Settlement of the List of Contributories (s.467):*** The court has the power to cause the assets of the company to be collected and applied in discharge of its liabilities. For this purpose the court has the power to make a list of contributories. In settling the list of contributories the court shall distinguish between those who are contributories in their own right and those who are contributories as being representatives of, or liable for the debts of others.

3. ***The Power to Make Calls (s.470):*** The court is empowered to make call on all or any of the contributories to the extent of their liability. It should be noted that, no statutory liability for an unpaid call can be set off against a credit except in the following cases: (a) in the case of an unlimited company, a contributory may set off his debt against any money due to him from the company on any independent dealing or contract with the company. But no set off is allowed for any money due to him as a member of the company in respect of any dividend or profit; (b) if, in the case of a limited company, there is any director or manager whose liability is unlimited, he shall have the same right of set off as described in (a) above; (c) in the case of any company, whether limited or unlimited when all the creditors have been paid in full, any money due on any account whether to a contributory from the company may be allowed to him by way of set off against any subsequent call.

4. ***Payment into Bank of Moneys Due to Company (s.471):*** The court may order any contributory, purchaser or other person from whom any money is due to the company to pay the money into the public account of India in the Reserve Bank of India instead of to the liquidator.

5. ***Power to Exclude Creditors not Proving in Time (s.474):*** The court may fix a time or times within which creditors are to prove their debts or claims. In such a case, if the creditors fail to establish their claims in time, they may be excluded from the benefit of any distribution made.

6. ***Adjustment of Rights of Contributories (s.475):*** The court is empowered to adjust the right of the contributories among themselves and distribute any surplus among the person entitled thereto.

7. ***Power to Order Costs (s.476)****:* The court may, in the event of assets being insufficient to satisfy the liabilities, make an order for the payment out of the assets, of the costs, charges and expenses incurred in the winding up, in such order of priority *inter se* as the Court thinks just.

Notes

8. ***Power to Summon Persons suspected of having property of company, etc. (s.477):*** The court may summon before it any officer of the company or person known or suspected to have in his possession any property or books or papers of the company or known or suspected to be indebted to the company. Any such person may be examined on oath. The court may also require him to produce any books and papers in his custody or power relating to the company; but where he claims any lien on books or papers produced by him, the production must be without prejudice to that lien.

   If any officer or person summoned, after being paid or tendered a reasonable sum for his expenses, fails to appear before the court at the time appointed without any valid reason, the court may cause him to be apprehended and brought before the court for examination.

9. ***Power to Order Public Examination of Promoter, Directors, etc. (s.478):*** Where the Official Liquidator has made a report to the court, stating that in his opinion a fraud has been committed by any person in the promotion or formation of the company, or by any officer of the company since its formation, the court may direct that person or officer may appear before the court and be publicly examined. Examination shall relate to the promotion or formation or the conduct of the business of the company, or as to his conduct and dealings as an officer thereof. Official liquidator, any creditor or contributory may take part in such examination. The court may put such questions to the person examined as it thinks fit. The person shall be examined on oath and must answer all such questions as the Tribunal may put or allow to be put, to him. Notes of the examination must be taken in writing and must be read over to or by and signed by the person examined and may thereafter be used in evidence against him. Statement so recorded shall be open to the inspection of any creditor or contributory at all reasonable times.

10. ***Power to arrest a Contributory Intending to Abscond (s.479):*** At any time (either before or after making a winding up order), the court may, on proof of probable cause for believing that a contributory is about to quit India or otherwise to abscond or is about to remove or cancel any of his property, for the purpose of evading payment of calls or of avoiding examination in respect of the affairs of the company, cause: (a) the contributory to be arrested and safely kept until such time as the Tribunal may order; and (b) his books and papers and movable property be seized and safely kept until such time as the Court may order.

11. ***Power to Order for Dissolution of the Company (s.481):*** When the affairs of a company have been completely wound up or when the court is of the opinion that, the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason whatsoever and it is just and reasonable in the circumstances of the case that an order of dissolution of the company should be made, the court shall make an order that the company be dissolved from the date of the order. The liquidator must, within 30 days, send a copy of the order to the Registrar who shall make in his books a minute of the dissolution of the company. If he makes a default in forwarding a copy as aforesaid, he shall be punishable with fine which may extend to ₹ 500 for every day during which the default continues. On the expiry of 5 years from the date of dissolution, the name of the company should be struck off the register. But within 2 years of the date of the dissolution on application by the liquidator of the company or by any other person who appears to the court to be interested, the court may make an order, upon such terms as the court thinks fit, declaring the dissolution to have been void. After such an order is passed, such proceedings may be taken as might have been taken if the company had not been dissolved (s.559).

Notes

Task Randhir and Vipin formed a private company in which they were the only directors and shareholders having equal voting rights. Differences arose between them. They were not even on speaking terms. One of them filed a petition for winding up. Will he succeed in getting winding up order? [***Hint:*** He will succeed; there being a deadlock in management. Such a ground will fall under 'just and equitable' clause of winding up.]

14.6 Voluntary Winding Up

Winding up by the creditors or members without any intervention of the court is called 'voluntary winding up'. In voluntary winding up, the company and its creditors are left to settle their affairs without going to the court for directions or orders if and when necessary. Winding up should not be confused with insolvency. Company may be solvent and running a prosperous business yet it may decide to be wound up voluntarily, e.g., in pursuance of a scheme of reconstruction or amalgamation.

A company may be wound up voluntarily: (1) if the company in general meeting passes an ordinary resolution for voluntary winding up where the period fixed by the Articles for the duration of the company has expired or the event has occurred on which under the Articles the company is to be dissolved; (2) if the company resolves by special resolution that it shall be wound up voluntarily (s.484).

When a company has passed a resolution for voluntary winding up, it must within 14 days of the passing of the resolution, give notice of the resolution by advertisement in official gazette and also in some newspaper circulating in the district where the registered office of the company is situated. In case of default, the company and every officer of the company who is in default shall be punishable with fine which may extend up to ₹ 500 for every day during which the default continues (s.485).

14.6.1 Consequences of Voluntary Winding Up

The consequences of voluntary winding up are as follows:

1. A voluntary winding up is deemed to commence at the time when the resolution for voluntary winding up is passed (s.486). This will be so even when after passing a resolution for voluntary winding up, a petition is presented for winding up by the court (s.441).

2. The company, from the commencement of winding up, must cease to carry on its business except so far as may be required to secure a beneficial winding up, although the corporate state and powers of the company continue until final dissolution (s.487).

3. All transfer of shares and alterations in the status of members, made after the commencement, are void unless sanctioned by the liquidator (s.536).

4. A resolution to wind up voluntarily operates as notice of discharge to the employees of the company [Fowler vs. Commercial Times Co.] except: (a) when the liquidation is only with a view to 'reconstruction' [Midland Counties Bank Ltd. vs. Attwood (1905) 1 Ch. 357] or (b) when business is continued by the liquidator for the beneficial winding up of the company.

5. On the appointment of the liquidator, all the powers of the Board of directors, managing director or 'manager' shall cease except (s.491): (a) for the purpose of giving notice to the Registrar about the name of the liquidator appointed, or (b) insofar as the company in general meeting or the liquidator may sanction the continuance of their powers.

Notes

Self Assessment

8. Under which sec. if company fails to commence its main object the court may order winding up

   (a) 403 (f) (b) 413 (f)

   (c) 423 (f) (d) 433 (f)

9. Deposit holder can file winding up petition under which sec.

   (a) 433 (a) (b) 433 (c)

   (c) 433 (e) (d) 433 (f)

10. The capital which is part of the uncalled capital of the company which can be called up only in the event of its winding up it is called

    (a) Issued capital (b) Nominal capital

    (c) Authorised Capital (d) Reserve capital

11. Commencement of winding up of a company does not affect the nature of

    (a) A fixed charge (b) A floating charge

    (c) Both a and b (d) None of the above

14.7 Types of Voluntary Winding Up

Voluntary winding up may be of three types: (a) Members' Voluntary winding up; (b) Creditors' Voluntary winding up; (c) Voluntary winding up under supervision of court.

14.7.1 Members' Voluntary Winding up

Members' Voluntary winding up is possible only when the company is solvent and is able to pay its liabilities in full. Following are the important provisions regarding members' voluntary winding up.

Declaration of Solvency (s.488)

Where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full enquiry into the affairs of the company and that having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding 3 years from the commencement of the winding up as may be specified in the declaration. In order to be effective, this declaration must be: (i) made within five weeks immediately preceding the date of passing of the winding up resolution by the members; (ii) delivered to the Registrar for filing before the said date; (iii) accompanied by a copy of the report of the auditors of the company on the profit and loss account prepared since the date of the last account and the balance-sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at that date.

Any director of a company making a declaration under this section without having reasonable grounds for the opinion that the company will be able to pay its debts in full within the period specified in the declaration, shall be punishable with imprisonment for a term which may

Notes

extend to six-months, or with fine up to ₹ 5,000 or with both. If the company is wound up in pursuance of a resolution passed within the period of five weeks after making the declaration, but its debts are not paid or provided for in full within the period specified in the declaration, it shall be presumed, until the contrary is shown, that the director did not have reasonable grounds for his opinion.

If the above provisions are not complied with, the winding up shall not be a members' voluntary winding up [Vosica vs. Janda Rubber Works AIR (1950) East Punjab 180] and in such case provisions (s.490 and 498) relating to members voluntary winding up cannot apply and if liquidator is appointed in pursuance of s. 490 or 498 such appointment would be bad in law. In such a case, the provisions relating to creditor's voluntary winding up (Ss. 500-509) should be followed and the violation of these provisions will make the winding up proceedings *void ab initio* (M. Kakshmiah vs. Registrar of Companies, Trivandrum-unreported case decided by the Kerala High Court) and if default is made in calling a meeting of the creditors then the company and the Directors' as the case may be, shall be punishable with fine which may extend to ₹ 10,000 and in the case of default by the company, every officer of the company who is in default, shall be liable to the like punishment [s.500 (6)]. The Court may, if moved by the company or its shareholders, instead of treating the winding up proceedings as invalid, direct the company to convene the creditors meeting [Light of Asia Insurance Company, I.L.R. 1940 (2) Cal.325]. The above rules will be applicable even where a declaration of solvency has been filed but in accordance with the provisions of s.488(2).

The company, however, may pass a fresh resolution for its winding up after complying with the requirements of s.488 (Declaration of Solvency).

Appointment and Remuneration of Liquidators (s.490)

The company in general meeting must: (a) appoint one or more liquidators for the purpose of winding up the affairs and distributing the assets of the company; and (b) fix the remuneration, if any, to be paid to the liquidator or liquidators.

Any remuneration so fixed cannot be increased in any circumstances whatever, whether with or without the sanction of the Court. No liquidator shall take charge of his office unless his remuneration is fixed. Further, if a vacancy occurs by death, resignation or otherwise in the office of the liquidator appointed by the company, the company in general meeting may, subject to any arrangement with its creditors, fill the vacancy. For this purpose a meeting may be convened by any contributory or the continuing liquidator or by the Court on the application of any of them (s.492).

Board's Power to Cease

On the appointment of a liquidator, all the powers of the Board of directors and of the managing director or whole-time directors or manager shall cease except for purpose of giving a notice of such appointment to the Registrar. But their powers may continue if sanctioned by the general body or by the liquidator so far as the sanction applies (s.491).

Notice of Appointment of Liquidator to be given to the Registrar (s.493)

The company must give notice to the Registrar regarding the appointment of liquidator within 10 days of his appointment. In case of default, the company and every officer of the company (including liquidator) who is in default, shall be punishable with fine which may extend to ₹ 1,000 for every day during which the default continues.

Notes

Power of Liquidator to Accept Shares, etc., as consideration of Sale of Property of the Company (s.497)

The liquidator may accept shares, policies or like interests in consideration of the sale of the company's undertaking to another company, with an object to distribute them amongst the members of transferor company, provided: (a) a special resolution is passed by the company to that effect; and (b) he purchases the interest of any dissenting member at a price to be determined by agreement or by arbitration.

The money to the dissenting members should be paid before the company is dissolved and should be raised in such manner as may be determined by special resolution.

Duty of Liquidator to call Creditor's meeting in case of Insolvency (s.495)

If the liquidator is at any time of opinion that the company will not be able to pay its debts in full within the period stated in the declaration of solvency, or that period has expired without the debts having been paid in full, he must forthwith summon a meeting of the creditors and must lay before the meeting a statement of the assets and liabilities of the company. If he fails to comply with the above requirements, he shall be punishable with fine which may extend to ₹ 5,000.

Duty of the Liquidator to call General Meeting at the end of each year (s.496)

In case winding up continues for more than one year the liquidator must: (a) call a general meeting of the company at the end of the first year from the commencement of winding up and at the end of each succeeding year, or as soon thereafter as may be convenient within 3 months from the end of the year or such longer period as the Central Government may allow; and (b) lay before the meeting an account of his acts and dealing and of the conduct of the winding up during the preceding year.

Final Meeting and Dissolution [s.497]

As soon as the affairs of the company are fully wound up, the liquidator must: (a) make up an account of the winding up showing how the winding up has been conducted and the property of the company has been disposed of; and (b) call a general meeting of the company for the purpose of laying the account before it, and giving any explanation thereof.

The meeting must be called by advertisement specifying the time, place and object of the meeting and must be published at least one month before the meeting in the official gazette and also in some newspaper circulating in the district where the registered office of the company is situated.

Within one week after the meeting, the liquidator must send to the Registrar and the official liquidator each, a copy of the account and the return regarding holding of the meeting. In case quorum was not present at the meeting called, he must report accordingly.

On receipt of the above documents, the Registrar will register them and the official liquidator shall make a scrutiny of the books and papers of the company and report to the court, the result of his scrutiny. If the report of the official liquidator shows that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest, then, from the date of submission of report of the court, the company shall be deemed to be dissolved. In the case of an unfavourable report, the court shall direct the official liquidator to make a further investigation of the affairs of the company. On receipt of the report of the official liquidator on such further investigation, the court may either make an order that the company stands dissolved with effect from the date specified in the order or make such order as the circumstances of the case brought out in the report permit.

Self Assessment

Notes

State whether the following statements are true or false:

12. In the case of compulsory winding up, the official liquidator, by virtue of his office, becomes the liquidator of the company.
13. The terms 'liquidation' and 'dissolution' can be used interchangeably.
14. An unregistered company can be wound up either voluntarily or by court.
15. Any transfer of property, movable or immovable, or any delivery of goods made by a company within a period of one year before the commencement of its winding up is void as against the liquidator.
16. The liquidator has an absolute power to disclaim onerous property of a company.

Case Study

How to avoid Compulsory Liquidation

Protecta (Plymouth) Limited (a fictional company) is a security services company providing security guards to other businesses. The company has 50 employees. The company has minimal overheads, apart from the "wage cost" of the employees.

The company had four main customers, the largest of which failed leaving Protecta (Plymouth) Limited with a bad debt of £ 100,000. Since that bad debt was incurred three months ago the company has recovered its previous level of turnover, but that turnover is now spread over ten customers.

The cash flow reduction of £ 100,000 caused by the bad debt resulted in Protecta (Plymouth) Ltd "stretching the due dates" of the payments needed to be made to the company's creditors. One of those creditors issued a winding up petition two weeks ago and the court is to consider whether or not to make a winding up order at a hearing set to take place in three weeks time.

As soon as they receive the winding up petition the directors of Protecta (Plymouth) Ltd arrange to see a turn around specialist.

The realisable assets of the company are determined to be:

	£
Good trade debtors	170,000
Five vans	25,000
Office equipment	2,000
Goodwill	?
Total realisable value of assets	197,000

Contd...

Notes

The amounts owed out by the company are found to be:

	£	£
Bank (secured by a debenture)		160,000
VAT	120,000	
PAYE	60,000	
Other unsecured creditors	20,000	200,000
Total creditors		360,000

The adviser explains that since a change in the law on 15th September 2003 VAT and PAYE are no longer classed as preferential creditors. The advisor prepares a statement of affairs which (ignoring the new rules on "top slicing") shows the order of priority of distributing the realisable assets should a compulsory liquidation ensue.

	£
Realisable value of Assets	197,000
Less: Payable to bankers under their floating charge	160,000
Surplus cash available for other creditors which total £200,000 (subject to settling liquidators costs)	37,000

Clearly the £ 200,000 of creditors could not expect much of a dividend in the liquidation after costs were deducted from the £ 37,000 net sum available to any liquidator.

Question

Suggest the best possible way to avoid the liquidation of this company?

14.8 Summary

- Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members.
- A District court is subordinate to the High Court on which jurisdiction has been so conferred.
- Winding up by the court, also called compulsory winding up, may be ordered in cases mentioned in s.433.
- The Court may order a company to be wound up if it is unable to pay its debts.
- The court may also order for the winding up of a company if it is of the opinion that, it is just and equitable that, the company should be wound up.
- The court has the power to cause the assets of the company to be collected and applied in discharge of its liabilities.
- The court is empowered to make call on all or any of the contributories to the extent of their liability.

14.9 Keywords

Committee of Inspection: The court may, at the time of making an order of winding of a company or at any time thereafter, direct that there shall be appointed a committee of inspection to act with the liquidator.

Notes

***Members' Voluntary Winding up*:** Members' Voluntary winding up is possible only when the company is solvent and is able to pay its liabilities in full.

Voluntary Winding up: Winding up by the creditors or members without any intervention of the court is called 'voluntary winding up'.

Winding up: Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members.

14.10 Review Questions

1. What is winding up?
2. Define the term 'contributory.' Discuss the liability of members of a company in the event of its being wound up.
3. State the liabilities of contributories as present and past members.
4. Discuss the circumstances in which a company may be wound up by the court.
5. Explain the circumstances in which a company may be wound up by the court on the ground that the company is unable to pay its debts.
6. What are the circumstances in which a company may be wound up on the ground that it is just and equitable to wind it up?
7. State the ground on which the registrar may present a petition for winding up of a company.
8. What is the effect of a winding up order passed by the court?
9. Explain the procedure to wind up a company voluntarily.
10. What are the powers of the court to order winding up subject to its supervision? What are the consequences of such an order?

Answers: Self Assessment

1.	Winding up	2.	'liquidation'
3.	within a year	4.	debts
5.	Wages	6.	(b)
7.	(c)	8.	(d)
9.	(c)	10.	(d)
11.	(c)	12.	True
13.	False	14.	False
15.	True	16.	False

Notes

14.11 Further Readings

Books

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LOVELY PROFESSIONAL UNIVERSITY
Jalandhar-Delhi G.T. Road (NH-1)
Phagwara, Punjab (India)-144411
For Enquiry: +91-1824-521360
Fax.: +91-1824-506111
Email: odl@lpu.co.in

978-93-90164-24-0
9 789390 164240