

NATURE AND MEANING OF CORPORATION

COMPANY – MEANING

The word 'company' is derived from the combination of two Latin words, namely 'com' and 'panis'. The word 'com' means 'together' and 'panis' means 'bread'. Thus initially the word 'company' referred to an association of persons who took their meals together. The merchants in the leisurely past took advantage of these festive gatherings to discuss their business matters. Initially, the word 'Company' did not have strictly technical or legal meaning.

Broadly speaking, the word company connotes two ideas in a legal sense :-

1. The members of the association are so numerous that it cannot aptly be described as a firm or a partnership; and
2. A Member may transfer his interest in the association without the consent of other members. Such an association may be incorporated according to law; thereupon, it becomes a body corporate or what is usually called a corporation with perpetual succession and a common seal. It is then regarded as a legal person separate and distinct from its members.

The word 'company' is somewhat a loose term having different meanings in different contexts. Literally, the word 'company' means a group of persons associated for any common object such as business, trade, charity, sports, research etc. According to the ruling in *Soloman vs. Soloman and Co.* (1897), in common law, a company is a legal person or legal entity separate from, and capable of surviving beyond the lives of, its members. The company is not merely a legal institution. It is rather a legal device for the attainment of any social or economic end and, to a large extent, publicly and socially responsible. It is, therefore, a combined political, social, economic and legal institution. Justice Frankfurter in *Nierbo vs. Bethle Ram Shipping Corporation*, observed that corporate device is one form of associated enterprise. It is an intricate, centralised, economic, administrative structure run by professional managers who hire capital from the investor. In its wider and general sense, the expression 'company' means any association or collection of individuals having some object in common which is required to stamp the individuals animated by a common purpose with the charter of a company and it is –

1. Carrying on of a business, and
2. For the acquisition of gain.

So, company means an association of a number of persons formed for the purpose of some lawful commercial enterprise with a view to gain profits out of it.

In a practical way, a company means a company of certain persons registered under the Companies Act. Two or more persons who are desirous of carrying on Joint Business enterprises, have the choice of either forming a company or a partnership.

Before the inception of company as a device for business enterprise, two modes of coming out business activities were commonly prevalent namely, (1) monopoly, and (2)

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partnership, With the advance of time and impact of industrial revolution during 18th Century, the business activities expanded tremendously bringing about a radical change in the pattern of commercial activities. The monopolistic device involved great risk as it required investment of capital by a single person who in the event of loss, had to bear the entire burden himself. Partnership is a suitable device for a small scale business which can be financed and managed by a small group of partners who take personal interest and there is mutual trust and confidence among them. But where the enterprise requires a rather greater mobilization of capital which the resources of a few person cannot provide, the formation of a company is the only choice. But both these devices were unsuited to large scale business organizations which involved greater mobilization of

capital resources. Therefore, a new device in the form of company has now become the most dominant mode of carrying out business activities. It provides the structural framework for the modern industrial society.

Even for a small scale business, the choice of a company would be better because this is the only form of business organisation which offers the privilege of limiting personal liability for business debts. Accordingly, the company has become the most dominant form of business organisation. Companies abound in the National economy, ranging from the small family or partnership concern to the faceless multinational corporation. They provide the structural framework of the modern industrial society. Corporations are not novelties. They are institutions of very ancient age. But the large partnerships from which the modern business companies evolved appeared on the English scene during the commercial revolution.

The history of Indian Company Law began with the Joint Stock Companies Act of 1850. Since then the cumulative process of amendment and consolidation has brought to us the most comprehensive and complicated piece of legislation i.e., the Companies Act, 1956. But even so it is not exhaustive of all the modes of incorporating business concerns. Organisations for business or commercial purposes can still be incorporated by special acts of Parliament. *For example* : Life Insurance Corporation of India has been incorporated for business in life insurance under the LIC Act of 1956. Institutions so created are better known as corporations. Business firms, or other institutions incorporated under the Companies Act, are known as companies.

The Companies Act is also not exhaustive of the whole of the company law. It only amends and consolidates certain portions of company law. Common law has still a lot of role to play in this field. The duties of the corporate directors and their social responsibilities, which is at present one of the most developing aspects of company law, are still largely governed by the principles of common law.

According to Section 3(1) (i) and (ii) which gives a technical and statutory definition, **'company' means a company formed and registered under this Act, i.e. (Indian Company Act, 1956) or existing company formed and registered under any of the previous company laws.**

Lord Justice Lindley has given a very befitting definition. According to him, "By a company is meant an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who

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contribute it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share".

This definition gives an idea of the incorporated company and has been popularly accepted. According to Graf Evans, "In common law, a company is a 'legal person or legal entity; separate from and capable of surviving beyond the lives of its members.'"

In Halsbury's Law of England the term 'Company' has been defined as "a collection of many individuals united into one body under a special domination, having perpetual succession under an artificial form, and vested by the policy of Law with the capacity of acting in several respects as an individual, particularly of taking and granting property, of contracting obligations, and of suing and being sued of enjoying privileges and immunities in common, and of exercising a variety of political rights, more or less extensive, according to the designs of its institution, or the power upon it, either at the time of its Creation or at any subsequent period of its existence.

According to Justice James, a company means, "an association of persons united for a common object. Such association may be in the form of an ordinary firm or a Hindu

Joint family business or a society registered under the Societies Registration Act or Provident Fund Society, or a Trade Union or company incorporated by Royal Charter or by an Act of parliament or by some Indian Law or it may be a Company incorporated under Act relating to Companies.”

A more comprehensive legal definition of a company giving its main essentials has been given by Haney, “A company is an incorporated association, which is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal.”

Thus, a company may be defined as an association of individuals formed generally for the purpose of some business or undertaking carried on in the name of the association each member having the right of assigning his share to any other person. Subject to the regulation of the company. It can also be said that a company is an incorporated association which is an artificial person, having a separate legal entity. Hence in brief it may be stated that a company is an incorporated association which is an artificial person, having a separate legal entity, with a perpetual succession, a common seal and a common capital comprised of transferable shares and carrying limited liability.

COMPANY – NATURE

A company is an artificial legal person. It does not take its birth like a natural person but is created by the process of law alone. It is invisible, intangible and amoral because it has no body, no soul and no conscience. Still some rights of a natural person have been given to it.

As a rule, a company may acquire and dispose of property, it may enter into contracts, may be fined for the contravention of the provisions of Company Act. So, for most legal purposes a company is a legal person just like a natural person, who has rights and duties at law.

In short, it may be said that a company being an artificial legal person can do every thing

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like a natural person, except of course that, it can not take oath, can not appear in its own person in the court, can not be sent to jail, can not practice a learned profession like law or medicine, nor can it marry or divorce like a natural person.

However, it will be noteworthy here whether company is a citizen or not like a natural person. Article 19 of the constitution of India secures rights giving six fundamental freedoms. Yet, Article 19 does not specify whether these rights are available to juristic persons like incorporated bodies. In *S.T. Corporation of India Ltd. Vs Commercial Tax Officer*¹, the Apex Court held that companies are not citizens within the meaning of Article 19. ‘Citizens’ under Article 19 mean only natural persons having the status of citizenship under the Law.

COMPANY DEFINITION–LEGAL ASSOCIATION

COMPANY AND PARTNERSHIP

A partnership may be distinguished from a company in the following particulars –

1. A company, formed and registered under the companies Act, is a distinct legal entity having its existence distinct from its shareholders (the members constituting it) A partnership, on the other hand, generally called a ‘firm’ has no separate legal existence apart from its partners.
 2. A partnership firm cannot be formed, with more than ten members in the case of banking business & twenty members in case of any other business. A partnership in business for the purpose of gain, of more than 20 persons, is illegal [Sec 11 (2)].
- A company may consist of any number of persons subject to the minimum requirement as 2 in case of a private company and 7 in case of a public company.

The maximum number of members of a private company, however, must not exceed fifty excluding members who are or were in the employment of the company. However, there is no limit of maximum number of persons in case of a public company.

It may be noted here that in the case of a joint family, there is no restriction of number of its members. Even two joint families may carry business for gain in partnership [Sec. 11(3)]. Further that in the case of banking business, a partnership of more than 10 persons is illegal [Sec. 11(1)].

3. A partner can not transfer his share in the partnership without the consent of the other partners; whereas a shareholder can transfer his share intact without the consent of any other person.

4. Each partner is an agent of the firm to make contracts. A shareholder is not an agent of the company.

5. Partners are the agents of the firm, but members of a company are not its agents. Therefore, a partner can dispose of the property and incur liabilities so long as he acts in the course of firm's business. A member of a company has no such power.

6. A company can engage only in such trade, business or other activities that are authorised and permitted under its Memorandum, whereas a partnership can do anything which the partners agree to do.

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7. A company being a legal person' can own and deal with the property that belongs to it in its corporate name, while in case of partnership, it belongs to the partners collectively. In a partnership, the property of the firm is the property of the individual members who are collectively entitled to it. In case of a company the property belongs to the company and not the members.

8. The liability of partners is unlimited. He is liable for the debt of the 'firm' to the extent of his private property as well, whereas the liability of a shareholder in a company is limited to the extent of his unpaid value of shares or guarantee.

9. In the absence of any agreement to the contrary, every partner has an equal right in the conduct of the firm's business. But in case of a company, the right of management vests in few members called the Directors, and the rest of the members do not take any active part in the management of the company, nor do they necessarily know each other. So in short All partners are entitled to take part in the management of the partnership business while in case of a company management is in the hands of few selected persons called the directors.

10. A company has perpetual succession i.e. the death or insolvency of shareholder or all of them does not affect the life of the company. In case of a partnership, the death or insolvency or bankruptcy of a partner has, in law, the effect of dissolving the partnership itself.

11. There are certain obligations imposed upon companies, to comply with, such as, to get its accounts audited, maintenance of certain books of accounts and registers, holding of meetings, the filing of the balance-sheets, returns and other documents, etc. A failure to comply with the statutory obligations under the Act is penalised. In case of partnership, there are no such statutory obligations to be complied with. In short a company is legally bound to have its assets audited annually by a Chartered Accountant whereas the accounts of a partnership firm are audited at the discretion of partners.

12. A company is regulated by the Indian Company Act, 1956, whereas a partnership firm is governed by the provisions of the Indian Partnership Act, 1932.

13. A partnership firm may or may not be registered but in case of a company

registration is must.

14. In case of a partnership, 100% consensus is required for any decision. In case of a company, decision of the majority prevails.

15. The Creditors of a partnership firm are Creditors of individual partners & a decree against the firm can be executed against the partners jointly and severally. But the creditors of a company can proceed only against the company and not against its members.

16. The benefit or secret profit earned, if any by any members of the company does not belong to be company. But if a partner takes advantage of his position as partner of the firm. And consequently earns any secret profit it shall be deemed to be profit of the partnership firm.

17. The partnership firm can be dissolved voluntarily by partners. But the winding up of

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the company can only be done by the process of law, even if all the members of the company want its winding up.

18. The members of the company can enter into or commence competitive business in competition of the company. But the partner cannot enter into or commence any business in competition with that of the firm.

19. A partner cannot contract with his firm of which he is a partner, whereas a member of a company can contract with a company of which he is a shareholder.

20. Restrictions on the powers of a particular partner contained in the partnership agreement shall not avail against outsider, but those contained in the articles of association of a company are effective against the public because articles of association of a company being a public document, one can find out what is contained in them.

21. A company being a creature of law, can only be dissolved as laid down by law, but a partnership firm is the result of an agreement between the partners and therefore it can be dissolved any time by agreement.

Advantages of in Corporation

In fact, a thorough examination of the essential features of a company will make the nature of it clearly understandable which are as follows:

1. Separate Legal Entity : On incorporation under law, a company becomes a separate legal entity entirely distinct from its members. It means the assets of the company are not the assets of the members. Conversely, the assets of the members are not the assets of the company. It has its own name and its own seal, its assets and liabilities are separate and distinct from those of its members. It is capable of owning property, incurring debt, borrowing money, having a bank account, employing people, entering into contracts and suing and being sued separately and independently.

The leading case on the point is *Solomon Vs Solomon & Co. Ltd.*² The brief facts and principles laid down in this classical case are as follows :

Aron Solomon was a prosperous leather merchant and was running a boot business as a sole trader. Afterwards he formed a company and sold the carrying business to it, which was formed by the name of 'Solomon & Co. Ltd. There were seven members as required by law, namely his wife, daughter, four sons and he himself. All members took £ 1 share each, and he himself took £ 20,000 shares of the value of £ 1 each.

The price paid by the company to Mr. Solomon was £ 30,000; but instead of paying him in cash, the company gave 20000 fully paid £ 1 shares and £ 10000 in debentures.

Owing to strikes in the boot trade the company amounted to only £ 6000 out of which to pay the sum of £ 10000 due to Solomon secured by debentures, and a further £ 7,000 due to unsecured creditors. The unsecured creditors claimed that as 'Solomon & Co. Ltd.'

was the same person as 'Solomon', he could not owe money to himself and that they should be paid their £ 7,000 first. *Vanghan Williams, J.*, and the court of Appeal held that the company was mere agent of Solomon and he must indemnify his agent against the losses it had sustained, by paying the £ 7,000 himself; but the House of Lords reversed

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the decision and held that once a company is formed and registered under the Act, it is a separate legal person distinct from its members, and the motives of those who promoted it are irrelevant.

It is to be noted that it is a very famous and popular judgment which was delivered by five judges. While deciding this case, *Lord Halsbury* and *Lord Macnaghten* observed as follows –

'The Act does not say that members of a family should not form a company. The Act does not say that a member should have more than one share. The members need not have an independent mind and will of their own. There is no such thing as balance of power in the constitution of a company. Hence, Solomon forming a company with the members of his family was not an abuse of the companies Act'.

Lord Macnaghten specifically stated that "The company is at law a different person altogether from the subscribers to the memorandum of association; 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 not in law 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."

For further understanding the topic please see one more case law namely *Lee Vs Lee's Air Farming Ltd. (1961), AC 12; (1960) 3A11 ER 420*.

2. Limited Liability : In an incorporated company, the liability of the members of the company is limited to contribution to the assets of the company up to the face value of shares held by him. A member is liable to pay only the uncalled money due on shares held by him when called upon to pay and nothing more, even if liabilities of the company are up to the face value of shares held by him. A member is liable to pay only the uncalled money due on shares held by him when called upon to pay and nothing more, even if liabilities of the company for exceeds its assets. On the other hand, partners of a partnership firm have unlimited liability i.e. if the assets of the firm are not adequate to pay the liabilities of the firm, the creditors can force the partners to make good the deficit from their personal assets. This can not be done in case of a company once the members have paid all their dues towards the shares held by them in the company.

3. Perpetual Succession : A company does not die or cease to exist unless it is specifically wound up or the task for which it was formed has been completed. Membership of a company may keep on changing from time to time but that does not affect life of the company. Death or insolvency of member does not affect the existence of the company.

4. Separate Property : A company is a distinct legal entity. The company's property is its own. A member can not claim to be owner of the company's property during the existence of the company.

5. Transferability of Shares : Shares in a company are freely transferable, subject to certain conditions, as such no shareholder is permanently or necessarily wedded to a company. When a member transfers his shares to another person, the transferee

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steps into the shoes of the transferor and acquires all the rights of the transferor in

respect of those shares. Although, you cannot do it in a private company.

6. Common Seal : A company being an artificial person has no body or any physical presence and as such it can not sign documents for itself. Therefore, it acts through its Board of Directors for carrying out its activities and entering into various agreements. Such contracts must be under the seal of the company. The common seal is the official signature of the company. The name of the company must be engraved on the common seal. Any document not bearing the seal of the company may not be accepted as authentic and may not have any legal force.

7. Capacity to Sue and being Sued : A company can sue or be sued in its own name and distinct from its members.

8. Separate Management : A company is administered and managed by its managerial personnel i.e. the Board of Directors. The shareholders are simply the holders of the shares in the company and need not be necessarily the managers of the company.

9. One Share-one Vote : The principle of voting in a company is one share-one vote i.e. if a person has 10 shares, he has 10 votes in the company. This is in direct contrast to the voting principle of a co-operative society where the "one member one vote" principle applies i.e. irrespective of the number of shares held, one member has only one vote.

There are some other features of the company which are as under :-

1. Right to enter into contracts;
2. Flexibility of investment;
3. Separation of control from the ownership;
4. Entitled to collect money from public;
5. Permanence of capital stability of the company; and
6. Protection to investors Against Loss.

Disadvantages of In Corporation

1. Formality and expense

Incorporation is a very expensive affair. It requires a number of formalities to be complied with both as to the formation and administration of affairs.

2. Company not a citizen

In ***State Trading Corporation of India v. CTO***³, the SC held that a company though a legal person is not a citizen neither under the provisions of the Constitution nor under the Citizenship Act.

A company, though a legal person, is not a citizen. This has been the conclusion of a special bench of the Supreme Court in ***State Trading Corporation of India v. CTO***.⁴

The State Trading Corporation of India is incorporated as a private company under the

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Companies Act, 1956. All the shares are held by the President of India and two secretaries in their official capacities. The question was whether the corporation was a citizen. One of the contentions put forth on behalf of the corporation was that "if the corporate veil is pierced, one sees three persons who are admittedly the citizens of India", and, therefore, the corporation should also be regarded as a citizen.

But it was held that, "neither the provisions of the Constitution, Part II, nor of the Citizenship Act, either confer the right of citizenship on or recognize as citizen, any person other than a natural person. In striking words the Supreme Court observed, "If all the members are citizens of India the company does not become a citizen of India any more than, if all are married the company would not be a married person."

A company can have the benefit of only such fundamental rights as guaranteed to every "person" whether a citizen or not. However, it has a nationality, domicile and residence.

The hardship caused by the above pronouncement was later modified by holding that a citizen shareholder may petition, proceeding on behalf of the company, against violation of his company's fundamental rights.

3. Lifting of the Corporate Veil

As we have already studied once a company is formed and registered as per law, it is a separate legal entity from its members. Further it has been established by the judiciary also that a company is a quite distinct legal personality from the persons who have formed it. House of Lords has also observed it in a very famous case namely *Solomon Vs Solomon and Company Ltd.* But there are certain exceptions to this fundamental principle of separate corporate personality, where the veil is lifted or pierced and the identity of the members is revealed. It means that where the law disregards the corporate entity and pays regard instead to the individual members behind the legal facade due to certain situations or circumstances, it is known as lifting the veil of corporate personality. This simply means that there are circumstances when the members, directors or certain persons can be made personally liable for the debts or acts of the company.

THEORY OF CORPORATE PERSONALITY

Circumstances to lift the corporate veil...

The corporate veil can be lifted either under the

- Statutory provisions or
- Judicial interpretations

The statutory provisions are provided under the Companies Act, 1956. The other circumstances are decided through Judicial interpretations, which are based on facts of each case as per the decisions of the court.

It should be noted here that lifting the corporate veil can be done in two different ways:

1. By keeping the company intact and making the members liable. This happens when the corporate veil is lifted by an express provision in an enactment.

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2. By destroying the company itself as a sham. This happens when the court holds that the corporate device is used as camouflage (Cover).

When can Corporate Veil of a Company be Lifted

For all purposes of law a company is regarded as a separate entity from its shareholders. But sometimes it is sometimes necessary to look at the persons behind the corporate veil. The separate entity of the company is disregarded and the schemes and intentions of the persons behind are exposed to full view which is known as lifting or piercing the corporate veil. This is usually done in the following cases

1) Determination of real character of a company- In times of war, it may become necessary to lift the corporate veil of a company to determine whether the company has an enemy character. In **Daimler Co Ltd. v. Continental Tyre and Rubber Co.**, a company was incorporated in England for the purpose of selling tyres manufactured in Germany by a German company. The German company held the bulk of the shares in the English company and all the directors of the company were Germans, resident in Germany. During the First World War the English company commenced an action to recover a trade debt. And the question was whether the company had become an enemy company and should therefore be barred from maintaining the action.

The House of Lords held that though the company was registered in England it is not a natural person with a mind or conscience. It is neither loyal nor disloyal; neither friend nor enemy. But it would assume an enemy character if the persons in de facto control of the company are residents of an enemy country.

2) **To prevent evasion of taxation-** The separate existence of a company may be disregarded when the only purpose for which it appears to have been formed is the evasion of taxes. In **Sir Dinshaw Maneckjee, Re**, the assessee was a wealthy man enjoying large dividend and interest income. He formed four private companies and agreed with each to hold a block of investment as an agent for it. Income received was credited in the company accounts but company handed the amount to him as pretended loan. Thus he divided his income in four parts to reduce his tax liability. The Court disregarded corporate entity as it was formed only to evade taxes.

In **Bacha F Guzdar v. CIT, Bombay**, the SC rejected the plea of the plaintiff, a member of a tea company, who claimed that the dividend held by her in respect of her shares should be treated as agricultural income (as it was exempted from tax) and not income from manufacture and sale of tea.

3) **Avoidance of welfare legislation-** where it was found that the sole purpose of formation of new company was to use it as a device to reduce the amount to be paid by way of bonus to workmen, the SC pierced its corporate veil. –**The Workmen Employed in Associated Rubber Industries Ltd. v. The Associated Rubber Industries Ltd, Bhavnagar.**

4) **Prevention of Fraud or improper conduct-** In **Gilford Motor Co v. Horne**, H
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was appointed as the managing director of the plaintiff company on the condition that he shall not solicit the customers of the company. He formed a new company which undertook solicitation of plaintiff's customers. The company was restrained by the Court.

5) **Where a corporate façade is really an Agency or Trust-** The separate existence of a company may be ignored when it is being used as an agent or trustee. In **State of UP v. Renusagar Power Co**, it was held that a power generating unit created by a company for its exclusive supply was not regarded as a separate entity for the purpose of excise.

In **Re R.G.Films Ltd.**, an American company produced film in India technically in the name of a British company, 90% of whose share was held by the President of the American company. Board of Trade refused to register the film as the English company acted merely as the agent of the American company.

6) **To punish the real person in Quasi-Criminal cases against the company-**

The Courts have sometimes applied the doctrine of lifting the corporate veil in quasi-criminal cases relating to companies in order to look behind the legal person and punish the real persons who have violated the law.

7) **Under statutory provisions-** The Act sometimes imposes personal liability on persons behind the veil in some instances like, where business is carried on beyond six months after the knowledge that the membership of company has gone below statutory minimum (sec 45) - **Madanlal v. Himatlal**, when contract is made by mis-describing the name of the company (sec 147), when business is carried on only to defraud creditors (sec 542).

Personal liability of promoters and directors

1. Reduction of Membership below the Statutory minimum [Section 45] : If at any time the number of members of a company is reduced, in case of a public company, below seven, or in case of a private company, below two, and the company carries on business for more than six months while the number is so reduced, every continuing member of the company who is aware of the fact, shall be individually liable for the payment of the whole debts of the company contracted

during that time, and may be severally sued therefor [Section 45]. It may be observed, thus, that the law pierces the corporate veil under this section and makes those cloaked behind the company personally liable (inspite of their limited liability otherwise) in addition to the liability of the company as a separate legal person. One thing is notable here that the company still remains intact. The creditor of the company may file a suit against the company. He may also choose to ignore the company and file a suit against the members. Not only that, he may file a suit against any member for the whole obligation.

2. Misdescription of Name [Section 147(4)(c)] : If an officer of a company signs a cheque, bill of exchange, Hundi and promissory note, wherein the name of the company is not mentioned, apart from penal liability, the officer becomes personally liable on those instruments, unless the company duly pays those amounts. The

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object of this provision is that the third parties should be enabled to know that they are dealing with limited liability companies. We must note here that if the company pays those moneys, the officer will not be personally liable. However, penal liability will be attracted⁵.

3. Fraudulent Trading [Section 542] : This happens in the course of winding up of a company. In the winding up proceedings, it appears that certain persons have carried on the business of the company (i) with the intent to defraud the creditors of the company, or (ii) for any fraudulent purpose. Such persons can be made personally liable for all or any of the debts of the company without any limitation as to liability, as the tribunal may direct. An application may be made to the tribunal by the official liquidator or any creditor of the company.

Further Section 542 applies for application made under Section 397 or 398 in the form set out in schedule XI (Section 406). Section 397 deals with oppression and Section 398 deals with mis-management; under these sections an application may be made to the tribunal. The tribunal may declare that any persons who were knowingly parties to the carrying on the business:

- a) With the intent to defraud creditors of the company or any other persons, or
- b) For any fraudulent purpose, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the tribunal may direct.

4. Protection of Revenue : Section 179 of the Income-Tax Act and Section 18 of the Central Sales-Tax Act provide as follows: For any tax assessed on a private company whether before, during or after its liquidation, the directors are personally liable for the payment of such tax. (only required portion of the Section has been commenting here).

In *Re Sir Dinshaw Maneckjee Petti*⁶ case the assessee was a millionaire enjoying huge dividend and interest income. He formed four private companies and transferred his investments in part to each of these companies in exchange of their shares.

Now the companies received the dividend and interest income but they handed back the amount to him as a pretended loan. This way he divided his income in four parts for reducing his tax liability. The court held that “the company was formed by the assessee purely and simply as means of avoiding tax and the company was nothing more than the assessee himself. It did no business, but was created simply as a legal entity to ostensibly receive the dividends and interests and to hand them over to the assessee as pretended loans.” For more details on the topic please see –

i) *Income Tax Commissioner Madras Vs Shree Minakshi Mills, Madurai*⁷

ii) *Juggilal Kamalapat Vs Commissioner of Income Tax, U.P.*⁸

5. Company is formed to escape a legal obligation : Where a company is formed to escape a legal obligation the courts will not recognise such a company because the corporate device can not be used as a mask to escape a legal obligation. The leading case on the point under discussion is *Gilford Motor Co. Vs Horne*, (1933) Ch. 935. This case again was followed in another case namely *Jones Vs Lipman*,

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(1962) 1 WLR 832; (1962) 1 All. E.R. 422.

6. To find out the character of a company : A company is not a citizen but it can have nationality and residence. The birth place of the company, that is to say, the country where it is incorporated is its nationality. As we all are aware about the fact that due to the outbreak of war, a contract becomes void due to the enemy alien. But how do we decide whether a company is an enemy alien or not? We have to look behind the company and find out who are controlling the company. This was decided in *Daimler & Co. Vs Continental Tyre Co. Ltd.*⁹

Hence, it should always be kept in mind that the separate legal personality of the company is the bedrock of the company law. Corporate veil can be lifted only in exceptional circumstances. In case of *Cotton Corporation of India Ltd. Vs G.C. Odusumathd*, (1999) 22 SCL 228 (Kar.) the court observed that lifting of the corporate veil, as a rule, is not permissible in Law. Corporate veil can be lifted only if there are clear words for this purpose in a statute or there are demanding or compelling reasons.

THE RELATIONSHIP BETWEEN A HOLDING & SUBSIDIARY COMPANY

When businesses grow and become more complex, they often choose to own subsidiary companies. A holding company is a parent company that has control over a subsidiary company. A subsidiary company may be for-profit or nonprofit. The parent-subsidiary relationship has various legal and financial implications for both companies.

Introduction

Section 4 of the Companies Act, 1956 (the Act) prescribes dual test and conceptually defines the Holding-Subsidiary company relationship. This is a special provision extending the provisions of the Act to intra-company relationships. Two significant factors which determine the relationships are control and ownership. The business conduct of such companies are regulated in certain respects and the effect of such regulations will result in treating another company as a Subsidiary of the Holding company. With the result, the provisions of the Act applicable to a public company will also apply to the subsidiary private company. However, the character of private remains unchanged.

Board Control

The most common form of control in the case of bodies corporate is controlling the composition of the Board without being a member of the company. This may happen by direct control of the Board or through one or more Subsidiaries. Be that as it may, the Board occupies a pre-eminent position in the corporate hierarchy from the point of the view of enormous power it exercises and control it secures over the management of another company. It is not merely an economic unit but a power house. Considering these and other factors, the Act rightly recognizes the structure of the Board as a manifestation of its inherent strength and standing in the corporate structure.

Section 4 of the Act

The composition of Board of a company is deemed to have been controlled, by another company if, but only if, that other company, without the consent or concurrence of any

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other person, can appoint or remove the holders of all or majority of the directors by

virtue of exercise of some power exercisable by it, at its discretion. Further, the other company shall be deemed to have such a power of appointment

a. if the person thereto cannot be appointed without the exercise of the said power in his favor by the other company

b. that a person's appointment thereto follow necessarily from his appointment as director or manager or to any other office or employment in that other company or

c. that the director-ship is held by an individual nominated by that other company or a Subsidiary thereof.

This is the sum and substance of sub-section (2) of section 4 of the Act. If the conditions specified in the said sub-section are satisfied, then the first mentioned company is deemed to be Subsidiary of the other company by virtue of Board control.

Holding & Subsidiary Company Relationship

The manner of securing Board control is not envisaged as it is a matter relating to business practice. However, this is possible if the Articles of Subsidiary company specifically provide for a power to the other company to nominate all or majority of directors on the board of first mentioned company. The moot question is, can the Articles provide for such a provision if the other company does not hold all or majority of shares.

However, there can be an arrangement between the lender and borrower companies as part of financing under which the lender may nominate all or majority of directors with or without a specific provision in the Articles for the purpose of ensuring proper utilization of funds. This is possibly one of the reasons why section 4 provides for Board control as a means of creating Holding & Subsidiary company relationship. The immediate effect of such an arrangement is that lending company becomes a Holding company by virtue of section 4 of the Act.

Consolidated Balance Sheet

The consolidated balance sheet is the accounting relationship between the holding company and the subsidiary company, showing the combined assets and liabilities of both companies. The consolidated balance sheet shows the financial status of the entire business enterprise, which includes the parent company and all of its subsidiaries.

Stockholding

Holding companies create subsidiaries for various reasons. One common relationship between the holding company and the subsidiary is shareholding. The holding company is typically the primary and sole holder of stocks belonging to the subsidiary company. As the sole stockholder, the holding company makes decisions such as the election and appointment of the board of directors in the subsidiary company. However, the subsidiary company remains an independent and separate entity from the parent company.

Management and Control

The autonomy of a subsidiary company may seem to be only theoretical. Besides the majority stockholding, the holding company controls important business operations of a

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subsidiary. For example, the holding company is in charge of preparing the bylaws that govern the subsidiary, especially on matters of hiring and appointing senior management employees. The subsidiary company may not amend these bylaws on its own without the consent and approval of the sole shareholder — the parent company.

Responsibility

The subsidiary and holding companies are separate legal entities; each may be sued by other companies or may sue others. However, the parent company has the responsibility of acting in the best interest of the subsidiary by making the most favorable decisions that affect the management and financials of the subsidiary company. The holding company may be found guilty in a court, for breach of fiduciary duty, if it does not fulfill its

responsibilities. The holding company and the subsidiary are perceived to be one and the same if the holding company fails to fulfill its fiduciary duties to the subsidiary company. Both companies would share liabilities incurred by either.

IMPORTANT QUESTIONS

Q.1 What do you mean by the 'company'? Differentiate between company and partnership.

Q.2 What are the advantages and disadvantages of incorporation of a company?

Q.3 "An incorporated company is a totally different person or thing or entity from its members-the individuals comprising it." Explain and illustrate.

Q.4 Discuss the notion of corporate personality in the light of the decision given in Solomon vs. Solomon & Co. Ltd.

Q.5 What is a 'Corporate Veil'? Under what circumstances is it lifted or pierced?

Q.6 Define the term 'company' and discuss its characteristics in detail.

Q.7 What is the liability of promoters and directors for fraudulent conduct of business?

Q.8 What is the relationship between a holding & subsidiary company?

Q.9 Explain thesea.

Company not a citizen of India.

b. Theory of corporate personality.

(Footnotes)

1. AIR 1963 SC 1811

2. (1897) A.C. 22

3. (AIR 1963 SC 1811)

4. (AIR 1963 SC 1811)

5. Anantharaman, K.S., Lectures on Company Law and Competition Act, 9th ed., Wadhwa Pub., Nagpur, p.10

6 AIR, Bom. 371

7 AIR (1967) S.C. 819

8 AIR (1969) S.C. 932

UNIT 2

FORMS OF CORPORATE AND NON-CORPORATE ORGANIZATION

Structure

- Study of Selected Lit

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KINDS OF COMPANIES

The companies formed under the law may be classified as follows –

1. Incorporated companies

2. unincorporated companies

1. Companies incorporated by Royal Charter.

2. Companies incorporated by a Special Act of Parliament.

3. Companies registered under the Companies Act, 1956.

a. Companies limited by shares

b. Companies limited by guarantee

c. Unlimited companies.

UNINCORPORATED COMPANY

Unincorporated companies are always regarded as large partnerships as they are constituted by contract. The main characteristics of an incorporated company are (1) transferability of shares; (2) continuity notwithstanding death or bankruptcy of members; and (3) the

vesting of management in the select body of directors to the exclusion of the members. Though an unincorporated company resembles a registered company in these three aspects but as regards the liability of its members, it is unlimited, that is, held liable to the fullest extent as in case of a partnership.

Incorporated Companies

An incorporated company is corporation formed for the purpose of carrying on the business for profit. To understand properly incorporated companies further be subdivided into these below written three categories :

1. Companies Incorporated by Royal Charter : A company incorporated by a Royal Charter has an unrestricted corporate capacity as an ordinary person, though, there may be a direction in the creating charter in limitation of the corporate powers. However, such direction, though it may give the Crown a right to annul the charter, can not derogate from the plenary capacity with which the common law endows the company in spite of the limitation being an essential part of the so-called bargain between the crown and the corporation. This feature of a chartered company is in marked contrast to the strict delimitation by the legislature and the courts of the registered company to its defined objects.

For example, such companies are the East India Company incorporated under the charter of Queen Elizabeth on 31st December 1600 and the Peninsular and Oriental Steam Navigation Company incorporated in 1840.

2. Companies Incorporated by a Special Act of the Parliament : Such companies are formed by statutes and are therefore statutory companies. Companies in relation to railways, electric and tramway generally come under this type of company.

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There is one main point of distinction between such a company and a company mentioned in section 3 of the Indian Company Act, 1956. Companies incorporated by a special Act of the legislature are mostly invested with compulsory powers whereas in a company under the Act, the directors have always discretion in regard to the use of powers conferred on them by the memorandum and Articles of company.

Note : It is to be noted here that the distinction between a company incorporated by an Act of Parliament and one incorporated under a Royal charter is that the former can do such acts only as are authorised by the statute creating it; the latter, speaking generally, do every thing that an ordinary individual company can do.

3. Companies Registered under the Companies Act : Sec. 12(2) of the Indian Companies Act, 1956 provides for the registration of three classes of company. These are –

- a. Companies limited by shares
- b. Companies limited by guarantee
- c. Unlimited companies.

In the first two categories, companies may be either private company or public company:

1. Companies Limited by Shares : These are the companies which have the liability of their members limited by the Memorandum to the amount, if any, unpaid on the shares held by them. The main feature of these companies is the limited liability of the shareholders, i.e. the liability of a member, in the event of company being wound up, is limited to the extent of the amount that remains unpaid on shares held by them. The companies belonging to this class are, by far, the largest in numbers in India.

2. Companies Limited by Guarantee : A company limited by guarantee may also be called a guarantee company. It is a company wherein the liability of its members

extends to the amount undertaken to be contributed by each of them towards the assets of the company in the event its being wound up as stated in the memorandum of Association of the Company. The liability will arise only in the event of company being wound up & not otherwise.

A guarantee company may or may not have a share capital. In case it has a share capital, the liability of the members will also extend to the amount remaining unpaid on their share in addition to the guarantee amount. The voting power of a guarantee company having share capital is determined by the shareholding of the members. However, in case of a guarantee company not having share capital, every member has only one vote.

The companies under the first two categories, namely, companies limited by shares and companies limited by guarantee, may be either private or public companies. In a company limited by guarantee, the liability of the share holders to contribute to the assets of the company, in the event of a company being wound up, is limited by the memorandum of Association. The extent, to which the shareholders are liable

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to contribute, is the amount to which the shareholders have agreed to guarantee. In this category of companies, if the company has a share capital, the shareholders are liable to pay the amount which remains unpaid on their shares plus an amount payable under the guarantee. Such liability arises, because a guarantee is a promise to pay.

3. Unlimited Companies : In this class of companies the liability of shareholders depends upon the debts incurred by the company. There is no limit to liability and the shareholders are fully liable for all the debts of the company, how high soever it may be. [Sec. 12(2)C]

While discussing registered companies above it has already shown by the diagram that companies 'limited by shares' and companies 'limited by guarantee' may further be divided into 'private' and 'public' companies. Now we shall discuss here what private and public companies along with others are:

Public Company : As per Section 3(1)(iv), a public company means a company which—

- a) is not a private company,
- b) has a minimum paid up capital of Rs. 5 lakhs or such higher paid up capital, as may be prescribed,
- c) is a private company which is a subsidiary of a company which is not a private company.

Note : The requirement as to minimum paid up capital does not apply to a company registered under section 25 (licensed companies)

Private Company : According to Section 3 (1) (iii) of the companies Act. 1956 'Private Company' 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 :-

- a. Restricts the right to transfer its shares, if any;
- b. Limits the number of its members to fifty not including :-
 - i. Persons who are in the employment of the company, and
 - ii. Persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after employment ceases; and
- c. Prohibits an invitation to the public to subscribe any shares in or debentures of the company.
- d. Prohibits any invitation or acceptance of deposits from persons other than its

members, directors or their relatives.

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 members.

So in short according to Section 3, private company means a company which, by its Article of Association—

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- a) Restricts the right to transfer its shares, if any;
- b) Limits the number of its members to fifty excluding employee and ex-employee members;
- c) Prohibits an invitation to the public to subscribe to any shares in or debentures of the company.

Every public company, existing on the commencement of the companies (Amendment) Act, 2000; with paid up capital of less than five lakh rupees shall within a period of two years from such commencement enhance its paid up capital to five lakh rupees.

Thus a public Company may be said to be an association consisting of not less than seven members, which is registered under the companies Act, and which is not a private company within the meaning of the act. The shares and debentures of a public company may be listed on a stock exchange and are offered to public for sale.

PRIVILEGES AND EXEMPTIONS OF A PRIVATE COMPANY

The Act confers certain privileges on private companies. Such companies are also exempted from complying with some of the provisions of the companies Act. The reason for these privileges and exemptions is that private companies being restrained from inviting capital from public, not much public interest is involved in these companies. A private company shall however lose the privileges and exemptions as soon as it ceases to be a private company by choice or by operation of law. But a private company which is or becomes the subsidiary of a public limited company. Shall continue to avail of the privileges and concessions uninterrupted.

The privileges and exemption available to a private company are in fact nothing but its advantages over a public company. If a private company contravenes any of the aforesaid three provisions, it ceases to be private company and loses all the exemptions and privileges to which a private company is entitled as per law. Following are some of the privileges and exemptions of a private limited company—

1. According to section 12 (1) only two members are sufficient to form a private company.
2. The provisions of section 69 as to minimum subscription do not apply to a private company. It can therefore commence allotment of shares irrespective of the number of shares subscribed. It provides under section 149 (7) (a)
3. According to section 70, since a private company is restrained from inviting capital from the public. It is not required to file a prospectus or statement in lieu of prospectus to the public.
4. According to section 81. It need not offer preference shares to the existing share holders.
5. According to section 149, it may commence business immediately after incorporation.
6. According to section 165, A private company is not required to call a statutory meeting or file a statutory report.

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7. According to section 90 (2) it is free to issue any kind of shares and allow disproportionate voting rights to its shareholders.
8. Section 252 of the Act provides that a private company may have only two

minimum number of directors.

9. According to sections 263 and 264 and 266 a private company may appoint two or more directors by a single resolution and the directors need not file their consent to act or take up qualification shares prior to their appointment.

10. A special notice of 14 days as required by section 257 (i) of the act for appointment of new directors is not necessary in case of a private company provided it is not a subsidiary of a public company.

11. Section 300 of the act provides that the directors can freely vote on matters relating to contracts in which they have an interest.

12. Even one or two members may demand a poll in case of a private company under section 179.

13. Section 220 of the Act provides that the copies of profit and loss account filed by a private company with the registrar are not open to inspection by non-members.

14. According to section 255 the directors of a private company need not retire by rotation, and the restrictions on appointment or advertisement of directors as contained in section 266 do not apply to a private company.

15. According to section 309 there are no restrictions on the appointment or reappointment of managing director and also there is no maximum limit for managerial remuneration in a private company.

It must, however, be noted that many of the concessions listed above are not available to private companies which are subsidiaries of public companies.

A company which is purely a private company i.e. not a subsidiary of a public limited company or not a deemed public company under section 43 A of the Act, is exempt from certain provisions of the Act. The following lists of provision are as under :-

1. Section 70 provides for statement in lieu of prospects.
2. Section 77 (2) provides for financial assistance.
3. Section 81 provides for increase of capital.
4. Share Capital and voting rights provides under sections 85 to 90.
5. Section 111 A talks about rectification of register on transfer.
6. Section 149 provides for commencement of business.
7. Section 165 provides for statutory meeting.
8. Section 170 to 186 provides provisions as to General Meetings.
9. Section 198 provides for managerial remuneration.
10. Section 204 provides appointment of firms or body corporate.

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11. Restriction on disclosure of profit and loss account provides under section 220.

12. Section 252 provides the number of directors.

13. Section 255 and 256 provides for rotational retirement of directors.

14. Section 257 provides notice for election as director.

15. Section 259 provides increasing number of directors.

16. Section 261 talks about the holding place of profit.

17. Sections 262 to 264 provides for filling of casual vacancies voting and filing of consent.

18. Section 266 provides restriction on appointment or advertisement of directors,

19. Sections 268 and 269 provides for appointment of managing, whole-time director.

20. Sections 270 to 273 provides for qualification shares.

21. Section 274 provides disqualification for appointment of directors.

22. Sections 275 to 279 provides restriction on number of directorship.

23. Section 283 provides provision for vacation of office.

24. Section 293 provides restriction on powers of directors.
25. Section 295 provides for loans to directors.
26. Section 300 provides for interested directors.
27. Section 303 (i) provides for date of birth of director.
28. Sections 309 to 311 provides remuneration of Managing, whole time director.
29. Sections 316 and 317 provides numbers of managing directorship, term of appointment.
30. Sections 349 and 350 provides determination of net profits for remuneration.
31. Sections 386 and 388 provides restrictions as to managers.
32. Section 409 provides power to prevent changes in Board.
33. Section 416 provides for company an undisclosed principal.

These are the provisions of the Act relating to the privileges and exemptions available to a private company.

1. Prohibition of allotment of the shares or debentures in certain cases unless statement in lieu of prospectus has been delivered to the Registrar of companies does not apply.
2. Restriction contained in Section 81 related to the rights issues of share capital does not apply. A special resolution to issue shares to non-members is not required in case of a private company.

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3. Restriction contained in Section 149 on commencement of business by a company does not apply. A private company does not need a separate certificate of commencement of business.
4. Provisions of Section 165, relating to statutory meeting and submission of statutory report do not apply.
5. In case of a private company which is not a subsidiary of a public limited company or in case of a private company of which the entire paid up share capital is held by one or more bodies corporate incorporated outside India, no person other than the members of the company concerned shall be entitled to inspect or obtain the copies of profit and loss account of that company.
6. Minimum number of directors is only two in case of a private company in contrast with a public limited company where minimum three directors are required.

Distinction between Public and Private Company

It is desirable here to mention the main differences between a public and a private company. These are as under–

1. The minimum number of persons required to form a public company is seven whereas only two or more persons may form a private company. (Section 12)
2. The maximum number of members in case of a public company is not fixed whereas in case of a private company the number of members is limited to fifty. [Section 3(1)(iii)(b)]
3. There is no restriction of transfer of shares in case of a public company, but a private company having a share capital must have in its article, restrictions on the rights of transfer. (Section 27(3))
4. A public company extends its invitation to public to subscribe to shares whereas a private company cannot extend such invitation to the public.
5. Every public company and every private company which is a subsidiary of a public company shall have at least three Directors whereas every private company which is not a subsidiary of a public company shall have at least two Directors [Section 252].
6. A public company, on the application for registration of the Memorandum and the

Articles of the company, should file with the Registrar a list of the persons who have consented to be directors of the company whereas it is not required in case of a private company. [Section 266(4) and (5)(b)].

7. A public company is required to hold a statutory meeting within a fixed time period after the commencement of its business and to forward statutory report to the members and to file it with the Registrar whereas it is not required in case of a private company [Section 165].

Companies Deemed to be Public Limited Company : A private company will be treated as a deemed public limited company in any of the following circumstances :

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1. Where at least 25% of the paid up share capital of a private company is held by one or more bodies corporate, the private company shall automatically become the public company on and from the date on which the aforesaid percentage is so held.
2. Where the annual average turnover of the private company during the period of three consecutive financial years is not less than Rs. 25 crores, the private company shall be, irrespective of its paid up share capital, become a deemed public company.
3. Where not less than 25% of the paid up capital of a public company limited is held by the private company, then the private company shall become a public company on and from the date on which the aforesaid percentage is so held.
4. Where a private company accepts, deposits after the invitation is made by advertisement or renews deposits from the public (other than from its members or directors or their relatives), such companies shall become public company on and from date such acceptance or renewal is first made.

Producer companies

A 'producer company' in accordance with section 581C (1) of the Companies Act 1956, is a company where there are ten or more individuals, and each of them is a producer in any two or more producer institutions.

It can also be combination of ten or more individuals or producer institutions. These individuals and institutions should be desirous of performing the function of a producer company. The objects of the producer company should be specified under Sec. 581B of the Companies Act of 1956. It should also comply with the other provisions of the Companies Act of 1956.

Unregistered Company

Unregistered Company is not a defined term in the Companies Act, 1956, but Section 582 of the said act describes the expression Unregistered Company as below:

An unregistered company is a company which is not registered or covered under provisions of Companies Act. 1956 (582)

It shall include any partnership, association or company consisting of more than seven members at the time when the petition for winding up the partnership, association or company, as the case may be, is presented before the Court.

It shall not include -

1. A railway company incorporated by any Act of Parliament or other Indian law or any Act of Parliament of the United Kingdom ;
2. An illegal association formed against the provisions of the Act ;
3. A company registered under this Act ; or
4. A company registered under any previous companies law and not being a company the registered office whereof was in Burma, Aden or Pakistan immediately before the separation of that country from India.

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Section 25 Companies

Under the Companies Act, 1956, the name of a public limited company must end with the word 'limited' and the name of a private limited company must end with the words 'Private Limited'. However, under section 25, the Central Government may allow companies to remove the word "Limited/Private Limited" from the name if the following conditions are satisfied–

1. The company is formed for promoting Commerce, Science, Art, religion, charity, or other socially useful objects.
2. The company does not intend to pay dividend to its members but apply its profits and other income in promotion of its objects.

Government Companies

Government companies means any company in which not less than 51% of the paid up share capital is held by the central government or any state government 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 also governed by the provisions of the Companies Act. However, the central government may direct that certain provisions of the Companies Act shall not apply or shall apply only with such exceptions, modifications or adoptions as may be specified to such government companies.

Foreign Companies

Foreign companies means a company incorporated in a country outside India under the law of that other country and has established the place of business in India. (Section 591 to 597 and 584).

Holding and Subsidiary Companies : 'Holding Company' and 'Subsidiary Company' are relative terms. Where two companies are under such terms that one control the other, then the controlling company is called the 'Holding Company' and the company which is controlled is called the 'Subsidiary Company'.

Section 4 of the Indian Companies Act, 1956, provides that a 'Holding Company' is one which–

1. Controls the composition of the Board of Directors of another company.
2. Where that another company is an existing company, in respect of which the holders of preference shares issued before the commencement of the companies Act of 1956 have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company or
3. Where that another company is any other company, holds more than half in nominal value of its equity share capital.

If any one of the above conditions are satisfied, then the former is the holding company of which the latter is treated as a subsidiary company.

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Insurance Company

A company that offers insurance policies to the public, either by selling directly to an individual or through another source such as an employee's benefit plan. An insurance company is usually comprised of multiple insurance agents. An insurance company can specialize in one type of insurance, such as life insurance, health insurance, or auto insurance, or offer multiple types of insurance.

Banking Company

As per Section 5(c) of the Banking Regulation Act, 1949, a banking company is defined as any company which transacts the business of banking in India.

Banking is defined in Section 5(b) as the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and

withdrawable by cheque, draft, order or otherwise.

The Banking Regulation Act takes care to also specify which Companies are *not* banking companies. In the illustration to the Section, it states that Companies engaged in the manufacture of goods or carrying on any trade and which accept deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause.

Multinational Company

A multinational corporation (MNC) or multinational enterprise (MNE) is a corporation that is registered in more than one country or that has operations in more than one country. It is a large corporation which both produces and sells goods or services in various countries. It can also be referred to as an international corporation.

They play an important role in globalization. Arguably, the first multinational business organization is conjectured to be the Knights Templar, founded in 1120. After that came the British East India Company in 1600 and then the Dutch East India Company, founded March 20, 1602, which would become the largest company in the world for nearly 200 years.

NEED OF COMPANY

FORMATION AND INCORPORATION OF A COMPANY

The formation of a company is a very lengthy process indeed. To form a company the very first stage is that of 'Promotion'. Promotion refers to the entire process by which a company is brought into existence. It starts with the conceptualisation of the birth of a company and determination of the purpose for which it is to be formed.

The persons who conceive the idea of forming a company and invest the initial funds are known as the promoters of the company. Although there is no statutory definition of a promoter, this term is used expressly in section 62, 69, 76, 478 and 519. In the words of Bowen, L.J., "The term promoter is a term not of Law but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence." The promoters enter into preliminary contracts with vendors and make arrangements for the preparation, advertisement and

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the circulation of prospectus and placement of capital. However, a person who merely acts in his professional capacity on behalf of the promoter (e.g. lawyer, C.A., etc.) documents or prepares the figures on behalf of the promoter and who is paid by the promoter is not a promoter.

A promoter may be an individual, a firm, an association of persons or even a company. As far as the legal position of a promoter is concerned, a promoter is neither a trustee nor an agent of the company which he promotes because there is no trust or principal in existence at the time of his efforts. But certain fiduciary duties, like an agent, have been imposed on him under the companies Act. As such he is said to be in a fiduciary position (a position full of Trust and confidence) towards the company.

So, these are the persons who took the pains to form and incorporate the desired company. In order to form a company one should usually take five steps, namely:

- 1.** Preparation of Memorandum of Association;
- 2.** Preparation of Articles of Association;
- 3.** Preliminary Contracts, if any;
- 4.** Registration of Company; &
- 5.** Issue of a prospectus or delivery to the Registrar of a Statement in lieu of prospectus.

Mode of forming Incorporated Company : Under Section 12 of the Indian companies Act, 1956, any seven or more persons in case of a public company and any two or more persons in case of a private company may form an incorporated company for a lawful

purpose—

i) Subscribing their names to a Memorandum of Association; and

ii) Complying with other requirements in respect of registration.

Such incorporated company may be a company, (a) limited by shares, (b) limited by guarantee, or (c) an unlimited company.

Requirements to be gone through before incorporation :

1. Before the incorporation of the company the parties subscribing to the Memorandum of Association must file with the Registrar of companies **a.**

The Memorandum of Association;

b. The Articles of Association (except where table A is adopted as the Articles of the company)

c. The agreement (if any) which the company proposes to enter into with an individual, firm or body corporate, to be appointed its secretaries and treasurers;

d. (except in case of a private company) a list of persons who have consented to be the directors of the company together with the consent in writing of each of such persons to act as such director and pay for his qualification shares.

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e . A declaration under section 33 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 chartered accountant or by any director, manager, or secretary that all the requirements of the Act have been complied with.

2. On the documents mentioned above being filed with the Registrar, the Registrar issues a certificate known as the 'Certificate of Incorporation'. This certificate is, by Section 35 of the Act, made conclusive proof of the fact that all the requirements regarding registration have been complied with. The company is, however, still not entitled to commence its business. Before it can do so, it has, if a public company, to secure a 'certificate of commencement of business' from the Registrar which will be granted by him only after some other legal formalities have been completed.

Pre-incorporation Contracts

Company cannot be sued on Pre-incorporation Contracts : Sometimes contracts are made on behalf of a company even before it is duly incorporated. But no contract can bind a company before it becomes capable of contracting by incorporation. Two consenting parties are necessary to a contract, whereas the company, before incorporation, is a nonentity. A company has no status prior to incorporation. It can have no income before incorporation for tax purposes. Shares cannot be acquired in the name of a company before its incorporation. A transfer form is liable to be rejected where the name of a proposed company is entered in the column of transferee. In *English and Colonial Produce Co.*⁴, a solicitor, on the instructions of certain gentlemen, prepared the necessary documents and obtained the registration of a company. He paid the registration fee and incurred the incidental expenses of registration. But the company was held not bound to pay for those services and expenses. The company could not be sued in law for those expenses, in as much as it was not in existence at the time when the expenses were incurred and ratification was impossible. It is not desirable to saddle the corporation with burdens imposed upon it in advance by overly optimistic promoters.

Company cannot Sue on Pre-incorporation Contract

A company is not entitled to sue on a pre-incorporation contract. A company cannot by adoption or ratification obtain the benefit of a contract purporting to have been made on its behalf before the company came into existence. This was held in *Natal Land & Colonisation Co. vs. Pauline Colliery Syndicate*⁵. N. Co. entered into an agreement with

one C, who acted on behalf of a proposed syndicate. Under the agreement N. Co. was to give the syndicate a lease of coal mining rights. The syndicate was then registered and struck a seam of coal and claimed a lease which N. Co. refused. An action by the syndicate for specific performance of the agreement or in the alternative for damages was held not maintainable as the syndicate was not in existence when the contract was signed.

Ratification of Pre-incorporation Contract

So far as the company is concerned, it is neither bound by, nor can have the benefit of, a pre-incorporation contract. But this is subject to the provisions of the Specific Relief Act, 1963. Section-15 of the Act provides that where the promoters of a company have made a contract before its incorporation for the purposes of the company, and if the contract is

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warranted by the terms of incorporation, the company may adopt and enforce it. Warranted by the terms of incorporation means within the scope of the company's objects as stated in the memorandum. The contract should be for the purposes of the company. A person, who intended to promote a company, acquired a leasehold interest for it. He held it for sometime for a partnership firm, converted the firm into a company which adopted the lease. The lessor was held bound to the company under the lease.

In *Jai Narain Parasrampuriah vs. Pushpa Devi Saraf*, the Supreme Court held that the company has to accept the transaction but it is not necessary that the transaction should be mentioned in the company's articles. The very fact that the company was seeking a declaration of its ownership of the property which the directors had purchased for it before incorporation was sufficient to signify acceptance of the transaction.

Section-19 of the same Act provides that the other party can also enforce the contract if the company has adopted it after incorporation and the contract is within the terms of incorporation.

Personal Right and Liability of Contracting Agent

The contracts which do not fall within the purview of the above provisions, the question arises whether they can be enforced by or against the agent who acted on behalf of the projected corporation? The answer will depend upon the construction of the contract. If the contract is made on behalf of a company not yet in existence, the agent might incur personal liability. For, where a contract is made on behalf of a principal known to both the parties to be non-existent the contract is deemed to have been entered into personally by the actual maker. The idea is to protect the new company from the burden of promoters' promises, for they are proverbially profuse in their promises, and if the corporation were to be bound by them it would be subject to many unknown, unjust and heavy obligations.

COMPANY'S CONSTITUTIONAL DOCUMENTS

MEMORANDUM OF ASSOCIATION

The memorandum of association of a company is the most important document as it sets out the constitution of the company. It is in fact the foundation on which the entire structure of the company is based. It prescribes the name of the company, its registered office, objects and capital and also defines the extent of its powers. A company can exercise only such powers which are either expressly stated therein or as may be implied therefrom including matters incidental to the powers so conferred. Memorandum is therefore a document of great importance in relation to the proposed company. It is in fact a charter of the company.

An important step in the formation of a company is to prepare a document called the Memorandum of Association. It is a document of great importance in relation to the proposed company. A Memorandum of Association is the primary document which sets out the constitution of a company and as such, it is really the foundation on which the

structure of the company is based. It is also called the charter of the company. It defines its relation with the outside world and the scope of its activities. In the words of Lord Macmillan, 'Its purpose is to enable shareholders, creditors and those who deal with the company to know what its permitted range of enterprise is'.

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Definition

The preparation of memorandum of Association is the first step in the formation of a company. According to section 2 (28) of the Companies Act, 1956, 'memorandum' means memorandum of association of a company as originally formed or altered from time to time in Pursuance of any Previous companies law or of this Act. This definition, however, does not give an idea as to the nature of this document nor is it indicative of its importance.

The memorandum of association is a document which contains the fundamental conditions upon which alone the company is allowed to be incorporated. It defines the power or scope of the activities of the company. It lays down the object of the company and the company cannot exceed the objects even if every member agrees. Thus, a company cannot legally do any act which is not authorized by its memorandum of association. According to Lord Cairns, the memorandum is the area beyond which the action of the company cannot go. If an act of a company exceeds the objects fixed by its memorandum, the act is Ultra vires and therefore. Void.

The memorandum of a company regulates its relations with the outside world. It enables the outsiders dealing with the company to know the objects, powers and capital, etc. of the company. Thus, the memorandum and articles constitute the title-deeds of the company but the memorandum is more important document than the articles of association and, therefore, the memorandum overrides the articles in Conflicting matters contained in both documents.

Since the memorandum lays down the conditions upon which a company is incorporated, the law does not allow it to be altered except in the cases in the mode & to the extent provided by the Act.

In Short, the Memorandum of Association is the Charter of the Company, indicating the permitted range of its enterprise. It enables the outside World, the Shareholders, the creditors and others who deal with the company to know about certain vital aspects about the company with which they are dealing.

A statutory definition of the term has been provided under section 2(28) of the Company but this definition does not throw any light on the scope, use and importance of the memorandum in a company. Hence, it is desirable to mention another definition to make it clear, which has been observed in a very famous case by the court.

In a leading case of Ashbury Railway Carriage Co. Vs Richey, Lord Cairns as far back as in 1875 observed that "The memorandum of association of a company is its charter and defines the limitation of the powers of a company. The Memorandum contains the fundamental conditions upon which alone the company is allowed to be incorporated." So, it may be summed up that memorandum of Association is a life giving document of a company.

Purpose of Memorandum

The memorandum of a company serves two main purposes. Firstly, the prospective shareholders can know the field in which their funds are going to be used by the company and the purpose of the enterprise so that they can contemplate the risk involved in their

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investment. Secondly, the Outsiders dealing with the company can know exactly the

objects of the company and whether the contractual relation which they intend to enter into with the company is within the objects of the company.

A Company can exercise only such Powers which are either expressly stated in the memorandum or as may be implied there from including matters incidental to the powers so conferred. In short, it determines the extent of the powers of a company. A company must act within and not outside the scope of its memorandum. Any transaction which is not within the ambit of the powers of a company shall be ultra vires and void and cannot be validated on any ground. It is for this reason that a company while drafting its memorandum should exercise utmost care and ensure that its scope is wide enough to include all activities in which the company may engage are well within its range of activities.

Contents of the Memorandum: Section 13 prescribes the fundamental clauses which the memorandum of every company incorporated under the Act must contain. These are:

1. Name Clause : A company, being a legal person, must have a name to establish its identity. The promoters have to seek an advanced approval of the name and once an advance approval is granted to a particular applicant, the Registrar will not make that name available to any other person. A company by registering its name gains a monopoly of the use of that name. The name of a company is a part of its business reputation and that would definitely be injured if a new company could adopt an allied name. The name of the company is mentioned in the name clause. A public limited company must end with the word 'Limited' and a private limited company must end with the words 'Private Limited'. One is free to choose any name for the purpose but the company can not have the name which in the opinion of the Central Government is undesirable. A name which is identical with or nearly resembles the name of another company in existence will not be allowed. A company cannot also use a name which is prohibited under the names & emblems (Prevention of Misuse Act, 1950) or use a name suggestive of connection of government or state patronage. It is suggested that the word, 'corporation' should be used by companies with authorised capital of Rs.5 crores. The words like international, globe universal, continental, inter continental, Asiatic, Asia etc. as the first word of the name, must have an authorised capital Rs.1 crore and if used within the name, Rs.50 lacs. For the same reason it is further required that such name of the company must be painted on the outside of every place where the business of the company will be carried on.

So, the memorandum must state the name of the company. No company shall be registered by a name which, in the opinion of the Central Government, is undesirable. For instance, a name which is identical with, or too nearly resembles, the name by which a company in existence has been previously registered, is deemed to be undesirable.

Use of the Words 'Limited'/'Private Limited' : It is necessary that the word "Limited" must be mentioned as the last word of the name in the case of a public limited company and the word "Private Limited" must be the last words of the name in the case of a private limited company. The words "Limited" or "Private

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Limited" are to be used where the liability of the members of the company is limited, and the name of the company itself gives an indication to that effect. An "Unlimited company", i.e., a company not having any limit on the liability of its members, is not required to use "Limited" or "Private Limited" as the last words of its name.

Publication of Name by Company (Section 147) : Every company is required to

paint or affix its name (and the address of its registered office), outside every office or place in which its business is carried on, shall have its name engraved in legible characters on its seal, and shall have its name (and address of its registered office) mentioned in all its business letters and other documents. The company and its officers who make a default in fulfilling this duty are subject to punishment.⁸

Licence to Drop the Words 'Limited'/'Private Limited' (Section 25) : In the following exceptional cases, the Central Government may authorise a limited company not to use the words "Limited" or "Private Limited" at the end of its name—

- a) When the company is being formed for promoting commerce, art, science, religion, charity or any other useful object, and
- b) It intends to apply its profits, if any, or other income in promoting its objects, and to prohibit the payment of any dividend to its members.⁹

2. Registered Office Clause: It is also known as the domicile clause. The state in which the registered office of the company is to be situated is mentioned in this clause. If it is not possible to state the exact location of the registered office, the company must state to provide the exact address either on the day on which it commences to carry on its business or within 30 days from the date of incorporation of the company, whichever is earlier. Notice in form 18 must be given to the Registrar of companies within 30 days of the date of incorporation of the company. The registered office of the company is the official address of the company where the statutory books and records must normally be kept. Every company must affix or paint its name and address of its registered office on the outside of every office or place at which its activities are carried on. The name must be written in one of the local languages and in English. This clause of the memorandum must specify the state in which the registered office of the company is to be situated. All communication to the company must be addressed to its registered office. A company can shift its registered office from one place to another within the same city, town or village.

Shifting of the registered office from one state to another is a complicated affair because it involves alteration of the memorandum itself.

So, the Memorandum of every company must also mention the State in which the registered office of the company is to be situated.

Every company should have registered office, as from the day of commencement of its business, or within 30 days of its incorporation, whichever date is earlier, to which all communications and notices may be addressed.

Notice of Situation/Change in Registered Office: Notice of the situation of
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registered office, and of this record within 30 days after the date of the incorporation of the company or after the date of the change, as the case may be.¹⁰

A new Section 17A has been inserted by the Companies (Amendment) Act, 2000 providing for change in the registered office within a State. When the registered office of a company is changed from one place to another within the same State, the change is required to be confirmed by the Regional Director.

3. Object Clause : This clause is the most important clause of the company. It specifies the activities which a company can carry on and which activities it can not carry on. The company can not carry on any activity which is not authorised by its Memorandum. The memorandum must state the objects for which the proposed company is to be established. Choice of objects lies with the subscribers to the memorandum and their freedom in this respect is almost unrestricted. The only obvious restrictions are that the objects should not go against the law of the land

and the provision of the company's Act i.e. law prohibited gambling. Obviously, no company can be incorporated for that purpose. The ownership of the corporate capital is vested in the company itself. The statement of objects, therefore, gives a very important protection to the shareholders by ensuring that the funds raised for one undertaking are not going to be risked in another. The creditors of a company trust the corporation and not the shareholders and they have to seek their repayment only out of the company's assets. By confining the corporate activities within a defined field, the statement of objects serves the public interest also. It prevents diversification of a company's activities in directions not closely connected with the business for which the company may have been initially established. It also prevents concentration of economic power. This clause must specify –

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

It has already been noted that the Memorandum is to contain the main objects and the objects incidental or ancillary thereto, as well as other objects. Sometimes companies try to circumvent the ultra vires rule by incorporating numerous clauses in the Memorandum specifying a large number of "objects", some of them not having even a remote relation with the main objects of the company. This defeats the very purpose of the objects clause. The acts which are neither covered under the main objects, nor are incidental or ancillary thereto, are declared by the courts as ultra vires. Thus, when the County Council had been empowered to run tramways, the act of running omnibus to feed the tramways was held to be ultra vires as it was not fairly incidental to the main object. But when the company acquired land for the purpose of railway, and the railway was erected on arches, the letting of the arches as work-shops, etc. was held to be fairly incidental to the powers of the company, and thus valid.

In *Lakshmanaswami v. L.I.C.*,¹¹ shortly before the business of a Life Insurance Company was taken over by the L.I.C., at the extraordinary General Meeting of the shareholders a resolution was passed sanctioning a donation of Rs. 2 lakhs out

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of shareholders' Dividend Account to a certain memorial trust. No dividend was declared for the shareholders for that year. The objects of the trust, to whom the donation was made, included the promotion of art, science, industrial, technical or business knowledge including knowledge in banking, insurance, commerce and industry. On taking over the said insurance company in 1956, the L.I.C. challenged the vires of the said donation. It was held that the fact the trustees had no obligation to utilise the amount for promoting education in insurance, and even if that was done, there was very little chance of the insurance company gaining an advantage therefrom, and thus, the business for which the donation was made was too indirect to be regarded as incidental or naturally conducive to the objects of the donor company. The L.I.C. was, therefore, held entitled to demand the amount from the trustees.

In *Evans v. Brunner*,¹² the main object of the company was to carry on the business as chemical manufacturers, and it was held that the amount spent on scientific research was fairly incidental to that object. Similarly, when a company having the business of supplying boats for a ferry, employed the surplus boats, itself in excursions, or a hotel company temporarily let off a part of the premises, not required for its business at any particular time, the transactions were held to be intra vires, and valid.

Powers of the Company : A company may mention various acts which are within the power of the company, in addition to the stating of its objects in the Memorandum. For instance, it may be stated to be having the power to acquire similar business, power to dispose of the property of the company, power to give some benefits to its employees or their dependents like gratuity, pension, etc.

The power of the company to do various acts is, of course, to be exercised only for intra vires purposes. Thus, if a company had the power to borrow money, the borrowing of the money for pig-breeding, a purpose which was ultra vires, was also held to be ultra vires.

To circumvent the “main objects” rule of construction some companies incorporate a large number of objects in the Memorandum. So that none of these objects is considered to be ultra vires, it is also sometimes stated that all the objects are independent main objects. It, however, depends in each case whether the main objects rule gets excluded by declaring all the objects as independent main objects. In *Cotman v. Brougham*,¹³ subscription for the shares of other companies was stated to be one of the objects of a rubber company. Each of the objects was stated to be separate and independent main object of the company. The rubber company subscribed to the shares of an oil company. It was held that subscription to the shares of the other company was not ultra vires in this case. In *Re Introductions Ltd. v. National Provincial Bank Ltd.*¹⁴, on the other hand, a company whose sole business, which was pig-breeding, was ultra vires had also amongst its objects the borrowing of money. The company borrowed money from a bank for its ultra vires business. It was held that although borrowing money was within the objects of the company that was subject to the condition that the borrowing is for an intra vires purpose. In this case the borrowing was held to be

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ultra vires.

When the Main Objects cannot be Carried Out : Every company is formed for certain objects and the money of the shareholders and others is invested in it only for such objects. When the company cannot carry out the objects for which the company was formed, i.e., its substratum is gone, it has to be wound up. In *German Date Coffee Co. Ltd.*¹⁵, a company was formed for purchasing and working a German patent for manufacturing coffee from dates. The German Government did not grant the patent. It was held that since the achievement of the main object of the company had become impracticable, its substratum had gone and the company was to be wound up.

Action by the Company on an Ultra Vires Contract : It has been noted above that a company cannot be made liable in respect of ultra vires contracts. Regarding the question, whether a third party can be made liable in respect of an ultra vires contract with the company, it has been held that when a defendant is sued by the company in respect of an ultra vires contract, he can also plead the defence that the contract is ultra vires, and thus void.

4. Liability Clause: The fourth particular in a memorandum of association of a limited company is the mention of the fact that the liability of the company is limited notwithstanding the fact that the company is limited by guarantee or shares.

The Memorandum of a company limited by shares or by guarantee shall also state that the liability of the members is limited.

The Memorandum of a company limited by guarantee shall further state the maximum limit of the amount that each member undertakes to contribute in the event of the winding up of the company.

When the company is limited by shares, it means that the liability of its members is limited to the amount, if any, unpaid on the shares respectively held by them. In case of fully paid shares held by any member, he has no further liability. When the company is limited by guarantee, the liability of the members becomes limited 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.

5. Capital Clause: The amount of share capital with which the company is to be registered divided into shares must be specified giving details of the number of shares and types of shares. A company can not issue share capital greater than the maximum amount of share capital mentioned in this clause without altering the memorandum.

When the company is limited by shares and thus it has to have a share capital, the Memorandum shall state the amount of share capital with which the company is to be registered and the division of the capital into shares of a fixed amount. For instance, in this clause, it may be mentioned that the share capital of the company is Rs. 2,00,000/- divided into 1,000 shares of Rs. 200/- each.

It is to be noted that there are to be atleast 7 subscribers to the Memorandum in the case of a public company, and atleast 2 in the case of a private company. It is

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further necessary that each subscriber must take atleast one share, and each subscriber shall write against his name the number of shares he takes.

6. Association/SubSCRIPTION Clause: This is the last clause of the memorandum of Association wherein a declaration by the persons for subscribing to the Memorandum that they desire to form into a company and agree to take the shares place against their respective name must be given by the promoters. Apart from these clauses of the memorandum of association, there are other formal requirements. According to Section 15 these are—

- a) The memorandum shall be printed.
- b) Divided into paragraphs consecutively numbered.
- c) Signed by each subscriber in the presence of at least one witness and shall give his address, description and occupation, if any.
- d) The Shares taken by each subscriber to be mentioned opposite his name etc.

ALTERATIONS IN MEMORANDUM

Sections 16 to 23 of the Indian Companies Act, 1956 prescribe the mode of affecting alterations in respect of all the clauses of the memorandum of association as discussed below—

1. Change of Name

a) A company may change its name by passing a special resolution to that effect and having the consent of the Central Government prior to the passing of such resolution.

Provided that no such approval shall be required where the only change in the name of the company is the addition thereto or, as the case may be, the deletion therefrom, of the word 'private', consequent on the conversion in accordance with the provisions of this Act of a public company into a private company or of a private company into a public company (Section 21).

b) If a company (without obtaining the consent of the other company), is through inadvertence or otherwise, registered under a name identical with that of a company in existence, which is already registered or which so nearly resembles it, as to be calculated to deceive the first company, it may, with the approval of the Central Government and by passing an ordinary resolution, change its

name (Section 22).

2. Changes of Registered Office : A company may by passing a special resolution, and obtaining confirmation of the court, change the place of its registered office from one state to another. The procedure is by petition to the court, after the special resolution has been passed. The court sees whether sufficient notice, of the proposed alteration, has been given to all persons likely to be affected. Certified copy of the court's order sanctioning the change, and a copy of memorandum must be filed with the Registrar within three months.

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3. Change of Objects: The objects of a company can be altered by a special resolution but only to the extent allowed by Section 17 of the act. The Act permits the company to make the alteration in the objects in order to enable the company to –

- a) Carry on its business more economically or more efficiently;
- b) Attain its main purpose by new or improved means;
- c) Enlarge and change the local area of its operations;
- d) Carry on some business which under existing circumstances may conveniently or advantageously be combined with the business of the company;
- e) Restrict or abandon any of the objects specified in the memorandum;
- f) Sell or dispose of the whole, or any part of the undertaking, or any of the undertakings, of the company;
- g) Amalgamate with any other company or body of persons.

Before changing the objects, a special resolution is to be passed and then a petition is to be made to the court to confirm the alterations.

4. Change of Liability Clause

A company cannot alter its liability clause so as to enhance the liability of its members or compelling them to take further shares (sec-38). Such an alteration would be void in law. There are, however certain exception to this rule where addition liability may be attributed to members by altering its liability clause.

DOCTRINE OF ULTRA-VIRES

Introduction

The object clause of the Memorandum of the company contains the object for which the company is formed. An act of the company must not be beyond the objects clause, otherwise it will be ultra vires and, therefore, void and cannot be ratified even if all the members wish to ratify it. This is called the doctrine of ultra vires.

The word 'ultra' means beyond and 'vires' means powers. Thus the expression ultra vires means an act beyond the powers. Here the expression ultra vires is used to indicate an act of the company which is beyond the powers conferred on the company by the objects clause of its memorandum.

The application of the doctrine of ultra-vires was first demonstrated by the House of Lords in **Ashbury Railway Carriage & Railway Co. v. Riche**, where the mem of a co defined its objects: 1) to manufacture and sell railway carriages etc; 2) to carry on the business of mechanical engineers and general contractors. The company contracted with Richie to finance the construction of a railway line in Belgium and subsequently repudiated it as one beyond its powers. Richie brought an action for breach of contract. The House of Lords held that the contract was ultra vires and void. They were of the opinion that general terms like general contractors must be taken in reference to the main objects of the company which otherwise would authorize every kind of activity making the

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memorandum meaningless.

In the next leading case of **Attorney General v. Great Eastern Railway Co**, this doctrine was made clearer. The House of Lords held that the doctrine of UV as explained in **Ashbury case** should be maintained but reasonably understood and applied. Thus, an act which is incidental to the objects authorized ought not to be held as UV, unless it is expressly prohibited. Thus in **Evans v. Brunner, Mond & Co**, a chemicals manufacturing company was allowed to donate 1,00,000 pounds to universities and scientific institutions for research as this would be conducive for the progress of the company.

In India the Supreme Court has affirmed the doctrine in **A Lakshmanaswami Mudaliar v. LIC**, where the donation made as charity was held ultra vires and the directors were held personally liable to compensate the money.

Thus an act of the company is ultra vires if it is not

- a) Essential for the fulfillment of the objects stated in the memorandum;
- b) Incidental or consequential to that attainment of its objects
- c) Which the company is authorized to do by the Company's Act, in course of its business.

Present Position

In England the doctrine of ultra vires has been restricted by the European Communities Act, 1972. Thus, as against a third person acting in good faith, the company can no longer plead that the contract was ultra-vires.

In India, the principles laid down in **Ashbury case** are still applied without restrictions and modifications. Thus, in India the ultra vires act is still regarded, as void and it cannot be validated by ratification.

Consequences

- 1) **Injunction**- whenever an ultra vires act has been or is about to be done, any member of the company can get an injunction to restrain the co from proceeding further.
- 2) **Personal liability of the directors**- it is the duty of the directors to see that the funds of the company are used only for legitimate business of the company. If the funds of the company are used for a purpose foreign to its memorandum, the directors will be personally liable to restore it.
- 3) **Breach of warranty of authority**- an agent who acts beyond the scope of his authority will be held personally liable. The directors of a company are its agents. If they induce an outsider to contract in a matter the company does not have power to act, they will be personally liable to him.
- 4) **Ultra vires acquired property**- if a company's money has been spent ultra vires in purchasing some property, the company's right over that property must be held secure. For that asset, though wrongfully acquired, represents corporate capital.
- 5) **Ultra vires contracts**- an ultra vires contract being void ab initio, cannot become intra vires by reason of estoppel, lapse of time, ratification, acquiescence or delay.

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No performance of either side can give an unlawful contract any validity or right of action upon it.

- 6) **Ultra vires torts**- a company can be made liable for an ultra vires tort committed, provided, it is shown that

- a) The activity in the course of which it has been committed falls within the scope of the mem.
- b) That the servant committed the tort.

The company should devote itself only to the objects set out in the memorandum and to no others. It is the function of the memorandum to delimit and identify the objects in such plain and unambiguous manner as that the reader can identify the field of industry within

which the corporate activities are to be confined. It is the function of the courts to see that the company does not move in a direction away from that field. That is where the doctrine of ultra vires comes into play in relation to joint stock companies. An action outside the memorandum is ultra vires the company.

Any transaction which is outside the scope of the powers specified in the objects clause of the Memorandum of Association and is not reasonable incidentally or necessary to the attainment of the objects is ultra vires or beyond the powers of the company and therefore null and void. No rights and liabilities on the part of the company arise out of such transactions and it is a nullity even if every member agrees to it.

The application of Doctrine of ultra-vires was first explained by the House of Lords in a leading case of *Ashbury Railway Carriage & Iron Co. Ltd. Vs Riche* in this case, the company's objects as stated in the Memorandum were –

- a)** to make and Sell, and lend on hire railway carriages and wagons, and all kinds of railway plants, fittings, machinery and rolling stock;
- b)** to carry on the business of mechanical engineers and general contractors;
- c)** to purchase, lease, work and sell mines, minerals, land and buildings, and
- d)** to purchase and sell as merchants, timber, coal, metals or other materials and to buy and sell any such materials on commission or as agents.

The directors entered into a contract with Riche, for financing the construction of a railway line in a foreign country and the company subsequently purported to ratify the act of the directors by passing a special resolution at a general meeting. The company, however, repudiated the contract. Riche thereupon sued the company for breach of contract. The House of Lords held that the contract, being of a nature not included in the company's objects, was void as being ultra-vires not only of the directors but of the whole company, and could not be made valid by ratification on the part of the shareholders, and therefore the company was not liable to be sued for breach. So, the consequences of an ultra-vires transaction are–

- a)** The company can not sue any person for enforcement of any of its rights.
- b)** No person can sue the company for enforcement of its rights.
- c)** The directors of the company may be held personally liable to outsiders for ultra

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vires acts.

However, the doctrine of ultra-vires does not apply in the following cases–

- a)** If an act is ultra-vires of powers of the directors but intra-vires of company, the company is liable.
- b)** If an act is ultra-vires the articles of the company but it is intra-vires of the Memorandum, the articles can be altered to rectify the error.
- c)** If an act is within the powers of the company but is irregularly done, consent of the shareholders will validate it.

The Memorandum is registered with the Registrar, and hence it is a public document, open to public inspection. The persons dealing with the company are deemed to know the Memorandum and the objects of the company, and because of the doctrine of constructive notice, they cannot be allowed to say that they were not actually aware about the objects of the company. Accordingly, an ultra vires contract cannot be enforced, even though the person dealing with the company was working under an impression that the act is intra vires (within the company's powers).

*In re Jon Beauforte (London) Ltd.*¹⁶¹⁶

(1953) Ch. 131, a company formed for the business of costumiers and gown makers, started carrying on the ultra vires business of making veneers panels. The supplier of various kinds of building materials, veneers and coke for this business were not aware of

the fact that the business was ultra vires, but still they were held not entitled to recover the price of the same.

It can be concluded that an UV act is void and cannot be ratified. It prevents the wrongful application of the company's assets likely to result in the insolvency of the company and thereby protects creditors. It also prevents directors from departing the object for which the company has been formed and, thus, puts a check over the activities of the directions. However, it has sometimes led to injustice of third parties acting in good faith.

ARTICLES OF ASSOCIATION

Articles of Association is the second document which has, in the case of some companies, to be registered alongwith the memorandum. Companies which must have articles of association are :

- 1) Unlimited companies
- 2) Companies limited by guarantee and,
- 3) Private companies, limited by shares

This document contains rules, regulations and bye-laws for the general administration of the company. Schedule I of the Companies Act, 1956, contains various model forms of memorandum and articles. The schedule is divided into several tables. Each table serves as a model for one kind of company.

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The preparation of the Articles of Association is the next step towards the formation of a company. It has been provided under Section 30 of the Act that it should be printed, divided into paragraphs numbered consecutively and signed by each signatory of the memorandum in the presence of at least one attesting witness. Each subscriber of the memorandum has to sign the document in the presence of at least one attesting witness, both of them adding their address and occupations. The main provisions regarding the Article of Association are given in sections 26 to 31, 36 and 38 of the Act. The document must not conflict with the provisions of the Act. Any clause which is contrary to the provisions of the Act or of any other law for the time being in force, is simply inoperative and void.

Articles have always been held subordinate to the memorandum. If, therefore, the memorandum and articles are inconsistent the articles must give way. In other words articles must not contain anything the effect of which is to alter a condition contained in the memorandum or which is contrary to its provisions. This is so because the object of the memorandum is to state the purposes for which the company has been established, which the articles provide the manner in which the company is to be carried and its proceedings disposed off. That constitutes the principal difference between the two documents. The memorandum contains the fundamental condition upon which alone the company is allowed to be incorporated. They are conditions introduced for the benefit of the creditors, and the outside public, as well as of the shareholders. The articles of association are internal regulations of the company.

It contains the rules and regulations of the internal management of a company. The Articles of Association is nothing but a contract between the company and its members and also between the members themselves that they shall abide by the rules and regulations of internal management of the company specified in the Articles of Association. It specifies the rights and duties of the members and directors.

The provisions of the Articles of Association must not be in conflict with the provisions of the memorandum of Association. In case such a conflict arises, the memorandum will prevail.

Normally, every company has its own Articles of Association. However, if a company

does not have its own AA, the model AA specified in Schedule I – Table A will apply. A company may adopt any of the model forms of AA, with or without modifications. The AA should be in any of the one form specified in the tables B, C, D and E of schedule 1 to the companies Act, 1956. Form in Table B is applicable in case of companies limited by shares, Form in Table C is applicable to the companies limited by guarantee and not having share capital, Form in Table D is applicable to company limited by guarantee and having a share capital whereas form in table E is applicable to unlimited companies. However, a private company must have its own Article of Association.

The important items covered by the Articles of Association include–

1. Powers, duties, rights and liabilities of members and directors.
2. Rules for meetings of the company.
3. Dividends.

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4. Borrowing powers of the company.
5. Calls on shares.
6. Transfer and transmission of shares.
7. Forfeiture of shares and
8. Voting powers of the members, etc.

ALTERATIONS IN ARTICLES OF ASSOCIATION

A company can alter any of the provisions of its Articles of Association, subject to the provisions of the Companies Act and its Memorandum of Association. A company by special resolution at a general meeting of members, alter its articles provided that such alteration does not have the effect of converting a public limited company into a private company unless it has been approved by the Central Government (Section 31). The Articles of Association of the company when registered bind the company and the members thereof to the same extent as if it was signed by the company and by each member.

Effect of Memorandum and Articles : Section 36 contains provision regarding the binding force of the Memorandum and the Articles on the company and its members. According to that provision the Memorandum and Articles of a company, when registered, bind the company and its members to the same extent as if they respectively had been signed by the company and by each member, and contained agreement on the part of the company and the members that all the provisions of the Memorandum and the Articles would be observed. It means that the company and the members are bound towards one another, and if either a member or the company does not observe the provisions of the Memorandum or the Articles, he can made liable for the same.

1. Members and the Company Bound Towards Each Other : It has already been noted above that, according to section 36, the Memorandum and the Articles bind the company and its members to the same extent as if they respectively had been signed by the company and each member.

This may be explained by referring to *Borland's Trustee v. Steel Brothers and Co. Ltd.*¹⁷ In this case, the Articles of the company empowered it to sell the shares of a member, who became bankrupt, at a fair price. J.E. Borland, who was a member became bankrupt. His trustee in bankruptcy challenged the right of the company to sell his shares. It was held that Borland and his trustees were bound by the terms and conditions stated in the Articles.

As a member is bound by the Articles, so also is the company, If a company purports to act against the provisions contained in the Articles, a member can obtain an injunction to restrain the company from doing so. In *Wood v. Odessa Waterworks Co.*¹⁸ 18

(1889) 42 Ch. D. 636., the Articles of Association of a Waterworks Company empowered the directors, with the sanction of the company, to declare a dividend “to be paid” to the shareholders. Instead of paying the dividend, the company passed a resolution to give to the shareholders debenture bonds bearing interest.

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The company was restrained by an injunction from acting on the resolution, and was thus compelled to pay dividend to the shareholders, in accordance with the Articles.

2. Company not Bound to Third Parties : The Articles constitute a contract between the company and its members. An outsider, therefore, cannot sue a company to enforce a provision contained in the Articles. In *Eley v. Positive Government Security Life Assurance Co.*¹⁹, the Articles of a company contained a clause stating that the plaintiff should be the solicitor of the company, and should not be removed from his office, unless for misconduct. The plaintiff acted as solicitor to the company for sometime, but ultimately the company ceased to employ him and employed other solicitors. The plaintiff sued the company for breach of contract. It was held that the plaintiff, being an outsider, the Articles did not create any contract between him and the company, and therefore, the plaintiff’s action failed.

Although the Articles by themselves do not constitute a contract between a company and an outsider, there is no bar to a contract, express or implied, arising between the company and the outsiders in terms of the Articles. If such a contract has been created, the company may be liable even towards an outsider in terms of the Articles. The Lahore High Court’s decision in *Gulab Singh v. Punjab Zamindara Bank*²⁰ explains the point. In this case Article 101 of the Articles of Association of the Company, inter alia, provided that the plaintiff, Sardar Gulab Singh, will be the first Managing Director of the company, and he will remain the Managing Director for the time he holds shares of atleast Rs. 20,000 and further that his remuneration shall be 25% of the net profits. The plaintiff took the requisite number of shares, acted as Managing Director of the company for 11 years, and also got the remuneration in terms of the Articles. Then his services were terminated. It was held that the facts as noted above proved an implied contract between the plaintiff and the defendant company and the plaintiff was, therefore, entitled to the declaration that he was the Managing Director of the company.

Similar was also the position in *Re new British Iron Co., Ex Parte Beckwith*²¹, where it was held that when the Articles of a company provided a certain amount of remuneration to be paid to the directors, a director appointed by the company was entitled to such remuneration, because his acceptance of the office raised a presumption that he had accepted the office on the basis of the Articles.

Similarly, if the Articles of a company require the holding of a certain number of qualification shares by a director, a person becoming a director of the company is deemed to have agreed to the same, and if such a company goes into liquidation, such director will be liable as a contributory in respect of that number of shares.

3. Members inter se Bound : Each member is bound to the other members by the terms contained in the Articles. Thus, if the Articles provide certain rights of the members inter se, a member can enforce such rights against the other members. In *Rayfield v. Hands*²², the plaintiff was the shareholder of a private company.

Article 11 of Articles of Association required a member, who wanted to transfer his

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shares to inform the directors of his intention, and then the directors “will take the said shares equally between them at a fair value”. The plaintiff sought to enforce this provision to compel the directors to purchase his shares at a fair price. It was held that Article 11 created a contractual relationship between the plaintiff, as a member, and the defendants, also as members of the company (and not as directors) and, therefore, the defendants were bound to purchase the plaintiff’s shares at a fair price.

Distinction between Memorandum & Articles

The main points of distinction between memorandum and articles are as follows:-

(1) Contents: Memorandum is the charter of the company which defines the fundamental conditions and objects for which it is incorporated. Articles of association on the other hand, contain the internal rules & regulations framed by the company to govern its internal management.

(2) Relationship: Memorandum determines the objects, scope and extent of the activities of the company. While articles are the bye-Laws of the company which prescribe regulations by which the management of affairs of the company is to be carried out.

(3) Registration: Every joint stock company must get its memorandum duly registered under the Act. But in case of Articles, a Public Company may adopt the model specified in Table A of schedule I so as to avoid the formalities of registration.

(4) Alteration: Clauses of the memorandum cannot be easily altered. The company has to pass a special resolution and seek confirmation of the Company Law Board, for making alteration in its memorandum. In case of articles of Association, members have a right to alter the articles simply by a special resolution and there is no need to obtain the confirmation of the Company Law Board.

(5) Ultra Vires Acts: Any act done by a company beyond the scope of its memorandum shall be ultra vires being void and the same cannot be ratified even by unanimous vote of all the shareholders. But the acts of the Board of Directors beyond the articles may be rectified.

(6) Limitation: Memorandum of a company cannot include any clause which is contrary to any of the provisions of the companies Act, but articles of association are subsidiary to both, i.e. the companies Act and the memorandum.

(7) Conflict: Articles of association are subordinate to memorandum and, therefore, the memorandum overrides the articles in conflicting matters contained in both the documents. Thus, the provisions of the articles of a company must not be in conflict with its memorandum, otherwise they will be void & ineffective.

(8) Effect: Memorandum regulates also the relation of the company with the outsiders who are dealing with the company while the articles regulate the relation between the company and its members or members inter se.

Doctrine of Constructive Notice : It has already been noted that the Memorandum of Observation/Note

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Association and the Articles of Association are required to be registered with the Registrar as pre-requisite to the formation of a company. Both these documents are public documents and are, therefore, open to inspection. They can be inspected by any person. Every person dealing with a company, having a right to know the contents of the Memorandum and the Articles, is deemed to have known them, or, in other words, there is a presumption that the person dealing with the company has the notice of the contents of these documents. As a result of the notice (constructive notice) of the contents of these documents, if a person enters into a contract with a company which is not permitted by the Memorandum or the Articles, i.e., it is ultra vires (out of the powers) of the company, the company

cannot be made liable for the same. The person dealing with the company is bound by the law of estoppel, and he cannot be allowed to say that he had no actual notice of the contents of these documents.

The doctrine of constructive notice applies not only to Memorandum and Articles, but also other documents which have to be filed with the Registrar, such as special resolutions, and particulars of charges.

It may be noted that a person dealing with the company is taken to have not only read the documents but also to have understood their proper meaning. He is presumed to have understood not only the company's powers but also those of its officers.

Constructive notice is more or less an unreal doctrine. It does not take notice of the realities of business life. People know a company through its officers and not through its documents.

In *Kotla Venkataswamy v. Ram Murthy*²³, the Articles of Association of a company stipulated that a deed on behalf of the company should be signed by three specified officers viz., the Managing Director, the Secretary and a Working Director. The plaintiff accepted a mortgage deed which was signed by two officers only, i.e., the Secretary and a Working Director.

It was held that the said mortgage deed was invalid, and the plaintiff could not claim any rights under it. The reason for the decision was that if the plaintiff had consulted the Articles, she could have known that the deed needed signatures of three specified officers. The fact that the plaintiff had acted in good faith, and her money had been utilised by the company could not change the position.

Every person who enters into any contract with a company will be presumed to know the contents of the memo of ass and the articles of ass. This is known as the doctrine of constructive notice.

The memorandum and the articles of association of every company are registered with the Registrar of Companies. The office of the Registrar is a public office. Hence, the memo and the articles of ass become public documents. It is therefore the duty of person dealing with a company to inspect its public documents and make sure that his contract is in conformity with their provisions.

As observed by Lord Hatherley, "...whether a person actually reads them or not, he is to be in the same position as if he had read them". Every person will be presumed to know the contents of the documents.

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The practical effects of this rule can be observed in *Kotla Venkataswamy v. Ramamurthy*-

The articles of a company provided that its deeds etc should be signed by the managing director, the secretary and a working director on behalf of the co. the plaintiff accepted a deed of mortgage executed by the secretary and a working director only. The plaintiff could not claim his deed. It was held that, "notwithstanding, therefore, she may have acted in good faith and the money may have been applied for the purposes of the company, the bond is nevertheless invalid."

Another effect of this rule is that a person dealing with the company is taken not only to have read the documents but also to have understood them according to their proper meaning. Further, there is a constructive notice not merely of the memo and art, but also of all the documents, such as special resolutions and particulars of charges which are required by the Act to be registered with the Registrar. But there is no notice of documents which are filed only for the sake of record, such as returns and account.

Statutory reform of constructive notice

The 'doctrine of constructive notice' is more or less an unreal doctrine. It does not take notice of the realities of business life. People know a company through its officers and

not through its documents. Section 9 of the European Communities Act, 1972 has abrogated this doctrine. These provisions are now incorporated in sec 35 of the (English) Companies Act, 1985.

Position in India

The courts in India do not seem to have taken the doctrine seriously. For example, the Calcutta High Court in **Charnock Collieries Co Ltd. v. Bholanath**, enforced a security which was not signed in accordance with the company's articles.

Also, in **Dehra Dun Mussorie Electric Tramway Co. v. Jagmandardas**, the Allahabad High Court allowed an overdraft incurred by the managing agent of a company when under the articles the directors had no power to delegate their borrowing power.

Thus, the doctrine of constructive notice seeks to protect the company against the outsider by deeming that such an outsider had the notice of the public documents of the company. However, in India the courts with a view to protect the innocent third parties acting in good faith have not relied upon the doctrine seriously.

DOCTRINE OF INDOOR MANAGEMENT

The doctrine of the indoor management is opposed to that of the rule of constructive notice. The latter seeks to protect the company against the outsider, the former operates to protect outsiders against the company. The rule of constructive notice is confined to the external position of the company and therefore, it follows that there is no notice as to how the company's internal machinery is handled by its officers. If the contract is consistent with the public documents, the person contracting will not be prejudiced by irregularities that may beset the indoor working of the company.

Memorandum of Association and Articles of Association, both these documents on registration assume the character of public documents and every person dealing with the company is deemed to have the notice of their contents. An outsider dealing with a

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company is presumed to have read the contents of the registered documents of a company. The further presumption is that he has understood them in proper sense. This is known as rule of constructive notice. So, constructive notice is a presumption operating in favour of the company against the outsider. There is however, one exception to this rule of constructive notice. This is known as the doctrine of Indoor management. It is also popularly known as the Rule in Royal British Bank Vs Turquand or Turquand case.²⁴

The doctrine of Indoor management means that the outsiders dealing with a company are entitled to assume that everything has been regularly done, so far as its internal proceedings are concerned. In this case, a company has powers to borrow money provided a proper resolution was passed. The company borrowed money and issued bonds. The resolution was not in fact passed. The court held that company was bound. The fact that the resolution was not passed did not affect the lender. Same view was again followed by the court in case of **Mahony V/s East Holyford Mining Co. (1875) L.R. 7 H.L. 869**.

Hence, doctrine of indoor management is intended to protect an outsider against the company. But as this is a rule of presumption there are certain exceptions of this rule of indoor game. These are –

1. This rule of indoor management does not protect those persons who have the actual knowledge of the irregularity.
2. This is again inapplicable to the persons who have purported to act as a director in the transaction.
3. If there is any forgery, indoor management is a rule of presumption. By a presumption a forgery can not be converted into a genuine transaction.
4. When your suspicions are aroused, you should investigate. If you fail to investigate, you can not presume that things are rightly done.

The doctrine of indoor management is an exception to the rule of constructive notice. It imposes an important limitation on the doctrine of constructive notice. According to this doctrine, a person dealing with a company is bound to read only the public documents. He will not be affected by any irregularity in the internal management of the company.

The rule of indoor management had its genesis in **Royal British Bank v. Turquand**- The directors of the company borrowed a sum of money from the plaintiff. The company's articles provided that the directors might borrow on bonds such sums as may from time to time be authorized by a resolution passed at a general meeting of a company. The shareholders claimed that there was no such resolution authorizing the loan and, therefore, it was taken without their authority.

The company was however held bound for the loan. Once it was found that the directors could borrow subject to a resolution, the plaintiff had the right to assume that the necessary resolution must have been passed.

The rule is based on public convenience and justice and the following obvious reasons:

1. The internal procedure is not a matter of public knowledge. An outsider is presumed to know the constitution of a company, but not what may or may not have taken

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place within the doors that are closed to him.

2. The lot of creditors of a limited company is not a particularly happy one; it would be unhappier still if the company could escape liability by denying the authority of officials to act on its behalf.

The rule/doctrine is applied to protect persons contracting with companies from all kinds of internal irregularities. It has been applied to cover the acts of de facto directors, who have not been appointed but have only assumed office at the acquiescence of the shareholders or whose appointment is defective, or have exercised authority which could have been delegated to them under the Act but actually not delegated, or who have acted without quorum.

Exceptions to the rule

- 1) **Knowledge of irregularity** A person who has actual knowledge of the internal irregularity cannot claim the protection of this rule, because he could have taken steps for self-protection. A person who himself is a party to the inside procedure, such as a director is deemed to know the irregularities, if any.

T.R Pratt (Bombay) Ltd. V. E.D. Sassoon & Co. Ltd. - Company A lent money to Company B on a mortgage of its assets. The procedure laid down in the articles for such transactions was not complied with. The directors of the two companies were the same. Held, the lender had notice of the irregularity and hence the mortgage was not binding.

- 2) **Negligence and suspicion of irregularity**: where a person dealing with a company could discover the irregularity if he had made proper inquiries, he cannot claim the benefit of the rule of indoor management. The protection of the rule is also not available where the circumstances surrounding the contract are so suspicious as to invite inquiry, and the outsider dealing with the company does not make proper inquiry.

- 3) **Forgery**: The rule in **Turquand's case** does not apply where a person relies upon a document that turns out to be forged since nothing can validate forgery. In **Ruben v. Great Fingall Ltd**, a co was not held bound by a certificate issued by the secretary by forging the signature of two directors. However, in **Official Liquidator v. Commr of Police**, the Madras High Court held the company liable where the Managing Director had forged the signature of two other directors.

- 4) **Representation through articles**: A person who does not have actual knowledge

of the company's articles cannot claim as against the company that he was entitled to assume that a power which could have been delegated to the directors was in fact so delegated. In ***Rama Corporation v. Proved Tin and General Investment Co***, the plaintiffs contracted with the defendant co and gave a cheque under the contract. The director could have been authorized but in fact, was not. The plaintiffs had not read the articles. The director misappropriated the cheques and plaintiff sued. Held, director not liable as it was outside his authority.

PROSPECTUS

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Any document inviting offers from the public for the subscription of shares or debenture of a company is called prospectus. Where a company intends to issue a public appeal for subscription of its shares or debentures, it is essential for it to issue a prospectus. Section 56 (3) of the companies Act requires that no application for shares or debentures of a company can be invited unless the appeal is accompanied with a prospectus.

MEANING AND DEFINITION OF PROSPECTS

A prospectus is an invitation to an offer to subscribe for shares or debentures.

According to Section 2(36) of the companies Act, 1956, A prospectus may be defined as "any documents described or issued as a 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."

In essence, any advertisement offering to the public shares or debentures of the company is known as prospectus. In essence, it means that a prospectus is an invitation issued to the public to take shares or debentures of the company or to deposit money with the company any advertisement offering to the public shares or debentures of the company for sale is a prospectus.

Application forms for shares or debentures can not be issued unless they are accompanied by a memorandum containing such salient features of a prospectus as may be prescribed. Thus, the effect is that only a document has to be sent alongwith application forms showing a brief version of the salient features of the prospectus.

In *Pramatha Nath Sanyal vs. Kalikumar Dutt*, AIR 1925 Cal., an advertisement was inserted in a newspaper stating that some shares are still available for sale according to the terms of the prospectus of the company which can be obtained on application. This was held to be a prospectus as it invited the public to purchase shares. The Directors were accordingly convicted under Sec. 32(5) [Now Section 60(5)] for not complying with the requirements of the Act.

Public Issue : The provisions of the Act relating to prospectus are not attracted unless the prospectus is issued. "Issued" here means issued to the public. What does or does not amount to an issue is a question of fact in each case and is not capable of exact definitions. In *Nash vs. Lynd* (1929 AC 158) it was held that the term issue is not satisfied by a single personal communication. The facts were that a document marked strictly private and confidential, but in form of prospectus was prepared by the defendant, the MD of a company. But the document did not contain all the material facts required by the Act to be disclosed. A copy of it alongwith application forms was sent to a solicitor who in turn sent it to the plaintiff. It was held that this did not amount to an issue and accordingly the plaintiff's action for compensation for sustained by reason of the omissions was dismissed. Viscount Summer observed that it is difficult to think of a prospectus being issued without some measure of publicity, however modest. Though literally it is true that the issue is not expressly said in the section to be an issue to the public, I think it must be so in substance, otherwise any private letter, written by a person engaged in

forming a co. and advising his correspondent to take shares would become an issued

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prospectus. The public is of course a general word. No particular nos. 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 proceedings needless by himself subscribing the whole. The point is that the offer is such as 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. A private communication is not thus open.

Thus, the issue need not be made to the public as a whole. An advertisement among a group or a class of persons only would be an issue.

ESSENTIALS OF PROSPECTUS

The essential ingredients of a prospectus are :-

- (i) There must be an invitation offering to the public;
- (ii) The invitation must be made by or on behalf of the company or in relation to an intended company;
- (iii) The invitation must be "to subscribe or purchase"; and
- (iv) The invitation may relate to shares or debentures.

KINDS OF PROSPECTUS

The main kinds of prospectus are as follows :-

1. SHELF PROSPECTUS

The concept of shelf prospectus had been introduced by the companies [Amendment] Act, 2000 by insertion of new section 60 A.

"Shelf Prospectus" means a prospectus issued by any financial institution or bank for one or more issues of securities or class of securities specified in the prospectus.

The concept of shelf prospectus will save expenditure and time of the companies in issuing a new prospectus every time they wish to issue securities to the public within a period of one year. The validity period of this is one year from the date of first issue.

2. RED-HERRING PROSPECTUS

Red Herring means a preliminary registration statement that must be filed with the SEC describing a new issue of stock and the prospectus of the issuing company.

Investopedia explain Red Herring as there is no price or issue size stated in the red herring and it is sometimes updated several times before being called the final prospectus. It is known as a red herring because it contains a passage in red that states the company is not attempting to sell its shares before the registration is approved by the SEC."

Red-herring prospectus means a prospectus which does not have complete particulars on the price of the securities offered and the quantum of securities offered. The information memorandum and red-herring prospectus carry same obligations as are applicable in the case of prospectus. Every variation between the information memorandum and the redherring prospectus shall be highlighted by the issuer company and shall be individually intimated to the persons invited to subscribe to the securities.

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3. Abridged Prospectus

The memorandum accompanied with application form is called abridged prospectus. Every application for shares should contain salient features of the prospectus information is given to prospective investor to take informed decision. This is also known as memorandum containing salient features of prospectus. As per rule 4 CC which has been inserted in the companies [Central Government] General Rules and Forms, 1956, the salient features required to be included in the abridged prospectus shall be in form 2 A.

4. FINAL PROSPECTUS

Final Prospectus means the final version of a prospectus for a public offering of securities. This document is complete in all details concerning the offering and is referred to as a "statutory prospectus" or offering circular. Because open-end mutual funds are continuously offering shares to the public, a final prospectus is usually updated annually and made available to the public. Mutual fund prospectuses are all of the final variety. Investopedia explains final prospectus as with public offerings of securities, investors first receive what is called a preliminary prospectus, commonly called a 'red herring' because of the pinkish color of the paper on which it is printed. Subsequently, the final prospectus is made available to investors who are considering a purchase of the security in question. A key difference between a final prospectus and a preliminary prospectus is that the final prospectus contains the security's price.

Final prospectus may be defined as a document containing information on a new issue, including the delivery date, the underwriting spread, and financial information about the company; it is given to all investors who wish to purchase the issue.

Contents of Prospectus :

- 1) Every Prospectus to be Dated (Section 55)
- 2) Every Prospectus has to be Registered (Section 60)
- 3) Experts' Consent (Section 58)
- 4) Disclosures to be made (Section 56)

Statement in Lieu of Prospectus (Sec. 70) : One of the great advantages of promoting a company is that the necessary capital for business can be raised from the general public. This advantage is, however, enjoyed only by a public company. A private company is, by its very constitution, prohibited from inviting monetary participation of the public. But even a public company need not necessarily go to the public for money. The promoters may be confident of obtaining the required capital through private contacts. In such a case, no prospectus need be issued to the public. The promoters are only required to prepare a draft prospectus containing the information required to be disclosed by Schedule III of the Act. This document is known as a Statement in Lieu of Prospectus. A copy of it must be filed with the registrar at least three days before any allotment of shares is made. This is intended to preserve an authoritative record of the terms and conditions of the capital issue. If the statement contains any misrepresentation the liability

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civil and criminal is the same as in the case of prospectus.

According to section 70, where a company can raise its share capital without making a public offer for subscription through a prospectus, it has to file at least three days before the allotment with the registrar of companies, a statement in lieu of prospectus signed by every person who is named therein as director or proposed director. The form is set out in Schedule-III. It contains an official record of particulars on which shares are allotted. If a statement in lieu of prospectus contains any untrue statement, any person who allowed delivery of such statement in lieu of the prospectus shall be liable to punishment with imprisonment for two years or with fine which may extend to Rs. 5000/- or with both; unless he proves that the statement was immaterial or that he believed it to be a true statement.

If the statement in lieu of prospectus is not delivered, the company and every director shall be liable to a fine upto rupees one thousand. Section 70 (S) imposes exactly the same criminal liability; penalties and defences as section 63 imposes in respect of a prospectus. The remedy or damages or rescission are also available to the aggrieved parties.

An allotment made by the company to an applicant in contravention of section 69 or 70

i.e. before minimum subscription is received or before filing statement in lieu of prospectus is voidable at the instance of the applicant provided he moves within two months of the date of allotment.

Most companies however, have to issue a public appeal for subscription. This involves the issue of a prospectus. No application for shares or debentures of a company can be invited unless the appeal is accompanied with a prospectus.

Golden Rule : Above all, the golden rule as to the framing of pros. must be observed. The rule was laid down by Kindersely VC in New Brunswick and Canada Railway and Land Co. vs. Muggerridge, 1860 LT and was described as a "Golden Legacy", by Page Wood VC in Henderson vs. Lacon, 1967 LT. Briefly, the rule is that those who issue a prospectus hold out to the public great advantages which will accrue to the persons who will take shares in the proposed undertaking. Public is invited to take shares on the faith of their representations contained in the prospectus. The public is at the mercy of company promoters. Everything must, therefore, be stated with strict and scrupulous accuracy. Nothing should be stated as fact which is not so and no fact should be omitted the existence of which might in any degree affect the nature or quality of the privileges and advantages which the prospectus holds out as inducement to take shares. In a word, the true nature of the company's venture should be disclosed.

This golden Legacy has condensed in few words the whole doctrine as to the rule of conduct between shareholders and the Directors.

MIS-STATEMENTS IN A PROSPECTUS

Any omission from a prospectus of those matters which are required to be stated as per section 56 and Schedule-II shall render the director or any other person responsible for the issue of prospectus, liable to fine not exceeding rupees fifty thousand. In addition to this, the director or the official concerned may also incur civil or criminal liability for

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disclosure.

Any person who has been induced to invest money in a company relying on a fraudulent statement in the prospectus can sue the director or the person responsible for issuing it and claim damages. In order to prove a fraud the aggrieved investor has to prove that the false representation was made by the company (a) Knowingly, or (b) Without belief in its truth or (c) recklessly whether it be false or true. Thus a fraud may be committed by reckless and careless statement in the prospectus without bothering about the truth or false of it.

Section 65 of the companies Act, 1956 provides that a statement included in the prospectus shall be deemed to be untrue, if the statement is misleading in the form and content in which it is included. It also provides that 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. Thus it would appear that the law ascribes a wider meaning to the term 'fraud' or 'untrue statement'. Regarding liability for fraudulent mis-statement in the prospectus four generalizations may provide sufficient guidelines to proceed in an action for fraud or deceit. They are as follows :-

1. The aggrieved party has to prove that the person making the suggestion knew that what he is stating in the prospectus is not true or did not believe it to be true or it is an active concealment of some material fact. However, if a person making the statement honestly believes it to be true, he is not guilty of fraud even if the statement is not true. This principle has been enunciated by House of Lords in Deery Vs. Peek [1889] 14 AC 337.

2. The false representation must relate to some existing facts which are material to the contract of purchasing shares.

3. In order to succeed in an action for fraud in prospectus it is necessary that the plaintiff should have taken the shares or debentures directly from the company by allotment and not from any intermediary agency or open market. This in other words means that only the allottees can have remedy against the directors. This rule was for the first time laid down in *Peek Vs. Currency* (1873) 43 LJ Ch. 19.

4. In the absence of a contractual relationship a person who makes a statement owes a duty of care to anyone whom he knows or has reasonable grounds for expecting will rely on his statement. If he fails in that duty of care and the party which is misled suffers loss, he shall be liable for negligence.

Remedies for Misrepresentation

- 1) Damages for Deceit
- 2) Compensation under Section 62
- 3) Rescission for Misrepresentation
- 4) Liability under Section 56

Besides damages for deceit and fraud the company may also be sued for damages

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provided it is shown that the fraud was committed by the directors within the scope of their authority i.e. with the authority of the company. The company is also liable if the prospectus is issued by the Board which adopts the issue, for the prospectus is the basis of the contract for share.

Thus the first remedy against the company is to rescind a contract and claim the money back. The allottee, however must act within a reasonable time. He shall lose his right to rescind if he attempts to sell the shares or attends a general meeting of the company or receives dividends from the company.

CIVIL LIABILITY [SECTION 62]

The inadequacy of action for damages for deceit came to light in the House of Lords decision in *Derry Vs. Peek* [1889] 14 AC 337 and this remedy was found to be inadequate to protect the interests of investors. It was realized that a common investor is hardly concerned whether this mis-statement in the prospectus was a deliberate falsehood or made by the directors in good faith innocently. What he is concerned with is that he should be compensated for the loss caused to him due to mis-representation. It is for this reason that within a year of the decision in *Derry Vs. Peek*, an Act called the Director's Liability Act 1908 was passed in England whereby the directors were made liable for mis-statements in the prospectus although they might have believed that the statement was substantially true. Subsequently this provision was incorporated in section 43 of the English Companies Act, 1948 and a corresponding provision to this effect is to be found in Section 62 of the Companies Act, 1956 in India.

The Section provides that the directors, promoters and every other person who is authorized to issue the prospectus of a company shall be liable to pay compensation to the investor for any loss sustained by him due to untrue statement in the prospectus. The liability of the directors or promoters as the case may be is joint and several and they may recover contribution from others who are guilty of misrepresentation.

DEFENCES TO CIVIL LIABILITY [SECTION 62 (2)]

Section 62 (2) of the Companies Act provides that a person [other than an expert] shall not be liable to pay compensation for any mis-statement in the prospectus in the following circumstances :-

1. Withdrawal of consent,
2. Without Knowledge,

3. Ignorance of untrue statement,
4. Has reasonable ground for belief,
5. Reliance on expert's opinion,
6. Statement based on Public Official document.

Criminal Liability for Misrepresentation (Section 63)

Apart from civil liability for mis-statements in the prospectus, the company law also provides for criminal liability under section 63 of the Act. The section says that where prospectus

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includes any untrue statement, every person who has authorized the issue of the prospectus shall be punishable with :

- (a) Imprisonment for a term which may extend to two years; or
- (b) Fine which may extend to Rs. 50,000/- or
- (c) Both imprisonment and fine.

He shall, however, not be criminally liable if he proves that the statement was immaterial or that he had a reasonable ground to believe that it was true.

An expert who has given the consent as required by Section 58, shall not be criminally liable for the purpose of section 63. It is provided under section 63(2).

To conclude it can be said that prospectus is the window through which an investor can look into the soundness of a company. Investor therefore be given a complete picture of the activities and financial position. Prospectus is divided into there kinds which are discussed above. In those kinds, Red-Herring prospectus and final prospectus are mostly issued by the companies. A company may not invite shares from the general public but arranges the money from private services it need not issue prospectus, it just has to file atleast 3 days before the allotment of shares or debentures deliver to ROC for registration a statement signed by the directors which is called statement in lieu of prospectus. A statement is deemed to be untrue if it is false in form and context in which it is included. If any person has been induced to invest money in a company relying on that false statement, he can sue that person who is responsible. For issuing it and claim damages. A subscribes who has taken shares on the basis of a mis-statement and criminal remedies discussed above.

IMPORTANT QUESTIONS

Q.1 Enumerate different kinds of companies. Distinguish between a Public and a Private Company.

Q.2 What are the kinds of companies from the point of view of incorporation or origin of a company?

Q.3 Define a Private Company. What are the special privileges and exemptions enjoyed by it under the Companies Act, 1956? Also explain its obligations or disadvantages.

Q.4 Explain briefly what particular steps, as a promoter, would you take for the formation of a public company, from promotion to the commencement of business.

Q.5 What are the contents of Memorandum of Association of a Company? State the provisions of company law regarding alteration of objects clause of MOA.

Q.6 Write an explanatory note on the doctrine of ultra-vires and state the liability of the company.

Q.7 What are the usual contents of Articles of Association? Explain the significance of this document.

Q.8 What do you understand by the doctrine of 'Indoor Management' in Company Law? Are there any exceptions to the Doctrine? Discuss.

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Q.9 What is the relation between the doctrine of Indoor Management and doctrine of

constructive notice? Discuss.

Q.10 What do you mean by Memorandum of Association and the various clauses of MOA? Differentiate between Memorandum of Association and Articles of Association. Out of these two documents which one is in superior position from the legal point of view?

Q.11 What is 'Prospectus'? Does it also include a document inviting deposits from the public? Discuss the remedies available to a person who has been induced to subscribe for shares in a company on the basis of misstatements in a prospectus.

Q.12 "Those who issue a prospectus holding out to the public the great advantages which will accrue to persons who will take shares in a proposed undertaking, and inviting them to take shares on the faith of the representation therein contained, are bound to state everything with strict and scrupulous accuracy, and not to omit any fact within their knowledge the existence of which might in any degree affect the nature, or extent, or quality of the privileges and advantages which the prospectus holds out as inducement to take shares." In the light of above statement discuss the civil as well as criminal liability for the misstatement in the prospectus.

Q.13 Discuss the responsibilities of persons issuing the prospectus of a company. Discuss the extent to which they are liable for omissions, misrepresentation and fraud in respect of the contents of the Prospectus.

Q.14 "Half truth is sometimes no better than downright falsehood." Discuss this statement with reference to the liability of Director for untrue statement in a prospectus. Illustrate with reference to decided cases.

Q.15 Can a company have the benefits of fundamental rights given in the Indian Constitution?

Q.16 Write short notes on :

- a) Doctrine of Indoor Management
- b) Doctrine of Ultravires
- c) Rule in Royal British Bank's case

Q.17 Explain these –

- a) Government Company
- b) Foreign Company
- c) Difference between Public & Private Company
- d) Holding & Subsidiary Company.
- e) Multinational company

(Footnotes)

1. Barkat Ali Vs Official Liquidator, AIR 1948 Mad 111
2. Sabratnam Vs O.L. Travancore N & Q Bank, 1943

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3. Whaley Bridge Printing Co. Vs Green (1980) 5Q. BD 109
4. [1906] 2 Ch 435: 22 TLR 669
5. 89 LT 678: 1904 AC 120
6. (2006) 133 Comp Cas 794 SC
7. (1875), L.R. 7 H.L. 653
8. Section 147. See Recormentine Co. Ltd. v. Ashworth, (1905) 21 T.L.R. 510; Nossan Steam Press v. Tyler, (1894) 70 L.T. 376.
9. Section 25(1); Sunil Dev v. Delhi & Distt etc. Assu (1994) 80 Comp. Cas. 174 (Delhi).
10. Section 146(2); see Harendra Nath Ghosal v. Suprfoam P. Ltd., (1991) 74 Comp. Cas. 740 Ghosal v. Superfoam P. Ltd., Steel & Alloys P. Ltd. (1993) 76 Comp. Cas. 244; T.O. Supplies (London Ltd. v. Jerce Creeghton Ltd., (1952) 1 K.B. 42.

11. A.I.R. 1963 S.C. 1185.
12. (1921) 1 Ch. 259
13. (1918) A.C. 514
14. (1969) 2 W.L.R. 731.
15. (1881-85) Ail. E.R. 372; See also Re, Amalgamated Syndicate, (1897) 2 Ch. 600; Cotman v. Pororougham, (1918) A.C. 514; In re Kitson & Co. Ltd., (1946) 1 All E.R. 435 C.A.
17. (1940) 10 Comp. Cas. 255 : (1940) A.C. 701; See British Murac Syndicate Ltd. v. Alpertan Rubber Co., (1915) 2 Ch. 186; Bushell v. Faith, (1970) 1 All E.R. 53 (H.L.).
19. (1876) 1 Ex. D. 88.
20. A.I.R. 1942 Lah. 47. It may be noted that in this case although the plaintiff also happened to be a member of the company, but his action in this case was not in that capacity, but he was enforcing rights not based on membership, but as an outsider.
21. (1898) 1 Ch. D. 324
22. (1958) 2 W.L.R. 851 : (1958) 2 All. E.R. 194 : (1960) Ch. 1; Welton v. Saffery, (1897) A.C. 299
23. A.I.R. 1934 Mad. 579; Also see Honry Ernest v. Nicholls, (1857) 6 H.L.C. 401; Oak bank Vil Co. v. Crum, (1882) 8 A.C. 65; Ridley v. Plymouth Grinding & Banking Co., (1848) 2 Ex. 711.
24. (1856) 6 E & B. 37

UNIT 3

Structure

- Study of Selected Lit

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Promoters

A promoter is a person who does the necessary preliminary work incidental to the formation of a company. It is a compendious term used for a person who undertakes, does and goes through all the necessary and incidental preliminaries, keeping in view the object, to bring into existence an incorporated company.

Chronologically, the first persons who control a company's affairs are its promoters.

Fiduciary position

1. Not to make any profit at the expense of the company-the promoter must not make, either directly or indirectly, any profit at the expense of the company which is being promoted. If any secret profit is made in violation of this rule, the company may, on discovering it, compel him to account for and surrender such profit.

2. To give benefit of negotiations to the company-the promoter must, when once he has begun to act in the promotion of a company, give to the company the benefit of any negotiations or contracts into which he enters in respect of the company.

Thus where he purchases some property for the company, he cannot rightfully sell that property to the company at a price higher than he have for it. If he does so, the company may, on discovering it, rescind the contract and recover the purchase money.

3. To make a full disclosure of interest or profit-if the promoter fails to make a full disclosure of all the relevant facts, including any profit and his personal interest I a transaction with the company, the company may sue him for damages for breach of his fiduciary duty and recover from him any secret profit made even though rescission is not asked or is impossible.

4. Not to make unfair use of position-the promoter must not make an unfair or take care to avoid any unreasonable use of his position and must take care to avoid anything which has the appearance of undue influence or fraud
Further, a promoter cannot relieve himself of his liability by making provisions to that effect in the Articles of the company.

5. Duty of promoter as regards prospectus-the promoter must see, in connection with the prospectus, if any is issued, that the prospectus –

(a) contains the necessary particulars

(b) does not contain any untrue or misleading statements or does not omit any material fact.

Quasi-trustee-a promoter is neither an agent nor a trustee of the company under incorporation but certain fiduciary duties have been imposed on him under the Companies Act, 1956. He is not an agent because there is no principal born at the time and he is not a trustee because there is no cesti que trust in existence. Hence he occupies the peculiar position of a quasi-trustee.

Rights of promoter

The promoters have certain rights. They are:-

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1. Right to receive preliminary Expenses

The promoters are entitled to receive all the expenses incurred for in setting up and registering the company, from Board of Directors. The articles will have provision for payment of preliminary expenses to the promoters. The company may pay the expenses to the promoters even after its formation, but such payments should not be Ultra Vires the articles of the company. The Articles may have provision regarding payment of fixed sum to the promoters.

2. Right to recover proportionate amount from the Co-promoters

The promoters are held jointly and severally liable for the secret profits made by them in formation of a company. Therefore if the entire amount of secret profits is paid to the company by a single promoter, he is entitled to recover the proportionate amount from co-promoters. Likewise the entire liability arising out of mis-statement in the prospectus is borne by one of the promoters; he is entitled to recover proportionately from the co-promoters.

3. Right to Remuneration

The promoter has the right to paid remuneration for the efforts. It may be fully or partly paid shares. If there is no agreement, the promoter will not be entitled to receive remuneration.

4. Disclosure of remuneration paid to promoter

The remuneration or benefit paid to the promoter must be disclosed in the prospectus, if it is paid within two years preceding the date of the prospectus.

Duties of promoter

The main duties of a promoter are as follow:

- 1) To discover an idea for establishing a company.
- 2) To make detailed investigation about the demand for the product, availability of power labour raw material, etc.
- 3) To find out suitable persons who are willing to act as first directors of the company and are ready to sign on the memorandum of association.
- 4) To select bank, legal advisor, auditors, underwriters for the company.
- 5) To prepare essential documents of the company

Functions

1. The promoter of a company decides its name and ascertains that it will be accepted

by the Registrar of Companies.

2. He settles the details of the company's Memorandum and Articles, the nominations of directors, solicitors, bankers, auditors and secretary and the registered office of the company.

3. He arranges for the printing of the Memorandum and Articles, the registration of the company, the issue of prospectus, where a public issue is necessary

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He is responsible for bringing the company into existence for the object which he has in view.

Remuneration

A promoter has no right to get compensation from the company for his services in promoting the company unless there is a contract to that effect. In practice, a promoter takes remuneration for his services in one of the following ways-

1. he may sell his own property at a profit to the company for cash or fully- paid shares provided he makes a disclosure to this effect

2. He may be given an option to buy a certain number of shares in the company at par.

3. He may take a commission on the shares sold

4. He may be paid a lump sum by the company.

DIRECTORS

A company is treated as an artificial person, it carries out its affairs by human agent. It is invisible, intangible and existing only in contemplation of law. It has neither a mind nor a body of its own. This makes it necessary that the company's business should be entrusted to human agents. These human agents are called directors, managers and governors of the company. The directors are superintendents of the company. According to Section 2(13) of the Companies Act, the expression "director" includes any person occupying the position of director by whatever name called.

Section 252 of the Companies Act provides that every public company shall have a minimum of three directors if a public company is having –

a) a paid-up capital of five crore rupees or more;

b) one thousand or more small shareholders.

Every other company i.e., private company shall have a minimum of two directors.

Who can be appointed as a Director

Appointment of a Director is not only a crucial administrative requirement, but is also a procedural requirement that has to be fulfilled by every company. Under the Companies Act, only an individual can be appointed as a Director; a corporate, association, firm or other body with artificial legal personality cannot be appointed as a Director.

APPOINTMENTS

Directors may be appointed in the following ways–

1. By the Articles (First directors (Section 254)

2. By the Company (Section 255, 261)

3. By the Directors (Section 260, 262, 313)

4. By the Managing agent (Section 377)

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5. By third parties (Section 255)

6. By the Central Government (Section 408)

1. Appointment of Directors by Articles (First Directors) : The first directors

are usually named in the article. The articles may, instead of naming the first

directors, confer a power upon the subscribers of the memorandum or a majority of

them to appoint them as in clause 64 of table A. If there are no articles, or there is no such provision, the subscribers of memorandum or a majority of them may appoint them by virtue of clause 64 of table A. On the other hand, where there are articles which neither name the directors nor contain any provision for appointing them and table A is excluded, the subscribers of the MOA, who are individuals, shall be deemed to be the directors of the company until the directors are duly appointed under section 255. (Section 254)

2. Appointment of Directors by Company : Unless the articles provide for the retirement of all directors at any annual general meeting, not less than two-thirds of the total number of directors of a company shall,

a) be persons whose period of office is liable to determination by retirement of directors by rotation, and

b) save as otherwise expressly provided in this Act, be appointed by the company in general meeting.

The remaining directors in case of any such company shall in default of and subject to any regulation in the article of the company, also shall be appointed by the company in general meeting. (Section 255)

3. Appointment of Directors by Directors : Directors may appoint–

a) Additional directors (Section 260);

b) Directors in casual vacancies (Section 262) and

c) Alternate directors (Section 313).

4. Appointment of Directors by Managing Agent : The managing agent of a company, if so authorized by its articles, appoints not more than two directors where the total number of the directors exceeds five, and one director where the total number does not exceed five. The managing agent may, at any time, remove any director so appointed and appoint another director in his place or in the place of director so appointed. Managing agent can, in no case, appoint the chairman of the board of directors (Section 377).

5. Appointment of Directors by Third Parties : The Article of a company may empower debenture – holders or other creditors of the company to appoint their nominees in the board.

6. Appointment of Directors by Central Government : Section 408 empowers the central government to appoint not more than two persons to hold office as directors in a company for a period not exceeding three years on any occasion as it thinks fit. Such an appointment will be made if the central government on

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application of not less than one hundred members or members holding not less than one tenth of the voting power of the company, is satisfied that it is necessary to make the appointment in order to prevent the affairs of the company being conducted in a manner oppressive or prejudicial to any member of the company. Hence, these are the modes of appointment of directors but it is to be noted that only individuals with their consent can be appointed as directors (Sec. 253).

Qualifications for Directors

The Companies Act does not prescribe any qualifications for Directors of any company. An Indian company may, therefore, in its Articles, stipulate qualifications for Directors. The Companies Act does, however, limit the specified share qualification of Directors which can be prescribed by a public company or a private company that is a subsidiary of a public company, to be five thousand rupees (Rs. 5,000/-).

Share qualification

qualification shares are those which are purchased by a person to become the director of

thecompany

(1) a) Without prejudice to the restrictions imposed by section 211, any director of a company who is by its articles required to hold a specified number of qualification shares, and who does not hold such qualification shares shall vacate his office if he does not obtain such qualification shares within two months, or such shorter period as may be provided in the articles of the company, from the date of his appointment, and shall not be capable of being reappointed until he has obtained such qualification shares.

b) For the purposes of any provision in the articles of a company requiring a director to hold a specified number of shares as qualification shares, the bearer of a share warrant shall not be deemed to be the holder of the shares specified in the warrant.

2) Any person who accepts an appointment or acts as a director of a company contrary to any provision of subsection (1), shall be guilty of an offence.

Minimum number of directors.

(1) Every public company (other than a public company which has become such by virtue of Section 43A), shall have at least three directors.

(2) Every other company shall have at least two directors.

(3) The directors of a company collectively are referred to in this Act as the "Board of directors" or "Board".

Restrictions on number of Directorships

The Companies Act prevents a Director from being a Director, at the same time, in more than fifteen (15) companies. For the purposes of establishing this maximum number of companies in which a person can be a Director, the following companies are excluded:

1. A "pure" private company;

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2. An association not carrying on its business for profit, or one that prohibits the payment of any dividends; and

3. A company in which he or she is only appointed as an Alternate Director.

Failure of the Director to comply with these regulations will result in a fine of fifty thousand rupees (Rs. 50,000/-) for every company that he or she is a Director of, after the first fifteen (15) so determined.

Director Identification Numbers

All Directors of Indian companies are required to obtain Director Identification Numbers ("DINs"). Primarily, DINs are required to authenticate any electronic filings made by the company.

VACATION OF OFFICE

The office of a director shall become vacant if—

1. he fails to obtain within the time specified in Section 270, or at any time thereafter ceases to hold, the share qualification, if any required of him by the articles of the company;

2. he is found to be of unsound mind by a court of competent jurisdiction;

3. if he applies to be adjudicated as an insolvent;

4. he is adjudged an insolvent;

5. he is convicted by a court of any offence involving moral turpitude, and sentenced in respect thereof to imprisonment for not less than six months;

6. he fails to pay any calls in respect of shares of the company held by him whether alone or jointly with others within six months from the last date fixed for the payment of the call unless the central government has by notification in the official gazette, removed the disqualification incurred by such failure;

7. he absents himself from three consecutive meetings of the board of directors, or from all meetings of the board for a continuous period of three months, whichever is longer, without obtaining leave of absence from the board;
8. he (whether by himself or by any person for his benefit or on his account), or any firm in which he is a partner or any private company of which he is a director, accepts a loan, from the company in contravention of Section 295;
9. he does not disclose his interest in any contract or proposed contract as required under section 299;
10. he becomes disqualified by an order of the court under section 203;
11. he is removed in pursuance of Section 284 etc.

Appointment of Managing Directors

A Managing Director must be an individual and can be appointed for a maximum term of five (5) years at a time.

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A person who is already a Managing Director / Manager of a public company or a private company subsidiary of a public company can become the Managing Director / Manager of only one other company (whether private or public) with the prior unanimous approval of the Board of such company. However, no such restrictions are applicable to a Manager or a Managing Director of “pure” private companies.

In case of a public company or a private company that is a subsidiary of a public company, if the appointment is not in accordance with Parts I and II of Schedule XIII of the Companies Act, such appointment must be approved by the Central Government.

Conditions for appointment of managing / Whole-time Directors; Disqualifications

The Companies Act, under Schedule XIII, also prescribes certain other conditions that are to be fulfilled for the appointment of a Managing or a Whole-time Director or Manager in case of a public company and a private company that is a subsidiary of a public company. Accordingly, no person shall be eligible for appointment as a Manager, a Managing Director or a Whole-time Director if he or she fails to satisfy the following conditions:

1. He or she should not have been sentenced to imprisonment for any period, or a fine imposed under any of the following statutes, namely:
 - i. The Indian Stamp Act, 1899;
 - ii. The Central Excise Act, 1944;
 - iii. The Industries (Development and Regulation) Act, 1951;
 - iv. The Prevention of Food Adulteration Act, 1954;
 - v. The Essential Commodities Act, 1955;
 - vi. The Companies Act, 1956;
 - vii. The Securities Contracts (Regulation) Act, 1956;
 - viii. The Wealth Tax Act, 1957;
 - ix. The Income Tax Act, 1961;
 - x. The Customs Act 1962;
 - xi. The Monopolies and Restrictive Trade Practices Act, 1969 – now the Competition Act, 2002;
 - xii. The Foreign Exchange Regulation Act, 1973 – now the Foreign Exchange Management Act, 1999;
 - xiii. The Sick Industrial Companies (Special Provisions Act) 1985;
 - xiv. The Securities Exchange Board of India Act, 1992; and / or
 - xv. The Foreign Trade (Development and Regulation) Act, 1973.
2. He or she should not have been detained or convicted for any period under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act,

1974.

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3. He or she should have completed twenty-five (25) years of age, but be less than the age of seventy (70) years. However, this age limit is not applicable if the appointment is approved by a special resolution passed by the company in general meeting or the approval of the Central Government is obtained.

4. He or she should be a managerial person in one or more companies and draws remuneration from one or more companies subject to the ceiling specified in Section III of Part II of Schedule XIII.

5. He or she should be a resident of India. 'Resident' includes a person who has been staying in India for a continuous period of not less than twelve (12) months immediately preceding the date of his or her appointment as a managerial person and who has come to stay in India for taking up employment in India or for carrying on business or vocation in India. However, this condition is not applicable for companies in the Special Economic Zone, as notified by Department of Commerce from time to time.

Additional disqualifications in case of a public company

In addition to the requirements mentioned above, the Companies Act further provides that a person shall not be eligible to be appointed as a Director of any other public company for a period of five (5) years from the date on which the public company, in which he or she is a Director, has failed to file annual accounts and annual returns or has failed to repay its deposits or interest thereon or redeem its debentures on the due date or pay dividends declared.

Additional disqualification in case of a "pure" private company

A private company that is not a subsidiary of a public company can, by its Articles, provide that a person shall be disqualified for appointment as a Director on any grounds in addition to those specified in the Companies Act.

Additional disqualifications for Managing and Whole-time Directors

An individual cannot be appointed as a Managing or a Whole-time Director of a company if he or she:

1. is an undischarged insolvent, or has at any time been adjudged an insolvent;
2. suspends, or has at any time suspended, payment to his or her creditors, or makes, or has at any time made, a composition with them; or
3. is, or has at any time been, convicted by a court of an offence involving moral turpitude.

These requirements are not only more stringent than the requirements for an ordinary Director, but are also of an absolute and mandatory nature.

REMOVAL

The removal of a director can be done (1) by shareholders, (2) by the Union Government and (3) by the Company Law Board.

Section-284 provides that a company may, by ordinary resolution, remove a director

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before the expiration of his period of office. A special notice of a resolution to remove a director is required, that is, notice of the intention to move the resolution should be given to the company not less than fourteen days before the meeting. This is to enable the company to inform the members beforehand. As soon as the company receives the notice, it must furnish a copy of it to the director concerned who will have the right to make a representation against the resolution and to be heard at the general meeting. If the director submits a representation and requests the company to circulate it among the

members, the company should, if there is time enough to do so, send a copy of the representation to every member of the company to whom notice of the meeting is sent. If this is not possible, the representation may be read out to the members at the meeting. A director may also be removed at the initiative of the Central Government. A special Chapter of the Companies Act enables the Central Government to remove managerial personnel from office on the recommendation of the Company Law Board. The Government has the power to make a reference to the CLB against any managerial personnel. When, on an application to the CLB for prevention of oppression or mismanagement, the CLB finds that a relief ought to be granted, it may terminate or set aside any agreement of the company with a director or managing director or other managerial personnel. When the appointment of a director is so terminated he cannot, except with the leave of the CLB, serve any company in a managerial capacity for a period of five years. Neither can he sue the company for damages or compensation for loss of office.

Position of director

A director is a manager, controller of the company. He cannot be treated as an employee of the company. However, a director may work as an employee in another capacity rather in a different position. For illustration—

In *Lee v. Lee's Air Framing Ltd.*¹ Mr. Lee formed the company for carrying out business of aerial top dressing. He was a qualified pilot and held all but one of the shares in the company. By virtue of articles of association Mr. Lee was assigned governing directorship of the company and was also appointed as an employee i.e., Chief Pilot. Mr. Lee was killed while flying the company's aircraft and consequently, his widow brought the claim for compensation under the Workmen's Compensation Act.

Mr. Lee's widow's claim was opposed by the company on the ground that Mr. Lee was not a "workman" because the same person could not be both employer and employee. However, the Privy Council reversing the judgment of the Court of Appeal, held that there was a valid contract of service between Lee and the Company, and Mr. Lee was, therefore a "workman" entitled to get the compensation under the Workmen's Compensation Act.

In reference to the management of company sometimes the directors are described as agents, managers and trustees, but these expressions are not the exact indications of their powers and responsibilities. In the view of the Supreme Court as expressed in *Ram Chand & Sons Sugar Mills v. Kanhayalal*² the position that the directors occupy in a corporate enterprise is not easy to explain. In reality, the directors are professional men, hired by the company to control, supervise and manage the affairs of company. They are regarded as the officers of the company. "A director is not a servant of any master. He

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cannot be described as a servant of the company or of anyone."

Directors as Organs of the Company : In the eyes of law there are two types of persons—i.e., artificial person and natural person. A company being an artificial person has to be managed and controlled by natural persons. These natural persons are directors of company. They are the brain and mind of the artificial person i.e., the company.

According to Neville J.— Man uses his bodily organs for a purpose, Corporation uses men. The board of directors is the brain and the only brain of the company, which is the body and the company can and does act only through it.

Thus, the board of directors represents the mind or will of the company. "When the brain functions the corporation is said to function." The Calcutta High Court in *Gopal Khaitan v. State*³, had put emphasis on the organic theory of corporate life. The Court said that "a theory which treats certain officials as organs of the company, for whose action the company is to be held liable just as a natural person is for the action of the limbs." In

other words, the board of directors of a company is recognised as the most important part of the company. The modern directors of company are mere clerks or servants of the company as they have extensive duties and responsibilities and have authorities to sign contracts on behalf of the company and are liable for the entire machinery of the corporate body.

Lord Justice Denning rightly said in *Bolton (Engineering) Co. Ltd. v. Graham & Sons*⁴—

“A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.” This, it was held that it was sufficient to show that the board of directors was the mind of a corporate body indeed.

Directors as Agents of Corporate Body : It is a well settled legal principle that the directors are agents of the company. They act on behalf of the principal i.e., the company. A clear illustration is *Ferguson v Wilson*⁵, wherein the directors allotted certain shares to the plaintiff. But, the allotment of shares could not be made as the company had exhausted its shares and consequently, the plaintiff sued the directors for damages.

It was held that the directors were not liable. In the instant case Cairns L.J. said—

“Directors are merely agents of the company. The company itself cannot act in its own person, for it has no person, it can only act through directors and the case, as regards those directors, is merely the ordinary case of principal and agent. Wherever an agent is liable those directors would be liable, where the liability would attach to the principal, and the principal only, the liability is the liability of the company.” Thus, the directors incur no personal liability, if they acted within the scope of their authority while entering into a contract on behalf of the company.

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As the directors are agents of the company the notice to a director will constitute a notice to the company. However, Privy Council in *T.R. Pratt (Bombay) Ltd. v. M.T. Ltd.*⁶, has held that the notice to a director will amount to a notice to the company in the same manner as a notice to an agent is the notice to the principal. Section 230 of the Indian Contract Act reads as under —

“In the absence of any contract to that effect an agent cannot personally enforce contracts entered into by him on behalf of his principal, nor is he personally bound by them.”

Therefore, the company as a principal shall be liable. The directors incur no personal liability on contracts made by them on behalf of the company, provided they acted within the scope of their authority.

Directors as Trustees of the Company : The directors are described as trustees of the company in respect of property and money of the company. They are also entrusted with the powers to deal with the company's money and property. For example in *Joint Stock Discount Co. v. Brown*⁷, wherein the directors had misapplied funds of the company, it was held that they had committed a breach of trust and were jointly and severally liable. Similarly, in *York and North Midland Railway v. Hudson*⁸, the directors who had improperly dealt with the funds of the company were held liable as trustees.

The Madras High Court in *Ramaswamy Iyer v. Brahmayya & Co.*⁹, observed that—

It is the settled view that for the company the directors of a company are trustees.

The directors, with reference to their entrusted power of applying money and property of

the company and for misuse of the power, the directors could be rendered liable as trustees and on their death, even the cause of action survives against their legal successors. It is to be made clear that the directors are trustees of the company and not of individual shareholders.

Whether Directors are Quasi-Trustees : The directors are regarded as trustees of the company but they are not trustees in reality. It is to be seen that the trust property invests in the trustees, but on the other hand the company's property and money are not vested with the directors of the company but in company itself. The duties of directors are not the same as the duties of trustees. According to Romer J. in *Re, City Equitable Fire Insurance Co. Ltd.*¹⁰,

"It is sometimes said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship to the company, the statement is true enough. But, if the statement is meant to be an indication by way of analogy of what those duties are, it appears to me to be wholly misleading. I can see but little resemblance between the duties of director and the duties of a trustee of a will or of a marriage settlement. It is indeed impossible to describe the duty of directors in general term, whether by way of analogy or otherwise."

Thus, the directors of a company are not the trustees of that company in absolute term. But, the directors are trustees of the money and property of the company and also agents in the deal which they perform on behalf of the company. In other words the directors are the mere trustees or agents of the company.

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Hence in brief and compact sense though a company is a legal entity in the eyes of law it can not, in the nature of things, act by itself. A company's personality is the creation of legal fiction and it has no material existence. Accordingly, it must act through some human agency. The persons through whom it acts and carries on its affairs are usually termed 'Directors'.

Section 2(13) of the company Act defines 'director' thus : "director" includes any person occupying the position of director, by whatever name called but this is not a satisfactory definition of director. In fact, directors are the select body of persons upon whom lies the responsibilities of the management of the company as well as the business run by the company. In brief 'a person having the direction, conduct, management or superintendence of the affairs of the company is a director. Directors of a company are collectively referred to in the Act as the 'board of directors' or 'Board' under section 252(3) of the Act.

Legal Position of Directors : It is very difficult to precisely define the true legal position of directors. They are sometimes agents of the company and sometimes trustees of the company. At any rate they are not employees of the company. But in any case they stand in a fiduciary position towards the company.

In *Ferguson Vs Wilson*¹¹, Cairns L.J., observed as follows –

"What is the position of directors of a public company? They are merely agents of a company. The company itself can not act in its person, for it has no person; it can act through directors, and the case is, as regards those directors, merely the ordinary case of principal and agent."

In *York & North Midland Rly Vs Hudson*¹², directors who had improperly dealt with the funds of the company were liable as trustees. The learned judge observed as follows: "The directors are selected to manage the affairs of the company for the benefit of the shareholders. It is an office of trust which, if they undertake, it is their duty to perform fully and entirely."

Both characters of directors were summed up in *G.E. Rly Vs Turner*¹³.

“The directors are the mere trustees or agents of the company-trustees of the company’s money and property-agents in the transactions which they enter into on behalf of a company.”

POWERS OF DIRECTORS

The powers of directors are normally set out in the articles of the company. Once these powers are delegated to and vested in the Board of Directors, only Board may exercise them. The powers of directors are generally contained in the articles and there is usually a clause giving them the powers of management of the company and all other powers which are not otherwise dealt with. This general clause is, however, not to be construed ‘ejus dem generis’ but it has been held to cover and render valid all acts of the directors done bonafide in the management of the company.

Thus directors of a company have no other authority other than that which is given to them by the articles of association; these are open and supposed to be known to all persons who have dealings with the company.

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The directors of a company can do whatever the company can do, subject to the restrictions imposed in articles of the company.

1. General powers vested in the Board of Directors provided under section 291

Section 291 declares that subject to the provisions of the Act the Board shall be entitled to exercise all such powers, and do all such acts, as the company is authorized to exercise and do. It therefore follows, that subject to the restrictions contained in the Act, and in the memorandum and articles of the company, they powers of the Board are coextensive with those of the company itself. But these powers of the Board are subject to two restrictions. These are :-

1. The directors can do nothing that the company itself cannot do under its memorandum and any such ultra vires acts done by the Board shall be void.
2. When acting within the powers of the company the powers of the Board are limited to the extent the company has delegated them by its articles.

2. Specific powers vested in the Board

In Addition to the general powers vested in the Board by section 291 of the companies Act, certain specific powers have also been conferred on the Board by the Act. These specific powers relate to :-

- (a) Exercise superintendence, control & direction over the affairs of the company;
- (b) Dispose off the shares which are available for issue in order to increase the subscribed capital of the company after complying with the provision of section 81 of the Act;
- (c) Appoint the first auditor within 1 month of the registration;
- (d) Fill up casual vacancy in the office of an auditor if it is not caused by his registration;
- (e) Appoint additional directors it authorized by the articles;
- (f) File casual vacancies;
- (g) Appoint alternate directors;
- (h) Contribute such amount as it thinks fit to the National Defence fund for the purpose of national defence.

3. Powers to be exercised only at Board Meetings

According to section 292 of the Act, the following powers can be exercised only by means of resolutions passed at Board meetings and not by circulation :

- (a) The powers to make calls on share holders in respect of money unpaid on their shares;
- (b) The power to issue debentures;
- (c) The power to borrow moneys otherwise than on debentures;
- (d) The power to invest the funds of the company;

(e) The powers to make loans.

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4. Power which must be exercised by the Board Unanimously :-

The following powers of the Board must be exercised by a resolution passed at the Board's meeting by an unanimous vote :

- (a) Powers to appoint or employ a person as managing director U/S 316 or manager U/S 386 if he is already a managing director or manager of another company; and
 - (b) Power to invest in any shares or debentures of any other body corporate U/S 372.
- Apart from the power of management and general supervision of the company's affairs, the directors also exercise the following powers and rights –

1. to appoint and dismiss officers;
2. to declare dividends;
3. to issue shares and debentures;
4. to make calls;
5. to inspect corporate books; and
6. to delegate powers to sub-committee or other officers, etc. etc.

The present Act lays down some specific provisions in this regard and certain powers are to be exercised by the Board of Directors only at a meeting. These are–

1. The power to make calls on shareholders in respect of money unpaid on their shares;
2. The power to issue debentures;
3. The power to borrow moneys otherwise than on debentures;
4. The power to invest the funds of the company; and
5. The power to make loans.

The company in general meeting may impose further restrictions and conditions on the exercise by the board of any of the powers mentioned above (Section 292)

Besides the powers specified in section 292, there are certain other powers also which are required to be exercised only at the meetings of the board, such as –

1. The power of filling casual vacancies in the board (Section 262);
2. Sanctioning or giving consent to contracts of or with any director [Section 297(4)];
3. Receiving of notice of disclosure of interest (Section 299);
4. Unanimous consent of all directors present at board meeting necessary for appointing as managing director or manager of a person who is already managing director or manager of another company [Section 316(2) and 286(2)].
5. Sanction by unanimous consent of all the directors present at a Board meeting necessary for making investments in the companies in the same group [Section 37(5)]; and

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6. Receiving notice of share-holdings of directors (Section 308).

DUTIES

Directors hold the most important office in the company's administration. This very fact is sufficient to indicate how onerous the duties of directors may be. Directors perform multifarious duties of varying significance.

"Directors", says Lindley, M.R., "if act within their powers, if they act with such care as is reasonably to be expected from them having regard to their knowledge and experience, if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company¹⁴." The general duties of directors may be summarised as follows–

1. **Duty to Exercise Reasonable Care, Skill and Diligence** : It is the first and

foremost duty of directors to carry out their duties with such care as is reasonably expected from persons of their knowledge and status. "A director needs to exhibit in the performance of his duties a greater skill than may be expected from a person of his knowledge or experience." Romer J., in *Re City Equitable Fire Insurance Co.*¹⁵

2. Duty to Act Honestly : Lindley M.R., in the above cited case observed that, "If they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company."

3. Duty to apply company's fund for company's business.

4. Duty to prevent misappropriation and breach of trust.

5. Duty when Selling Shares Company : Directors are duty bound to dispose of their company's shares on the best terms obtainable and must not allot them to themselves or their friends at a lower price in order to obtain a personal benefit.

6. Duty When Making Call : The duty of director, when a call is made, is to compel every share holder to pay to the company the amount due from him in respect of that call; and they are guilty of a breach of their duty to the company if they donot take all reasonable means for enforcing that payment. Apart from these general duties, the directors have some specific duties laid down by the companies Act itself under various sections. They are –

a) Duty to certify annual returns (Sec. 161)

b) Duty to make statutory reports (Sec. 165)

c) Duty to call general meetings (Sec. 166)

d) Duty to call extraordinary meetings (Sec. 169)

e) Duty to lay before the company annual accounts and balance sheet (Sec. 210)

f) Duty to attach Board's report (Sec. 217)

g) Duty to assist the Inspector (Sec. 240)

h) Duty to assist the prosecution (Sec. 242)

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i) Duty to acquire share qualifications (Sec. 270)

j) Duty to disclose age (Sec. 282)

k) Duty to disclose interest (Sec. 299)

l) Duty to disclose holding of office in other body corporate (Sec. 305)

m) Duty to make disclosure of share holdings (Sec. 308) and

n) Duty in winding up of a company (Sec. 454).

These are only illustrative and not the exhaustive duties of the directors.

MEETINGS AND ITS VARIOUS KINDS

There are three types of general meetings of the shareholders of a company. These are–

1. Statutory Meeting : It is the first official general meeting of the shareholders. All public companies having a share capital except unlimited companies are required to hold a statutory meeting compulsorily. It implies that private companies, unlimited companies and companies limited by guarantee but not having a share capital are not required to hold such a meeting. Statutory meeting must be held after one month but within six months of obtaining the certificate to commence business. [Section 165(1)]. Unlike other types of general meetings, this meeting is held only once in the lifetime of a company.

The object of statutory meeting is to provide an opportunity to the members, as early as possible, of acquainting themselves with the assets and properties of the company and for the same a statutory report is to be prepared by the directors and sent to every member at least 21 days before the meeting.

Statutory report contains following information :

- a) Total number of shares allotted.
- b) An abstract of the receipts and payments up to date.
- c) Names, addresses and occupations of the directors.
- d) Particulars of the contracts, if any.
- e) The details of arrears due from directors and managing director or manager.
- f) The particulars of the commission etc. paid or to be paid to the directors, managers in connection with the sale of shares or debentures of the company etc.

2. Annual General Meeting : According to Section 166(1), every company shall in each year hold in addition to any other meetings, a general meeting as its annual general meeting. Every general meeting must be held during the business hours, on a day which is not a public holiday and at the registered office of the company. Annual general meeting is sometimes called 'ordinary general meeting' as usually it deals with the so called 'ordinary business'.

The following ordinary business must be transacted at the annual general meeting

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of a public company. [Section 173(1)(A)]

- a) The consideration of the annual accounts, balance sheet and the reports of the board of directors and auditors;
- b) The declaration of dividends;
- c) Appointment of directors in place of those retiring and
- d) The appointment of, and the fixation of the remuneration of the auditors etc.

3. Extraordinary General Meeting : All general meetings other than statutory and annual general meetings are called extraordinary general meetings. [Regulation 47 of 'Table A']. These meetings may be convened by the company at any time. The business transacted at an extra ordinary general meeting comprises anything which can not be postponed till the next annual general meeting, e.g. changes in the memorandum and article of association, reduction and reorganisation of share capital etc. All business transacted at this meeting is called special business [Section 173(1)(B)].

Extraordinary meetings may be called –

- 1. By the directors;
- 2. By the directors on requisition of members having 1/10 of total voting rights.
- 3. By the requisitionists themselves (Section 169)
- 4. By the tribunal (Section 186).

Apart from the above three kinds of meeting the court also has the power to convene the meeting of the company in the circumstances mentioned in Section 186 of the Act.

Insider Trading

Insider trading is the trading of a corporation's stock or other securities (e.g. bonds or stock options) by individuals with potential access to non-public information about the company. In most countries, trading by corporate insiders such as officers, key employees, directors, and large shareholders may be legal, if this trading is done in a way that does not take advantage of non-public information. However, the term is frequently used to refer to a practice in which an insider or a related party trades based on material nonpublic information obtained during the performance of the insider's duties at the corporation, or otherwise in breach of a fiduciary or other relationship of trust and confidence or where the non-public information was misappropriated from the company.

In the United States and several other jurisdictions, trading conducted by corporate officers, key employees, directors, or significant shareholders (in the U.S., defined as beneficial owners of ten percent or more of the firm's equity securities) must be reported

to the regulator or publicly disclosed, usually within a few business days of the trade. Many investors follow the summaries of these insider trades in the hope that mimicking these trades will be profitable. While “legal” insider trading cannot be based on material non-public information, some investors believe corporate insiders nonetheless may have better insights into the health of a corporation (broadly speaking) and that their trades otherwise convey important information (e.g., about the pending retirement of an important

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officer selling shares, greater commitment to the corporation by officers purchasing shares, etc.)

Illegal insider trading is believed to raise the cost of capital for securities issuers, thus decreasing overall economic growth.

Definition of “insider”

In the United States and Germany, for mandatory reporting purposes, corporate insiders are defined as a company’s officers, directors and any beneficial owners of more than ten percent of a class of the company’s equity securities. Trades made by these types of insiders in the company’s own stock, based on material non-public information, are considered to be fraudulent since the insiders are violating the fiduciary duty that they owe to the shareholders. The corporate insider, simply by accepting employment, has undertaken a legal obligation to the shareholders to put the shareholders’ interests before their own, in matters related to the corporation. When the insider buys or sells based upon company owned information, he is violating his obligation to the shareholders.

Legal insider trading

Legal trades by insiders are common, as employees of publicly-traded corporations often have stock or stock options. These trades are made public in the US through SEC filings, mainly Form 4. Prior to 2001, US law restricted trading such that insiders mainly traded during windows when their inside information was public, such as soon after earnings releases. SEC Rule 10b5-1 clarified that the U.S. prohibition against insider trading does not require proof that an insider actually used material nonpublic information when conducting a trade; possession of such information alone is sufficient to violate the provision, and the SEC would impute an insider in possession of material nonpublic information uses this information when conducting a trade. However, Rule 10b5-1 also created for insiders an affirmative defense if the insider can demonstrate that the trades conducted on behalf of the insider were conducted as part of a preexisting contract or written, binding plan for trading in the future. For example, if a corporate insider plans on retiring after a period of time and, as part of his or her retirement planning, adopts a written, binding plan to sell a specific amount of the company’s stock every month for the next two years, and during this period the insider comes into possession of material nonpublic information about the company, any subsequent trades based on the original plan might not constitute prohibited insider trading.

Illegal insider trading

Rules against insider trading on material non-public information exist in most jurisdictions around the world, though the details and the efforts to enforce them vary considerably. The United States is generally viewed as having the strictest laws against illegal insider trading, and makes the most serious efforts to enforce them.

For example, illegal insider trading would occur if the chief executive officer of Company A learned (prior to a public announcement) that Company A will be taken over, and bought shares in Company A knowing that the share price would likely rise.

In the United States and many other jurisdictions, however, “insiders” are not just limited to corporate officials and major shareholders where illegal insider trading is concerned,

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but can include any individual who trades shares based on material non-public information in violation of some duty of trust. This duty may be imputed; for example, in many jurisdictions, in cases of where a corporate insider “tips” a friend about non-public information likely to have an effect on the company’s share price, the duty the corporate insider owes the company is now imputed to the friend and the friend violates a duty to the company if he or she trades on the basis of this information.

Liability for insider trading

Liability for insider trading violations cannot be avoided by passing on the information in an “I scratch your back, you scratch mine” or quid pro quo arrangement, as long as the person receiving the information knew or should have known that the information was company property. It should be noted that when allegations of a potential inside deal occur, all parties that may have been involved are at risk of being found guilty.

For example, if Company A’s CEO did not trade on the undisclosed takeover news, but instead passed the information on to his brother-in-law who traded on it, illegal insider trading would still have occurred.

Misappropriation theory

A newer view of insider trading, the “misappropriation theory,” is now part of US law. It states that anyone who misappropriates (steals) information from their employer and trades on that information in **any** stock (not just the employer’s stock) is guilty of insider trading.

For example, if a journalist who worked for Company B learned about the takeover of Company A while performing his work duties, and bought stock in Company A, illegal insider trading might still have occurred. Even though the journalist did not violate a fiduciary duty to Company A’s shareholders, he might have violated a fiduciary duty to Company B’s shareholders (assuming the newspaper had a policy of not allowing reporters to trade on stories they were covering).

Proof of responsibility

Proving that someone has been responsible for a trade can be difficult, because traders may try to hide behind nominees, offshore companies, and other proxies. Nevertheless, the U.S. Securities and Exchange Commission prosecutes over 50 cases each year, with many being settled administratively out of court. The SEC and several stock exchanges actively monitor trading, looking for suspicious activity.

Trading on information in general

Not all trading on information is illegal inside trading, however. For example, while dining at a restaurant, you hear the CEO of Company A at the next table telling the CFO that the company’s profits will be higher than expected, and then you buy the stock, you are not guilty of insider trading unless there was some closer connection between you, the company, or the company officers. However, information about a tender offer (usually regarding a merger or acquisition) is held to a higher standard. If this type of information is obtained (directly or indirectly) and there is reason to believe it is non-public, there is a duty to disclose it or abstain from trading.

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Tracking insider trades

Since insiders are required to report their trades, others often track these traders, and there is a school of investing which follows the lead of insiders. This is of course subject to the risk that an insider is making a buy specifically to increase investor confidence, or making a sell for reasons unrelated to the health of the company (e.g. a desire to diversify or pay a personal expense).

As of December 2005 companies are required to announce times to their employees as

to when they can safely trade without being accused of trading on inside information.

Insider trading vs. insider information

In the industry of investing, there is a difference between insider trading and insider information. For example, there was information released about Continental and United Airlines merging in late 2009. At the turn of the year, it was believed that the merger was going to fall through and that the two companies were not going to act upon the merger. By summer of 2010 and the final signing of the legal details (a), the deal went through officially. The acquisition of the added resources, capital, and infrastructure for the two companies would easily drive up the stock price of the new “company” under UAL on the New York Stock Exchange. With this done, insider traders could have acted back when there were rumors assuming the price would have gone up. However, insider informants “said” that the merger fell through and nothing was going to happen. This creates gossip in the trading world and information that an insider can be giving out to friends and family may not be completely accurate since they do not know the full story. Generally, insider traders act upon information that they believe to be true that is not available to the public giving them the upper hand in making profits. Insider informants pass along information in the form of gossip and do not personally buy or sell stock based on projections. Whether or not either party is acting illegally is solely in the hands of the SEC.

IMPORTANT QUESTIONS

Q.1 What are the rights of the Promoters of the company?

Q.2 What is the liability of a promoter for the issue of prospectus containing false or deceptive statements?

Q.3 Define the term ‘promoters’. What is the legal position of the promoters of a company? What are their rights and liabilities?

Q.4 What do you mean by ‘Director’? Explain the legal position of the directors.

Q.5 What are the various categories of the powers of the directors? Discuss in details the duties of the directors.

Q.6 How is a director appointed and under what circumstances the office of a director shall become vacant?

Q.7 What is the civil liability of the directors of a company?

Q.8 Who is the Managing Director? How is he appointed and what is his status?

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Q.9 What is the minimum and maximum number of directors in a company?

Q.10 What is the Share qualification of a director?

Q.11 What is the nature of the acts of a director whose appointment is subsequently found to be defective or invalid?

Q.12 What precautions the Companies Act provides for ensuring that in the case of director, there is no conflict between his duty of the Company and his self-interest?

Q.13 What do you mean by meeting? Explain the various kinds of meetings. Also explain the requisities of a valid meeting.

Q.14 Discuss in detail the three kinds of meetings. What are the specific contents of these meetings respectively?

Q.15 In what different ways the directors of a company can be appointed and removed from office?

Q.16 Explain the position that the director occupies in the structure of corporate management.

Q.17 “A director has to act in the way in which a man of affairs dealing with his own affairs with reasonable care and circumspection could reasonably be expected to act”. Discuss with reference to Director’s duty of care, duty to attend board

meeting and the duty not to delegate. Refer statutory provision on this subject.

Q.18 Discuss the fiduciary duties of the directors in the management of the company with special reference to their liability for misuse of corporate opportunities and insider trading.

(Footnotes)

1. (1961) AC 12 (PC).
2. A.I.R. 1966 S.C. 1899.
3. State Trading Corporation v. CTO, A.I.R. 1963 S.C. 1811
4. (1957) 1 Q.B. 159 C.A.
5. (1866) 2 Ch. 77.
6. A.I.R. 1938 P.C. 159.
7. (1869) 8 E.Q. 376.
8. (1953) 16 Beav. 485.
9. (1966) 1 Comp. L.J. 107 Mad
10. (1925) Ch. 407.
11. (1866) LR 2Ch 77
12. (1853) 16 Beaw. 485
13. (1872) LR8 Ch. 149 by lord Selborne
14. Lagunas Nitrate Co. Vs Lagunas Syndicate, (1897) 2 Ch. 392.
15. (1925) Ch. 403

UNIT 4

Structure

- Study of Selected Lit

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SHARE

A share in a company is one of the units into which the total capital of the company is divided. It is an interest of a member in a company measured by a sum of money usually the nominal value of the share and also by the rights and obligations belonging to it.

Statutory definition of the term share has been given under section 2(46) of the Company Act that share is the share capital of a company, and includes stock except where a distinction between stock and share is expressed or implied'. The term along with other things may be understood from a very nice definition given by Lord Justice Lindley.

According to him 'by a company is meant an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the CAPITAL of the company. The persons who contribute it or to whom it belongs are MEMBERS. The proportion of capital to which each member is entitled is his SHARE'.

As far as the legal nature of a share is concerned it has been declared as a movable property under section 82 of the company Act. Shares are included in the definition of goods under the provisions of Sale of Goods Act, 1930 Section 2(7). In case of Arjun Prashad Vs Central Bank of India¹, court has also regarded a share as goods in India. The definition of the term 'share' is contained in section 2 (46) of the companies Act. It means "a share in the share-capital of a company, and includes stock except where a distinction between stock and shares is expressed or implied.

Dixon J., in Peter's American Delicacy co. Ltd. Vs Health (1939) 61 C.L.R.

457 defines share in the following words : "Primarily Share of any company is a piece of property Conferring right in relation to distribution of income and of capital."

The best definition of share has been given by Farewell J., in **Borland's Trustee Vs**

Steel Brothers & Co. (1901) 1 Ch. 279: “A share in a company signifies a definite portion of the capital of the company. A share held by member of a company represents the portion of the Company’s assets in which the member has interest less the same proportion of the company’s liabilities. In more simple language, the holder of a share has subject to and with the benefit of the regulations of the company, the right to receive a certain portion of the profit of the company and also of the capital of the company when it is wound up.”

It is to be noted that the holder of shares in a company cannot be treated as a part owner of the company’s capital because a company is something different from the totality of the company. However, the holder of a share in a company may be treated as an owner of certain rights and interests in the Company & along with it he is also burdened with certain liabilities. “A share is not a sum of money by an interest measured by a sum of money and made up of various rights & liabilities. A share is an existing bundle of rights. Thus it may be concluded that a share is a right to participate in the profits made by a company while it is a going on concern & declares dividends and in the assets of the company in the event of its being wound up.

Nature of Shares (Sec 82)

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According to Sec, 82, the shares or other interest of any member in a company shall be movable property, transferable in the manner prescribed by the Articles of the Company.

Shares have been declared as movable property, and their transfer has to be in the manner prescribed by the Articles of the Company, but it is not a negotiable instrument.

Sec 83 further provides that each share in a company shall be distinguished by its appropriate number, provided that nothing in this section shall apply to the shares held by a depository.

In India, a share has been regarded as ‘goods’ within the meaning of section 2 (7) of the Sales of Goods Act, 1930 which says “Goods means any kind of movable property other than actionable claims & money, and includes stock and shares.”

Kinds of Shares

The Share-capital of a company limited by shares, formed after the commencement of the companies Act, 1956 or issued thereafter consists of two kinds of shares:

(a) Preference shares

(b) Equity Shares (also known as ordinary shares), &

A Private company which is not a subsidiary of a Public Company may issue both or either types or these shares.

Preference Shares : Such shares enjoy preferential rights (a) as to the payment of dividend at a fixed rate during the life of the company, and (b) as to the return of capital on winding up of the company as per section 85(1). If any shares carry only one of these two preferential rights, they will be treated as equity shares. The holder of this type of shares enjoys only preferential rights over the equity shareholders. The preference shareholders do not enjoy normal voting rights like the equity shareholders with voting rights. They are, however, entitled to vote only in these two conditions –

1. When any resolution directly affecting their rights is to be passed; and

2. When the dividend due (whether declared or not) on their preference shares or part thereof has remained unpaid.

There may be different kinds of preference shares depending upon the terms of issue which are either defined in the Articles of Association or in the prospectus of the company. A company may issue the following types of preference shares–

1. Cumulative Preference Shares : They carry the right to cumulative dividends if the company fails to pay the dividend in a particular year. The accumulated arrears of dividends shall be paid, if any dividend is declared in subsequent years, before any dividend is paid to the equity share holders. If the company goes into liquidation, no arrears of dividends are payable unless either the Articles contain an express provision to this effect or such dividends have been declared. Of course, the arrears of undeclared dividends shall be payable, even if the Articles are silent, out of any surplus left, after returning in full the preference and equity share capital. It

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must be remembered that all preference shares are always presumed to be cumulative unless the contrary is stated in Articles or the terms of issue.

2. Non-Cumulative Preference Shares : Such shares donot carry the right to receive the arrears of dividend in a particular year, if the company fails to declare dividend in previous year or years. If no dividend is paid in any particular year, it lapses.

3. Participating Preference Shares : These are preference shares which receive their fixed dividends e.g. 11%, in the normal way, but which then participate further in the distributed profits along with the equity shares after a certain fixed percentage has been paid on them as well. The holder of such shares may also be entitled to get a share in the surplus assets of the company on its winding up if specific provision exists to that effect in the Articles.

4. Non Participating Preference Shares : These shares are entitled to only a fixed rate of dividends and do not participate further in the surplus profits irrespective of the magnitude of such profit. If the Articles are silent, all preference shares are deemed to be non-participating unless otherwise stated in the terms of issue.

5. Convertible Preference Shares : The holder of these shares is given the right of conversion of his shares into equity shares at a later date.

6. Non-Convertible Preference Shares : Here, the preference shareholder is not given the right of conversion of his shares into equity shares. If the Articles are silent, all preference shares are deemed to be non-convertible unless provided otherwise in the terms of issues.

7. Redeemable Preference Shares : Ordinarily capital received on the issue of shares can be returned on the winding up of the company only, because if the company is allowed to return it any time it so wished, the creditors could not rely on the company having any money at all. But section 80 of the Act authorises a company limited by shares to issue “redeemable preference shares”. Capital received on such shares can be paid back to the holders of such shares during the life time of the company. The paying back of the capital is called redemption.

8. Irredeemable preference shares : The repayment of such shares is possible on winding up of the company only. After the commencement of the Companies (Amendment) Act – 1988, issue of any further irredeemable preference shares is prohibited.

Equity Shares : According to section 85(2), ‘Equity shares’ means those shares which are not preference shares’. These shares carry the right to receive the whole of surplus profits after the preference shares, if any, have received their fixed dividend. If no profits are left after paying fixed preference dividends, the holders of such shares get no dividends. Same is the case with regard to the return of capital on winding up of the company. Further, directors have the sole right of recommending dividends to such shares and as such they may not get any dividends in case the directors so choose, in spite of huge profits. It is why in financial terminology the share capital raised through such

shares is called 'Risk Capital'. The fortune of equity shareholders is tied up with the ups

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and downs of the company. If the company fails, the risks fall mainly on them and if the company is successful they enjoy great financial rewards.

Equity shares are of two kinds. These are–

1. Equity Shares with Voting Rights : According to section [87(1)(a)], the holders of any such equity shares have normal voting rights on every resolution placed before the company at any general meeting. Further, Section 87(1) (b) provides that his voting right on a poll shall be in proportion to his shares of the paid up equity capital of the company.

2. Equity Shares with Differential Rights : The holders of any such shares shall have differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed by the Central Government.

Students are advised to study the Companies (Issue of share capital with Differential Voting Rights) Rules, 2001, passed by the Central Government for the purpose, for further knowledge and understanding of the subject.

Allotment of Shares

The capital of company is divided into certain indivisible units of a fixed amount. These units are called shares. 'Share' means share in the share capital of a company.

A share has been defined as "an interest having a money value and made up of diverse rights specified under the Articles of Association"- **Commr of Income Tax v Standard Vaccum Oil Co. Ltd**

A share is evidenced by a share certificate. A share certificate is issued by a company under its common seal.

Each share is to be distinguished by appropriate number (**Section 83**). Each share in a company having share capital is distinguished by its appropriate number.

General principles

An effective allotment has to comply with the requirements of the law of contract relating to acceptance of an offer.

1. Allotment by proper authority-an allotment must be made by a resolution of the board of directors. "Allotment is a duty primarily falling upon the directors.", and this duty cannot be delegated except in accordance with the provisions of the articles.

2. Within reasonable time-allotment must be made within a reasonable period of time, otherwise the application lapses. What is reasonable time must remain a question of fact in each case. The interval of about six months between application and allotment has been held to be reasonable. On the expiry of reasonable time Section 6 of the Contract Act applies and the application must be deemed to have been revoked.

3. Must be communicated-the allotment must be communicated to the applicant.

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Posting of a properly addressed and stamped letter of allotment is a sufficient communication even if the letter is delayed or lost in the course of post. **Household Fire & Carriage Accident Insurance Co. v Grant** is the leading authority.

4. Absolute and unconditional-allotment must be absolute and in accordance with the terms and conditions of the applicant, if any. Thus where a person applied for 400 shares on the condition that he would be appointed cashier of a new branch of the company. He was not bound by any allotment unless he was so appointed.

A condition which is to operate subsequently to allotment will not affect its validity. An applicant to whom shares were allotted on the condition that he would pay for them only when the company paid dividends was held to be bound even though the company had gone into liquidation before paying any dividend.

The applicant must promptly reject the allotment when shares have been allotted to him without his condition being fulfilled. An acquiescence on his part would amount to a waiver of the condition.

ISSUE OF SHARES

The Companies Acts have always discouraged issue of shares for a price less than their face value. Allotment of shares at a discount is ultra vires and, therefore, the allottees who have been put on the register of members become bound to pay the full value of their shares. But a contract to take shares at a discount is not enforceable.

Law does not tolerate issue of shares at a discount even in an indirect way. Thus, where a company issued debentures at a discount, which is allowed by the Act, and gave each debenture-holder the right to convert his issuing shares at a discount and, therefore, was not legal. But, subject to the following strict conditions, a company may issue its shares at a discount. In the first place, the shares of the class issued for the first time are not allowed to be sold at a discount. Discount can be allowed only on that class of shares which the company has already once issued before at full value. Secondly, the company contemplating such an issue must have become entitled to commence business at least one year before the date of issue. The procedure in this regard is that a resolution authorising the issue must be passed. The resolution must specify the rate of discount which must not exceed ten percent, except with the approval of the Union Government. Finally, the sanction of the Union Government must be obtained and the shares issued within two months of the Board's sanction.

If the market exists, a company may issue its shares or securities at a price higher than their nominal value. There is no restriction whatever on the sale of shares at a premium. But SEBI Guidelines have to be observed as they indicate when an issue has to be at par and when premium is chargeable. Premium may be received in cash or in kind. Where the value of the assets received by a company as a consideration for allotment is greater than the nominal value of shares, it is in essence an allotment at a premium. An amount equal to the extra value of assets would have to be carried to the share premium account. The act does regulate the disbursement of the amount collected as premium. It is clearly provided that separate account to be known as the The Securities Premium Account. The amount to the credit of share premium account has to be maintained with the same

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sanctity as share capital and can be reduced only in the manner of share capital. Liberty is, however, given to use the fund in the following four ways i.e. (1) It may be applied to issue to the members as fully paid by way of bonus the unissued shares of the company. (2) It may be used to write off preliminary expenses. (3) It may be used to write off commission or discount account. (4) It may be spent in providing for the premium payable on the redemption of preference shares or debentures of the company.

So far as the bonafide reduction of share premium account is concerned an example may be of a company which proposed to write off accumulated losses by utilising the share premium account and by reducing the face value of its shares. The need and purpose of reduction was duly explained and discussed at an extraordinary general meeting at which a special resolution was unanimously passed. The company had no secured creditors. The unsecured creditors had given their written consent. Nothing was shown to be there either against public interest or against law. The share premium account was treated as paid up share capital for a limited purpose, but not as a reserve fund. A company can be

allowed to write off or adjust a loss against share premium account if there is no diminution of the shares capital account and corresponding reduction in the share premium account.

Statutory restrictions

Sections 69 and 70 of the Companies Act deal with allotment of shares and lay down certain statutory conditions to be fulfilled before a company makes allotment of shares.

These restrictions are-

1. Minimum Subscription and Application Money under section 69,
2. Statement in lieu of prospectus under section 70,
3. Opening of the Subscription list under section 72,
4. Listing of shares in Stock Exchange under section 73.

Share Certificate

A share certificate is a written document signed on behalf of a corporation, and serves as legal proof of ownership of the number of shares indicated. Also referred to as a "stock certificate".

Investopedia explains 'Share Certificate'

In modern financial markets, individual investors rarely take physical possession of their share certificates. "Scripophily" is a term that signifies the collecting of share certificates and other forms of paper based financial securities. Similar to stamp collecting or bank note collecting, a share certificate's value is dependent on its condition and age.

Every person whose name is entered as a member in the register of members of a company has a right to receive a certificate of his shares [article 7(1) of table A, schedule 1]. A share certificate shall be under the seal of the company, and shall specify-

1. the shares to which it relates.

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2. the amount paid up thereon, and
3. the name of the holder of the shares. The share certificate shall be signed by at least 2 directors and the secretary.

LIMITATION OF A SHARE CERTIFICATE

The company shall deliver share certificate.

1. within 3 months of the allotment of shares, (or)
2. within 2 months after the application for registration of the transfer of any such shares. Issue of share certificates is however subject to any provision of law or of any order of any tribunal or other authority.

OBJECT OF SHARE CERTIFICATE

A share certificate under the seal of a company is prima facie evidence of the title of the member to the shares specified in the certificate. Estoppel, a share certificate of a company creates two kinds of estoppel against the company, namely:

DEFACED CERTIFICATE

A share certificate may be renewed or a duplicate or a certificate may be issued if such certificate.

- a) is proved to have been lost or destroyed, or
- b) having been defaced or mutilated or torn. is surrendered to the company.

Effects of Share certificate

A certificate issued under the common seal of the company, specifying any shares held by any member, shall be *prima facie* evidence of the title of the member to such shares. Every company pursuant to section 113 shall within 3 months of allotment of shares or debentures, issue certificates. The certificates after registration of transfer, shall be delivered within 2 months.

TRANSFER OF SHARES

When joint stock companies were established, the object was that the shares should be capable of being easily transferred. Accordingly, by Section 82 of the Companies Act, it has been provided that the shares or debentures or other interests of a member in a company shall be moveable property capable of being transferred in the manner provided by the articles of the company. The regulations of the company may impose fetters upon the right of transfer. But in the absence of restrictions in the articles the shareholder has by virtue of the statute the right to transfer his shares without the consent of anybody to any transferee provided it is a bonafide transaction in the sense that it is a complete disposal of the property without retaining any interest in the shares.

So far as the restrictions on transfer are concerned it is open to a company to restrict the right of its members to transfer their shares. The articles of a private company as against those of a public company contain more rigorous restrictions on the right of its members to transfer shares. This is because private companies are in law separate entities just as

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much as are public companies, but from the business and personal point of view they are much more analogous to partnerships than to public corporations. Accordingly, it is to be expected that in the articles of such a company the control of the directors over the members may be very strict indeed. Moreover, the Act itself requires a private company to impose some restrictions on the right of transfer.

So far as Judicial or Quasi-Judicial Interference in transfer matters is concerned, it can take place on the grounds of mala fide, inadequacy of reasons, irrelevant considerations, etc.

PROCEDURE FOR TRANSFER

The share certificate, along with the duly completed and stamped Share Transfer Form, should be sent to Registrar and Transfer Agent (RTA) of the Company. In view of the importance of transfer of such securities, provisions for the regulation of their transfer have been enacted in Sections 108 to 111 of the Companies Act, 1956 and the Securities Contracts (Regulation) Act, 1956 and a Share Transfer Form No 7B is prescribed under the Companies General Rules and Forms, 1956.

The instrument of transfer of shares must be in the prescribed Form No. 7B. This form provides for writing the name, address, and occupation of the transferee and requires a signature by the transferor and the transferee.

Role of public finance institution

Section 4A of the Companies Act, 1956 (the "Act") lays down what institutions shall be regarded as public financial institutions for the purposes of the Act. Section 4A(2) empowers the central government to specify other institutions as a public financial institution by a gazetted notification. This sub-section is 4A(2) has a proviso which lays down the following criteria for an 'institution' to be specified as a public financial institution by the central government:

- (i) the institution should have been established/constituted by or under any Central Act, or,
- (ii) not less than fifty-one percent of the paid up share capital of such institution must be held or controlled by the central government.

The Ministry of Corporate Affairs vide a circular dated 2 June 2011 has prescribed some additional conditions for an institution to be declared as a Public Financial Institution under Section 4A of the Act. These additional conditions are produced below from the said circular:

- (a) A company or corporation should be established under a special Act or the companies Act being Central Act;
- (b) Main business of the company should be industrial/infrastructural financing;

(c) The company must be in existence for at least 3 years and their financial statement should show that their income from industrial/infrastructural financing exceeds 50% of their income;

(d) The net-worth of the company should be Rs. one thousand crore;

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(e) Company is registered as Infrastructure Finance Company (IFC) with RBI or as an Housing Finance Company (HFC) with National Housing Bank;

(f) In the case of CPSUs/SPSUs, no restriction shall apply with respect to financing specific sector(s) and net-worth.

Henceforth, for any financial institution to be declared as a public financial institution, it will have to fulfill these additional conditions, apart from the requirements under the proviso to Section 4A(2) of the Act. These additional conditions inter alia prescribe that a financial institution to be declared as a public financial institution must be having industrial/ infrastructural financing as its main business and having a net worth of Rs. 1000 crores. While the Act uses the word 'institution' in the proviso to Section 4A(2), the circular uses the word 'company' in the conditions (a) to (e). The wording of condition (a) above appears to be confusing and suggestive of the first criteria under the proviso to Section 4A(2) of the Act.

The use of the phrase 'special Act' in condition (a) may also be interpreted to be a 'special Act' of a state legislature, for it is not clear if the qualification in the later part 'being central Act' applies to the phrase 'special Act'. This further gains support from condition (f) which exempts a state public sector undertaking (and also a central public sector undertaking) from conditions on financing specific sectors and net worth, thereby indicating that a state public sector undertaking can be a public financial institution.

Issue of shares at premium

A term used when a company issues shares of its stock at price above its par value. The excess cash, or premium received by the company is placed in a shared premium account and can be used to pay up unissued shares for distribution as bonus shares; to pay a premium on the redemption of preferred stock; writing down company expenses or expenses incurred in the issuance of the shares.

Issue of share at premium means when the share is issued at more than the price of the face value

of the share, then it is said to be issue of share at premium. Example: the face value is Rs.10 and the

share is issued at Rs.12, then the extra Rs.2 is known as the amount of premium.

A company may issue shares at a premium i.e. at a value above its par value. The following conditions must be satisfied in connection with the issue of shares at a premium:-

1. The amount of premium must be transferred to an account to be called share premium account. The provisions of this Act relating to the reduction of share capital of the company will apply as if the share premium account were paid up share capital of the company.
2. Share premium account can be used only for the following purposes :-
 1. In issuing fully paid bonus shares to members.
 2. In writing off preliminary expenses of the company.
 3. In writing off public issue expenses such as underwriting commission, advertisement expenses, etc

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4. In providing for the premium payable paid on redemption of any redeemable preference shares or debentures.

5. In buying back its shares.

Issue of shares at discount

Section 79 of the Companies Act, 1956 deals with the circumstances under which the company can issue shares at a discount.

- a. shares must be of a class already issued.
 - b. is authorised by a resolution passed by the company in general meeting, and sanctioned by the Central Government.
 - c. maximum rate of discount must be specified.
 - d. The maximum rate of discount specified in the resolution cannot exceed ten per cent, unless the Central Government deems it fit.
 - e. one year has at the date of the issue elapsed since the date on which the company was entitled to commence business.
 - f. The shares are to be issued at a discount are issued within two months after the date on which the issue is sanctioned by the Central Government.
- When a company issues a share at a price lower than its nominal or par value, the shares are said to have been issued at a discount. According to sub-section (1) of section 79, if any company proposes to issue any shares at a discount, it can do so only if the conditions stipulated in this section are fulfilled. The said conditions are as follows:
1. The shares to be issued are of a class which has already been issued by the company. Therefore, the first issue of shares of a company cannot be at a discount.
 2. The issue is authorised by an ordinary resolution passed by the company at a general meeting.
 3. The Company Law Board has sanctioned the issue.
 4. The ordinary resolution specifies the maximum rate of a discount at which the shares are to be issued. [Company Law Board shall not sanction a discount of more than ten per cent unless it is of the opinion that a higher percentage of a discount is justified in the special circumstances of the case].
 5. The issue is made after one year from the date on which the company became entitled to commence business. [In the case of a private company, the date of incorporation of the company will be taken as the date of commencement of business].
 6. The shares are issued within two months of the sanction by Company Law Board or within such extended time as it may allow.

Depository receipts

A **depository receipt** is a negotiable financial instrument issued by a bank to represent

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a foreign company's publicly traded securities. The depository receipt trades on a local stock exchange. DR listed and traded in the US economy are known as American Depository Receipts.

Depository receipts make it easier to buy shares in foreign companies because the shares of the company don't have to leave the home state.

When the depository bank is in the U.S., the instruments are known as American Depository Receipts (ADRs). European banks issue European depository receipts, and other banks issue global depository receipts (GDRs).

SHAREHOLDER

A **shareholder** or **stockholder** is an individual or institution (including a corporation) that legally owns a share of stock in a public or private corporation.

Stockholders are granted special privileges depending on the class of stock. These rights may include:

- The right to sell their shares.
- The right to vote on the directors nominated by the board.
- The right to nominate directors (although this is very difficult in practice because of minority protections) and propose shareholder resolutions.
- The right to dividends if they are declared.
- The right to purchase new shares issued by the company.
- The right to what assets remain after a liquidation.

Stockholders or shareholders are considered by some to be a subset of stakeholders, which may include anyone who has a direct or indirect interest in the business entity. For example, labor, suppliers, customers, the community, etc., are typically considered stakeholders because they contribute value and/or are impacted by the corporation. Shareholders in the primary market who buy IPOs provide capital to corporations; however, the vast majority of shareholders are in the secondary market and provide no capital directly to the corporation.

CALL ON SHARES

The procedure for making call on shares should not contravene the provisions of Section 69, Section 91, Section 92 (2), Section 292 (1) (a) of The Companies Act, 1956, SEBI Guidelines for Issue of Capital and Disclosure Requirements, Provisions of Table A in Schedule I of the Companies Act, 1956 and Listing Agreement with the Stock exchange(s).

1. Call means a demand by a company under the terms of its articles or terms of issue of shares, requiring the members to pay up fully or in part the unpaid amount of their shares.

2. Ordinarily, a part of the nominal value of a share is payable at the time of making the application for shares and a part on allotment and the remaining dues could be called up by the company at any point of time by way of making calls for the

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remaining unpaid part.

3. Every step pointed out by the Articles or the terms of the issue should be strictly followed in making a call on the shareholders.

4. A company can call up the balance remaining as and when its Board of directors considers it fit. The power of making a call vested in the directors is a fiduciary power to be exercised for the benefit of the company. [Re Cawley & Co. (1889) 42 Ch D 209 (CA)].

5. Convene a Board Meeting to pass the resolution calling upon the members to pay the unpaid part of their share capital within certain time period.

Application

1. The Companies Act nowhere provides for the amount which a company can demand as call money at a time, and thus provisions of Articles of Association of the company must be followed, and if they are silent the provisions contained in Table A, article 13, should be followed which provides that no call shall exceed one-fourth of the nominal value of the share.

2. The amount payable on application on each share shall not be less than 5% of the nominal amount of such share, and it applies both to the first as well as any subsequent public issue.

3. In the case of shares issued by a listed company, make sure that call money is according to the limit, if any, stipulated in the SEBI Issue of Capital and Disclosure Requirement

4. Calls must be made on a uniform basis on all shares falling under the same class, otherwise it will be void. But shares of the same nominal value on which different amounts have been paid-up shall not be deemed to be of the same class for the aforesaid purpose.
5. It is not proper to make full amount of the calls on some members only and not on others, merely because they are dilatory in the payment of previous calls. [Galloway v. Halle Concerts Society (1915) 2 Ch 233].
6. In the Board meeting the resolution must be passed taking into account the following details:-
 - a. The number of shares held by each member;
 - b. The call money payable on each share and the total amount payable;
 - c. The date and place of payment;
 - d. The manner of payment;
 - e. Interest on delayed payment; and
 - f. Consequences of failure to the call money, i.e., forfeiture of shares.
7. Send the Call Notice to every member who is liable to pay call money specifying the above details, well in advance and strictly in accordance with the provisions of the Articles in all respects.

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8. In the case of a listed company, get the format of the Call Notice approved from the Regional Stock Exchange and make arrangements for collection of the call money at select branches of the company's bankers and at all places where recognized Stock Exchanges are located. [Listing Agreement]
9. In case of Joint shareholding call notice will be sent to the first-named joint holder but since every joint shareholder is a member of the company, all of them are jointly and severally liable to pay the call money.

FORFEITURE OF SHARES

If a member, having been called upon to pay, defaults, the company may, of course, bring an action against him. But articles of association often provide that in such a case the company may proceed to forfeit his shares. Shares cannot be forfeited unless there is a clear power to that effect in the articles. Forfeited shares become the property of the company. To this extent forfeiture involves a reduction of the company's capital. The shares can, however, be re-issued, even at a discount, but that is not the same thing as an allotment.

The right to forfeit shares must be pursued with the greatest exactness: It must be exercised by the proper parties, that is, by directors properly appointed, and by the requisite number of them and in the proper manner and for the proper cause. The right must be exercised bona fide for the purpose for which it is conferred. The power of expulsion is a trust the execution of which will be narrowly scanned by the courts. The proper procedure to be observed in carrying out forfeiture is (1) In accordance with articles (2) Notice precedent to forfeiture (3) Resolution of forfeiture (4) Good faith, and (5) Right and liability after forfeiture to be observed.

Surrender of shares

Surrender means to hand over; relinquish possession of, especially on compulsion or demand. The Companies Act does not contain any provision on surrender of shares. Table A in the First Schedule also does not give power to a company to accept surrender of its shares; it contains no regulation on this subject.

But articles usually empower the companies to accept surrender of shares. There is difference between surrender and forfeiture of shares. There is no reference in the Act to surrender of shares; but these have been admitted by the courts, upon the principle that

they have practically the same effect as forfeiture, the main difference being that the one is a proceeding against an unwilling party and the other a proceeding taken with the assent of the shareholder who is unable to retain and pay future calls on the shares. One is voluntary and the other is due to breach of contract.

The surrender is good if it amounts to forfeiture. It is not open to a shareholder to surrender his shares at will, especially when he has to meet future calls, and it is not open to the company to accept a surrender of shares unless the act of the company can be brought within the rule relating to forfeiture of shares.

The Act permits forfeiture of shares on certain grounds; but to give an unlimited and wide power to a company to accept surrender of shares is opposed to the principle that a

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company cannot buy its own shares and to the principle that a company can reduce its capital only with the permission of the court and on such terms and conditions as the court may impose.

A surrender of shares releasing the shareholder from further liability in respect of the shares, is equivalent to a purchase of the shares by the company, and is therefore illegal and null and void. Thus, a surrender of shares is not valid merely because the articles of the company authorise the Board to accept surrender of shares, unless it can be shown that the surrender took place in circumstances, which would have justified a forfeiture.

There can be no valid surrender of shares that are not fully paid except where shares are lawfully forfeited, as it involves reduction of capital requiring the sanction of the court. A surrender of shares amounts to a reduction of capital, which is unlawful unless sanctioned by the court.

Where a company's articles give the directors power to accept a surrender of shares, this power will be recognised as valid if it is used merely to avoid the formalities of forfeiture.

Subject to the provisions allowing companies to acquire their own shares, a company cannot accept a surrender if the shares are not liable to forfeiture, so that such a surrender of partly paid shares would not relieve the shareholder from his uncalled liability; such a surrender would amount to an unauthorised purchase by the company of its own shares, or a reduction of capital without the court's sanction, and is invalid. It is, however, valid to accept the surrender of partly paid shares from an insolvent member and discharge liability for future calls thereon, if this represents bona fide compromise of the company's on him. The effect of a valid surrender is the same as forfeiture, provided the articles authorise it.

It is doubtful whether a company may accept a surrender of fully paid shares in exchange for the issue by the company of an equivalent nominal amount of fully paid shares.

Also there is a difference between surrender of shares and purchasing by a company its own shares. A company cannot make any payment or give any valuable consideration for the surrender. This is because a surrender of shares in consideration of a payment in money or money's worth by the company is a purchase by it of its own shares and is ultra vires that is to say, unless confirmed by the court as a reduction of capital.

Like forfeiture, surrender also does not involve any payment out of the funds of the company. If the surrender were made in consideration of any such payment it would be neither more nor less than a sale, and open to the same objections as purchase by the company of its own shares. If it were accepted in a case when the company were in a position to forfeit the shares, the transaction would be perfectly valid.

However, surrender of shares to the company for consideration may be valid if the circumstances are very special, e.g. where the surrender is part of a compromise.

As noted earlier, section 77(1) prohibits a public company or a private company which is a subsidiary company from 'buying' its own shares, unless the consequent reduction of

capital is effected and sanctioned in pursuance of sections 100 to 104 or of section 402. Purchase by a public company or a private company which is a subsidiary of a public company, of its own shares is a reduction of capital, and is, therefore unlawful, unless the provisions applicable to the reduction are complied with, unless the case falls within the

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purview of section 77A. A valid surrender of shares would not amount to buying by a company of its own shares.

Lien of shares

A lien is the right to retain possession of a thing until a claim is satisfied. In the case of a company lien on a share means that the member would not be permitted to transfer his shares unless he pays his debt to the company. The articles generally provide that the company shall have a first lien on the shares of each member for his debts and liabilities to the company. The right of lien is not inherent but must be clearly provided for in the articles. The articles may give the right of lien over share either for unpaid calls or for any other debt due by the member of the company. The company may have lien on fully paid-up shares. The lien also extends to the dividends payable on the shares. The death of a shareholder does not destroy the lien. The right of lien can be exercised even though the claim has become barred by law of limitation. Where the liability of the shareholder towards the company is disputed by him, it does not deprive the company of its right of lien on the shares. But a company will not be able to exercise its right of lien where the shareholder has mortgaged his shares before he has incurred any liability to the company and the company has notice of it. Similarly, a company will lose its lien if registers a transfer of shares subject to the lien.

SHARE CAPITAL

The term share capital denotes the amount of capital raised or to be raised by the issue of shares by a company.

'Capital' says Shah, usually means a particular amount of money with which a business is started but, in company law this word is used in the following different senses—

1. Nominal or Authorised Capital : Means the nominal value of the shares which a Company is authorised to issue by its memorandum. This kind of Capital must be stated in the memorandum and also each year in the annual return.

Where any notice, advertisement, or other official publication or any business letter, bill head or letter paper of a company contains a statement of the amount of its authorised capital, it must also contain a statement of the amount of capital which has been subscribed and the amount paid up in an equally prominent position and in equally conspicuous characters (Sec. 148).

2. Issued or Subscribed Capital : Issued or subscribed capital means nominal value of the shares actually issued and subscribed for.

3. Paid up Capital : Paid up capital means the amount paid up or credited as paid up on the shares issued, and

4. Capital Assets : Means the actual property of a company

5. Called up Capital : Called up capital denotes the total amount which a company has asked its shareholders to pay up by means of call, and

6. Uncalled Capital : Uncalled capital denotes the amount unpaid on the shares which has not been called up but which the company is entitled to call by means of calls.

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Reduction of Capital

The law regards the capital of a country as something sacred. The general principle of

law founded on principles of public policy and rigidly enforced by Courts is that no action resulting in a reduction of capital of a company should be permitted unless the reduction is effected-

(a) under statutory authority or by forfeiture

(b) in strict accordance with the procedure, if any, laid down in that behalf in the Articles of Association. Any reduction of capital contrary to this principle is illegal and ultra vires.

Reduction of capital with the consent of the court

1. It may extinguish or reduce the liability on any of its shares in respect of share capital not paid-up

2. It may, either with or without extinguishing or reducing liability on any of its shares, cancel any paid-up share capital which is lost, or is unrepresented by available assets.

3. It may, either with or without extinguishing or reducing liability on any of its shares, pay off any paid-up share capital which is in excess of the wants of the company.

Procedure for reduction of share capital

1. Special resolution-Section 100- a company shall first pass a special resolution for reduction of capital. Power to reduce capital must be granted in the Articles of the company. If the Articles do not grant such power, they may be altered by a special resolution giving such power.

2. Application to the Court-Section 101-the company shall then apply to the Court by petition for an order confirming the reduction.

3. Registration of order of Court with Registrar-Section 103- the order of the Court confirming the reduction shall be produced before the Registrar and a certified copy thereof shall be filed with him for registration. With such a copy shall also be filed a minute, showing with respect to the share capital of the company as altered by the order.

Reduction of capital without the sanction of the Court

1. Forfeiture of shares-the company may, if authorized by its Articles, forfeit shares for non-payment of calls. This results in reduction of capital if the forfeited shares are not re-issued

2. Surrender of shares-the company may accept surrender of partly paid shares to save it from going through the formalities of forfeiture.

3. Cancellation of shares-the company may, if so authorized by its Articles, cancel shares which have not been taken or agreed to be taken by any person and diminish the amount of its share capital by the amount of the shares so cancelled.

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4. Purchase of the shares by the company under Section 402(b)-the Court may order the purchase of the shares of any members of the company by the company.

5. Redemption of redeemable shares-the company may redeem redeemable preference shares in accordance with the provisions of Section 80

6. Buy-back of shares-a company may purchase its own shares, subject to fulfillment of conditions laid down in Section 79-A (2), purchase its own shares.

BORROWING POWERS

A company cannot borrow money unless it is so authorised by its memorandum. In the case of a trading company, it is not, however, necessary that the object clause of its memorandum should expressly authorise it to borrow. As borrowing is incidental to trading, such a company has implied power to borrow. Other companies must have a borrowing power clearly specified in the memorandum.

Borrowing without express or implied authority is ultra vires. The consequences of such a borrowing are: (1) No Loan, (2) Injunction, (3) Subrogation, (4) Identification and Tracing, etc.

Where, on the other hand, the borrowing is within the powers of the company, the lender would not be prejudiced simply because its officers have applied the loan to unauthorised activities, provided that the lender had no knowledge of the intended misuse. But where a lender provides finance for a business which within his knowledge is not within the company's objects, the loan is ultra vires and the lenders cannot enforce the security.

Another problem that may sometimes arise in this connection is where borrowing is within the company's power but it is beyond the powers of those managing the company. Where a loan has been taken in the name of the company it will not be liable even though it may have benefited.

The Companies Act, in Section 293(1)(d), provides that directors should not borrow beyond the paid-up capital of the company and its free reserves. Sub-section (5) further declares that such a loan shall not be valid, unless the lender proves that he advanced the loan in good faith and without knowledge that the limit had been exceeded.

CHARGE

Registration of Charges has been mentioned in Section 125 of the Companies Act, 1956. The power to borrow includes the power to mortgage the company's assets or to create a charge upon them. The reason is that lenders always insist on some security and the only security that a company can give is to charge its assets. Any charge or mortgage created on any of the following assets of a company must be registered with the Registrar of Companies under Section 125 of the Act i.e., (1) a charge for the purpose of securing any issue of debentures; (2) a charge on uncalled share capital of the company; (3) a charge on any immovable property, wherever situate or any interest therein; (4) a charge on any book debts of the company; (5) a charge, not being a pledge, on any moveable property of the company; (6) a floating charge on the undertaking or any property of the company including stock in trade; (7) a charge on calls made, but not paid; (8) a charge on a ship or any share in a ship; (9) a charge on goodwill, or a patent or a licence under a patent, on a trade-mark, or on a copyright or a licence under a copyright.

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The Registrar has to issue a certificate under his hand of the registration of any charges stating the amounts secured. The certificate is conclusive evidence that the requirements as to registration have been complied with. The advantage of registration is that the charge becomes binding on the company even in its winding up and also on every subsequent purchaser or innumbrancer of the property covered by the charge. The effect of non-registration is that the charge would be void against the liquidator and any creditor of the company. The lender would not have the benefit of the charge, although his loan stands and it shall become immediately repayable.

Sections 124 to 145 of the Companies Act, 1956 deal with registration of charges by companies. The subject can be conveniently divided in five topics :-

• Filing of particulars of charge created.

• Filing of particulars of modification of charge.

• Filing of particulars of series of debentures.

• Filing of particulars of satisfaction of charge.

• Condonation of delay in filing of particulars of charges created / modified / satisfied.

CREATION OF CHARGE (Section 125)

If a charge created by the company falls within any of the classes as specified in section 125 (4), its particulars shall be filed with the Registrar of Companies Act, 1956 within 30 days of creation of charge. If particulars of charge could not be filed within 30 days, the

ROC has power to extend the said period by 30 more days subject to payment of additional filing fee by the Company.

Particulars of creation of charge shall be filed in Form No. 8 & 13, in 3 sets, alongwith all the papers / instruments relating to creation of charge. Form No. 8 includes the following details :

- Description of instrument creating the charge
- Amount secured
- Property charged
- Terms & conditions of charge
- Name & address of person entitled to charge

Registrar of Companies (ROC) will verify the particulars filed under Form No. 8 & 13 and thereafter shall register charge which is conclusive evidence of compliance with the requirements as to registration of the charge. ROC shall deliver 2 sets duly registered under seal and signature, one for lender and second for borrower.

A charge on the property of the company as security for debenture or debt may be classified into two kinds. These are

1. Fixed or Specific Charge, a charge is fixed or specific when it is made specifically to cover assets which are ascertainable and definite at the time of creating the charge e.g., land, buildings etc. A fixed charge is a charge or mortgage secured on

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particular property, e.g. land and buildings, a ship, piece of machinery, shares, intellectual property such as copyrights, patents, trade marks, etc.

2. Floating Charge, a floating charge is not attached to any definite property but covers property which is of fluctuating nature such as stock in trade.

A floating charge is an equitable charge which is created on some class of property which is constantly changing, e.g. a charge on stock-in-trade, trade debtors, etc. The company can deal in such property in the normal course of its business until the charge becomes fixed on the happening of an event. The main idea behind floating charge is to allow the company to carry on its business in the ordinary course as if no charge had been created.

Debentures usually create a floating charge on the assets of a company.

Characteristics

In Re Yorkshire Woolcombers' Ass. Ltd-

1. It is a charge on a class of assets of the company both present and future
2. That class of assets is one which, in the ordinary course of the business of the company, is changing from time to time
3. It is contemplated by the charge that, until some steps are taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way.

Consequences of a floating charge

The company can-

1. Deal in the property on which a floating charge is created, till the charge crystallizes
2. Notwithstanding the floating charge, create specific mortgages of its property having priority over the floating charge
3. Sell the whole of its undertaking if that is one of its objects in the Memorandum, in spite of the floating charge on the undertaking.

Crystallization

Crystallization gets fixed when

1. The company goes into liquidation
2. The company ceases to carry on business
3. A receiver is appointed
4. A default is made in paying the principal and/or interest and the holder of the charge brings an action to enforce his security.

DEBENTURE

The most usual form of borrowing by a company is by the issue of debentures. According to Section 2(12), 'debenture' includes debenture stock, bonds and any other securities of

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a company, whether constituting a charge on the assets of the company or not. Section 2(12) however does not explain as to what a debenture really is.

'Debenture' means a document which either creates a debt or acknowledges it.-**Levy v Abercorris Slate & Slab Co.**

The term debenture is neither a technical, nor a term of Article but it was very commonly used as early as the time of Henry V, 1414 as observed by Chitty, J., in case of Levy Vs Abercorris Co. It is a very wide term but now generally used to signify a security for money, called on the face of it debenture, and providing for the payment of specified sum at a fixed date. It is an instrument under seal and evidencing a debt, the essence of it being the admission of indebtedness. The issuance of the debentures by the company is perhaps the most convenient method of long term borrowings.

Section 2(12) of the Act gives statutory definition of the word 'debenture'. "Debentures include debenture stock, bonds any other securities of a company whether constituting a charge on the assets of the company or not." So, a debenture is a document acknowledging the loans borrowed by a company issued under its authority and embodying the terms and conditions as to repayment of money, rate of interest, etc. In brief, a debenture is a certificate of loan issued by a company and it has nothing to do with security or lack of it.

The characteristics of a debenture are –

1. They are generally issued in series.
2. They are generally under the common seal of the company.
3. They provide for payment of a specified sum with interest at a specified date by a specified rate.
4. They are generally secured by charge on any part of the company's property.
5. They must be payable either to the registered holder or to the bearer.

A debenture, usually consists of two parts, namely –

1. the body of the instrument containing the bond and the charge, and
2. the conditions endorsed thereon.

Debentures in company law may be secured debentures, unsecured, registered debentures, bearer debentures, redeemable debentures, irredeemable and convertible debentures.

Kinds of debentures

Classification according to negotiability

1. Bearer debentures/unregistered debentures-these debentures are payable to the bearer. These are regarded as negotiable instruments and are transferable by delivery and a bona fide transferee for value is not affected by the defect in the title of the prior holder.

2. Registered debentures-these are debentures which are payable to the registered holders. A holder is one whose name appears both on the debenture certificate and in the company's register of debentures.

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Classification according to security

1. Secured debentures-debentures which create some charge on the property of the company are known as secured debentures. The charge may be a fixed charge or floating charge.

2. Unsecured or naked debentures.-debentures which do not create any charge on the assets of the company are known as unsecured debentures. The holders of these debentures like ordinary unsecured creditors may sue the company for recovery of debt.

Classification according to permanence

1. Redeemable debentures-debentures are usually issued on the condition that they shall be redeemed after a certain period. Such debentures are known as redeemable debentures. They may be re-issued after redemption in accordance with the provisions of Section 121.

2. Irredeemable or perpetual debentures-when debentures are irredeemable, they are called perpetual debentures.

Classification according to convertibility

1. Convertible debentures-these debentures give an option to the holders to convert them into preference or equity shares at stated rates of exchange, after a certain period.

2. Non-convertible debentures-these debentures do not give any option to their holders to convert them into preference or equity shares. They are to be duly paid as and when they mature.

Classification according to priority

1. First debentures-these are the debentures which are to be repaid in priority to other debentures which may be subsequently issued.

2. Second debentures-these are the debentures which are to be paid after the 'first debentures' have been redeemed.

Remedies of debenture holders

The remedies of a debenture-holder of a company vary according to whether he is secured or unsecured. An unsecured debenture-holder is in exactly the same position as an ordinary trade creditor. Like any other unsecured creditor he has two remedies-

1. He may sue for his principal and interest
2. He may, if he wishes, petition under Section 439 for the winding up of the company by the Court on the ground that the company is unable to pay its debts.

A **secured debenture-holder** has both the above remedies in addition to the following-

1. **Debenture-holder's action**-he may sue on behalf of himself and all other debentureholders of the same class to obtain payment and enforce his security by sale. If several debenture holders sue separately, the Court can consolidate their suits into one.

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2. Appointment of receiver-he may appoint a receiver if the conditions which give him power to do so are fulfilled or apply to the Court in a debenture-holders' action to appoint one.

3. Foreclosure-he may apply to the Court for foreclosure of the company's right to redeem the debentures. Foreclosure is a process by which the mortgagor, failing to repay the money lent on the security of property, is compelled to forfeit his right to redeem the property.

4. Sale-he may sell the property charged as security if an express power to do so is contained in the terms of issue of debentures. He may also have the property sold through trustees if such power is given by the debenture trust deed.

5. Proof of balance-if the company is insolvent and his security is insufficient, he

may value his security and prove for the balance. In the alternative, he may surrender his security and prove for the whole amount of his debt.

Distinguish between a debenture holder and share holder

Difference between shareholders and debenture-holders are discussed in detail as follows:

1. A shareholder or member is joint owner of the company; but a debenture-holder is only a creditor of the company.
2. A shareholder has a voting right whereas a debenture-holder has no such right at the meeting of the company. Section 117 of the companies act prohibits the issue of debentures carrying any kind of voting rights at general meeting of the company.
3. Interest on debentures is payable whether there are profits or not. But dividend on shares is to be paid only when the company has earned profits. Interest on debentures may be paid out of capital but dividend on shares can never be paid out of capital.
4. Debentures are generally secured and carry a charge on the assets of the company whereas shares have no such charge. The debenture-holder, being a secured creditor of the company, is paid-off prior to a shareholder in the event of winding up of a company.
5. A company can repay the debentures in accordance with the terms of issue but save in the case of redeemable preference shares, the share capital cannot be repaid without legal formalities.
6. Debentures can be issued at a discount whereas shares cannot be issued at a discount except as provided under section 79 of the companies act.

DIVIDENDS

The term 'dividend' is not defined in the Act. Further the Act does not mention any specific power to the companies registered under it to declare and pay dividends. The power to pay dividend is, however, inherent in every company and therefore it need not be given either in the Act or in memorandum or Articles.

Dividends are profits of a trading company divided amongst members in proportion to their shares. Such proportion may be determined by the articles; if not, dividends may be

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paid on each share in proportion to the nominal value of that share without reference to the amount actually paid up thereon, for members are 'prima facie' entitled to participate in the profits of a company in proportion to their respective interest therein, and the nominal amount of capital held by each is the measure of such interest.

Hence, in brief, a dividend is that portion of the distributable amount of profit to which each member is entitled when it is formally declared in the Annual General Meeting of members. It follows from it that if no profits are made or if none are made available for distribution, no dividend will be declared.

Students are advised to study carefully the legal provisions relating to dividends as laid down in Sections 93, 205, 205(2B), 205A, 206, 206A and 207 for full knowledge and understanding about dividends.

Hence, dividend means the profit that is divided amongst the members of the company on the basis of the shares held by them.

Dividend to be Paid to Registered Shareholders Only (Section 206) : According to section 206, no dividend shall be paid by a company in respect of any shares except to the registered shareholder or to his order or to his bankers. It may also be paid to the holder of a share warrant or to his banker in respect of the shares specified in the warrant.

Dividend to be Paid only Out of Profits (Section 205) : No dividend shall be declared or paid by a company except out of profits. It means that the dividend cannot be paid out of capital. It may be paid out of the profits of that particular year, or out of the

profits for any previous year. Only such profits can be distributed as dividend which have been arrived at after providing for depreciation. The Central Government may, if it thinks necessary in public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation.

According to section 205 (1), proviso cl. (b), if the company has incurred some loss in any previous financial year or years, then the amount of that loss or an amount equal to the amount provided for depreciation for that year or those years, whichever is less, shall be set off against the profits of the company for the year for which dividend is proposed to be declared or paid, or against profits for any previous financial year or years, after providing for necessary depreciation.

It has been held by the Supreme Court in *M/s Surana Steel Ltd. v. Dy. Commissioner, I. Tax*,² that the loss is to be arrived at after taking into account the depreciation provided for. Therefore, the word “loss” as used in proviso cl. (b) to sec. 205(1) signifies the amount arrived at after taking into account the amount of depreciation and it has to be so read and understood in the context of section 115-J of the Income Tax Act, 1961. If loss were to be taken as pre-depreciation loss, then the resultant computation shall not be in conformity with the tenor of the provisions of section 205.

The Companies (Amendment) Act, 1974 has introduced a provision which requires every company to transfer to the reserves of the company such percentage of profits for that year, not exceeding 10%, as may be prescribed, before the dividend is declared or paid by a company for any financial year.

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Interim Dividend : Sub-sections (1A), (1B) and (1C) to section 205 have been inserted by the Companies (Amendment) Act, 2000. They prescribe for the procedure for declaration of interim dividends. Section (14A), which has also been inserted by the Companies (Amendment) Act, 2000 defines dividend and states that “dividend” includes interim dividend.

The Supreme Court had held in *J. Dalmia v. C.I.T.*³ that a resolution to pay interim dividend did not create a debt against a company. The directors, therefore, could revoke the resolution declaring interim dividend. Now, the insertion of new clause (14A) in section 2, declaring ‘dividend’ to include interim dividend, puts interim dividend at par with final dividend. It has, thus, the effect of nullifying the effect of the above mentioned Supreme Court decision.

The (Amendment) Act, 2000 has also amended section 205, so as to make the following provisions regarding the interim dividend—

- 1.** The Board of Directors may declare interim dividend, and the amount of dividend including interim dividend shall be deposited in a separate bank account within 5 days of the declaration of such dividend.
- 2.** The amount of dividend including interim dividend so deposited above, shall be used for payment of interim dividend.
- 3.** Different provisions contained in the Companies Act, applicable to ‘dividend’, such as sections 205, 205A, 205C, 206, 206A and 207 shall also apply to ‘interim dividend’.

Investor Education and Protection Fund (Section 205C) : A new section 205C has been inserted in the Companies Act by the Companies (Amendment) Act, 1999, w.e.f. 31-10-1998. It provides for the establishment of a “Fund” by the Central Government, to be known as the Investor Education and Protection Fund. It aims at utilisation of the Fund for promotion of investors’ awareness and promotion of the interests of the investors in accordance with such rules as may be prescribed. The Central Government shall specify

an authority or a committee to administer the “Fund”, who will administer the Fund for carrying out the objects for which the Fund has been established.

There shall be credited to the Fund the following amounts–

- a) amounts in the unpaid dividend accounts of companies;
- b) the application moneys received by companies for allotment of any securities and due for refund;
- c) matured deposits with companies;
- d) matured debentures with companies;
- e) the interest accrued on the amounts referred to in clauses (a) to (d);
- f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and
- g) the interest or other income received out of the investments made from the Fund;

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Provided that no such amount referred to in clauses (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

Dividend to Registered Holders Pending Registration of Transfer of Shares

(Section 206A) : The Companies (Amendment) Act, 1988 has introduced a new provision (i.e., section 206A), to deal with a situation when instrument of transfer of shares has been delivered to a company for registration of the transfer of shares, but before the same has been done, the company declares dividend, rights shares, or bonus shares. In such a case the company should transfer the dividends to the ‘Unpaid Dividend Account’ referred to in section 205A, unless the transferor of shares has specified in writing that such dividend is to be paid to the transferee specified in such instrument. Similarly, any offer of rights shares or bonus shares has to be kept in abeyance till the title to the shares is decided.

Penalty for Failure to Distribute Dividends within 30 Days (Section 207) : Section 207 requires payment of dividend within 30 days of its declaration. Prior to the Companies (Amendment) Act, 2000 the payment of dividend was required to be made within 42 days of its declaration.

If the dividend is not paid to a shareholder entitled to the payment of the same within the prescribed time, every director of the company, who is knowingly party to the default, shall be punishable with simple imprisonment upto 3 years, and shall also be liable to a fine of Rs. 1000/- for every day of default. The company shall also be liable to pay simple interest of 18% per annum on the delayed payment for the period of delay.

Section 207 has been Substituted by the Companies (Amendment) Act, 2000 :

The main changes made by the (Amendment) Act, 2000 are as under–

1. The period for payment of dividend has been reduced from 42 days to 30 days.
2. The term of imprisonment on default in payment of dividend in time, has been increased from 7 days to 3 years.
3. Earlier no amount was specified by way of fine on default in payment of the dividend. The new Provision specifies that, in addition to imprisonment a fine of Rs. 1000/- for every day of default shall be payable.
4. The company shall also pay simple interest at the rate of 18% p.a. during the period for which the default continues.

No offence shall be deemed to have been committed in the following cases, namely–

- a) where the dividend could not be paid by reason of the operation of any law;
- b) where a shareholder has given such directions to the company, regarding the payment of dividend which cannot be complied with;
- c) when there is dispute regarding the right to receive the dividend ;

d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholders; or

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e) where for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company.

Power of the Company to Pay Interest out of Capital in Certain Cases (Section 208)

: Where any shares in a company are issued for the purpose of raising money to defray the expenses of the construction of any work or building, or the provision of any plant, which cannot be made profitable for a very long period of time, the company may pay interest on so much of that share capital as is paid up. The interest so paid may be charged to capital, as part of the cost of construction of the work or building or the provision of the plant. Such payment must be authorised by the Articles or by a special resolution, and there should also be a previous sanction of the Government.

One of the main objects of commercial enterprises is to earn profits which are disturbed among shareholders by way of 'dividend'. In commercial usage, 'dividend' is the share of the Company profits distributed among the members. Under Section 2(14A) of the Companies Act, 1956, 'dividend' includes any interim dividend.

In **Commr. Of Income-tax v Girdhadas & Co**, it was observed that the term 'dividend' has two meanings:

1. as applied to a company which is a going concern, it ordinarily means the portion of the profits of the company which is allocated to the holders of shares in the company

2. in the case of a winding up, it means a division of the realized assets among the creditors and contributories according to their respective rights

Rules regarding dividend

1. Resolution at the annual general meetings-the dividend is declared by a company by a resolution passed at the annual general meetings. The Board of directors determines the rate of dividend. The rate determined by the Board is to be sanctioned by the members of the company in general meeting. The members may reduce the rate recommended by the Board but they cannot increase it.

2. Payment of dividend in proportion to paid up capital (Section 93)-a company may, if authorized by its Articles, pay dividends in proportion to the amount paid up on each share. In the absence of such a clause in the Articles, members are entitled to dividend in proportion to the nominal value of the shares and not in proportion to the amounts paid thereon.

3. Dividend to be paid only out of profits (Section 205)-the dividend can be declared or paid by a company for any financial year only-

(a) out of profits of the company for that year arrived at after providing for depreciation in the manner laid down in the Act, or

(b) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation and remaining undistributed, or

(c) out of both, or

(d) out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by the Government

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4. Unpaid dividend to be transferred to special dividend account-(Section 205-A)- where a dividend has been declared by a company but has not been paid to or claimed by any shareholder within a period of 30 days from the date of declaration,

the company shall, within 7 days from the date of expiry of the 30 days, transfer the unpaid or unclaimed dividend to a special account with any scheduled bank to be called "unpaid dividend account of....company limited/company private limited"

5. If any amount remains unpaid or unclaimed for 7 years from the date of such transfer, it should be transferred to "**Investor Education & Protection Fund**"

6. Dividend to be paid to the registered shareholder-Section 206- the dividend shall be paid only to

(a) to the registered shareholder or to his order or to his bankers,

(b) in case a share warrant has been issued, to the bearer of such warrant or to his bankers.

7. Penalty for defaulting directors-section 207-every director, who is knowingly a party to the default, is punishable with simple imprisonment up to 3 years and liable to a fine of Rs. 1000 for every day during which such default continues and the company shall be liable to pay interest @ 18% p.a during the period of default.

MEMBERS OF A COMPANY

According to section 41, the following are the members of the company –

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 to become a member of a company and whose name is entered in its register of members shall be a member of the company.

However, there are other ways also to become a member of the company. These are–

1. By subscribing the memorandum : A person becomes a member of a company by subscribing the memorandum before its registration. [Sec. 41(1)]

2. By allotment : Here the share application offers to subscribe for shares in the company. By accepting the offer, the shares are allotted to him. However, he becomes a member when his name is entered into the register of members.

3. By transfer : As we all know by virtue of Section 82, shares are easily transferable. Hence the transferee becomes a member when his name is entered in the register of the members. A transfer may take place either by sale, gift or otherwise.

4. By transmission : Here, the ownership is transferred by operation of law and not by act of parties. Transmission takes place in two cases namely, (1) death of the member, or (2) insolvency of the members. In case of death, his legal representatives will become the members. In case of insolvency, his assignee will become the member. Under Sec. 109A and 109B, every holder of shares may at any time nominate in the prescribed manner, a person to whom his shares in the company

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shall vest in the event of his death. Under Section 172, they are entitled for notice of General Meetings. The nominee may elect to be registered himself as a holder of the shares, in which case he becomes a member.

5. By estoppel or by acquiescence : Estoppel is a rule of evidence. By permitting his name to be entered in the register of members he is estopped from denying that he is a member. It may be that his name is wrongly or improperly entered in the said register. When he comes to know of it, he shall take steps to have his name struck off the register. If he knows and assents to have his name in the register of member, he becomes a member by acquiescence.

It is to be noted that the terms 'member' and 'shareholder' have the same meaning in this Act.

However, a person may cease to be a member in below-mentioned circumstances.

Methods of ceasing to be a member :

1. By transferring his shares.
2. By forfeiture of his shares.
3. By a valid surrender of his shares.
4. By a sale by the company of his shares under some provisions in the Articles, e.g. in exercise of its lien over his shares.
5. By death of a member.
6. In case of insolvency, on a disclaimer by the official assignee of his estate.
7. On winding up of a company, and
8. On rescission of the contract of membership on the ground of misrepresentation or mistake.

RECONSTRUCTION AND AMALGAMATION

There is reconstruction of a company when the company's business and undertaking are transferred to another company formed for that purpose, so that as regards the new company substantially the same business is carried in it as in the case of the old company. A reconstruction may become necessary for several purposes e.g., the Court of the company may not sanction a radical change of objects. New objects can then be adopted only by the process of reconstruction. A reconstruction may also become necessary to cause material alterations of the rights of a class of share-holders or creditors.

There is amalgamation when two or more companies are joined to form a third entity or one is absorbed into or blended within another. The effect is to wipe out the merging companies and two fuse then all into the new one created. The new company comes into existence having all the property, rights and pointers and subject to act the duties and obligations, of both the constituent companies. The word amalgamation has not been defined in the Act. The ordinary dictionary meaning of the expression is 'construction'. The primary object of amalgamation of one company with another is to facilitate reconstruction of the amalgamating companies and this is the matter which is entirely left to

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the body of shareholders and essentially an affair relating to the internal administration of the transferor company.

There should be power in the company's memorandum to amalgamate. If it is not there it should be acquired by altering the memorandum. It is not necessary that the company adopting the scheme should be in financial difficulties or that it should not be an affluent company.

A reconstruction or amalgamation may take any of the following forms i.e., (1) By sale of shares, (2) By sale of undertaking, (3) By sale and dissolution, (4) By a scheme of arrangement.

Sale of Shares is the simplest process of amalgamation or take over. Shares are sold and registered in the name of the purchasing company. The selling shareholders receive either compensation or shares in the acquiring company.

The mode to carry out schemes of the reconstruction and amalgamation is provided in Sections 394 and 395 of the Indian Companies Act – 1956. The term 'Reconstruction' implies the formation of a new company to take over the assets of an existing company with the idea that the persons interested and the nature of business substantially remain the same.

The term 'Amalgamation' is taken to mean the union of two or more companies, so as to form a third entity or one company is absorbed into another company. Thus, the formation of a new company is not absolutely necessary for amalgamation.

The words 'reconstruction and amalgamation' do not have any precise legal meaning.

Reconstruction means internal arrangement of a Company's capital structure, while amalgamation means merger of two or more companies. Both have practically the same

effect : in both cases original company loses its independent existence. Both the above stated sections lay down two modes for carrying out of a scheme of reconstruction and amalgamation. These are –

1. By transfer of undertaking and

2. By transfer of shares for full and exhaustive details please see the text book of company law. Although besides the usual modes of amalgamation under sections 394 & 395, Central Government may also order for amalgamation in public/national interest under section 396.

Amalgamation in National Interest (Section 396) : Where the Central Government is satisfied that it is essential in the public interest that two or more companies should amalgamate the Central Government may by order notified in the official gazette provide for the amalgamation of those companies into a single company.

The order may provide for the continuation of legal proceedings by or against original companies in the name of resulting company. Every member, debenture-holder and the creditor of the original company shall have as far as possible the same interest in the resulting company as they had in the original companies.

Central Government shall not pass an order providing amalgamation unless the following requirements have been complied with–

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1. Where any such appeal has been preferred until such appeal has been disposed of or where no such appeal by any person aggrieved by the assessment in case of compensation for less interest, has been preferred until the time for preferring the appeal has expired.

2. A copy of the proposed order or draft has been sent to the companies concerned and they shall be given not less than two months' time to give their suggestion and objections.

3. The central government should have considered the suggestions and objections and made such modifications in the light of these suggestions and objections. Copies of the order shall be laid before both the Houses of Parliament.

IMPORTANT QUESTIONS

Q.1. What is the nature of a 'Share' in a company? What is a preference share and when is a preference shareholder entitled to vote?

Q.2. Explain the difference between nominal, issued and subscribed share capital of a company?

Q.3. Define 'debenture'. Discuss its nature, contents and characteristics.

Q.4. Who is a member of a company? What are the modes and methods to become or cease as member of a company?

Q.5. What is reconstruction and amalgamation? Discuss the provisions relating to reconstruction and amalgamation of companies.

Q.6. What is dividend? To whom is dividend paid? What is the source from which dividend is paid?

Q.7. What is Interim dividend?

Q.8. What is floating charge?

Q.9. What is issue of shares at premium?

Q.10. Who is responsible when company's business is carried on only to defraud creditors?

Q.11. What is allotment of shares?

Q.12. What is a certificate of shares?

Q.13. What is mortgage or pledge of shares?

Q.14. What is underwriting commission?

Q.15. What is calls on shares?

Q.16. Distinguish between :

- a) Share & Stock
- b) Share and Share Warrant
- c) Surrender of Share and Forfeiture of Shares

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- d) Transfer of Shares and Transmission of Shares
- e) Registration of shares

Q.17. Give a view of the provisions relating to registration of transfer of shares. What formalities have to be complied with for seeking registration of a transfer? On what grounds can a company refuse to accept a transfer and what remedy is available against such refusal?

Q.18. The legal title to shares may be transferred by way of gift or sale and it is right of transferee to get it registered in his name. How should the directors of a company exercise their powers in this regard? Do the directors have unlimited powers to refuse to register transfer of shares? Discuss with reference to recent cases.

(Footnotes)

1. AIR 1965, Pat. 32
2. A.I.R. 1999 S.C. 1455
3. (1964) 34 Comp. Cas. 683 (Supreme Court)

UNIT 5

Structure

- Study of Selected Lit

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MAJORITY RULE AND MINORITY PROTECTION

The protection of the minority shareholders within the domain of corporate activity constitutes one of the most difficult problems of modern company law. The main aim must be to strike a balance between the effective control of the company and the interests of the small individual shareholders. A proper balance of rights of majority and minority shareholders is essential for the smooth functioning of the company. The modern Companies Acts, therefore, contain a large number of provisions for the protection of the interests of investors in companies. The main aim of these provisions is to require from those, who control the affairs of the company, to exercise their powers according to certain principles of natural justice and fair play.

The management of a company is based on the majority rule. Like any democratic set up, the majority has its way in a company though due provision must also be made for the protection of the interests of minority. This principle that the will of the majority should prevail and bind the minority is known as the principle of majority rule.

'Majority must prevail' is the principle of company management. Except the powers delegated to the Board of Directors, the overall powers of controlling the affairs of a company rest with the shareholders which they exercise through general meetings. We also know that the decisions at general meetings are taken by the majority of shareholders which may consist of either a simple majority or a special majority depending upon the provisions of the companies Act or the Articles of the company. Under this set up of management and decision taking, it is evident that in all matters, except those delegated to the directors, the wish of the majority of shareholders will prevail in the administration of a company.

The rule of Supremacy of the Majority : The rule of supremacy of the majority was judicially recognised in the year of 1843 in a leading case namely *Foss Vs Harbottle*.

In this case Foss and Turton, two shareholders of the 'Victoria Park Company', brought an action on behalf of themselves and the other shareholders (except the defendants) against the five directors, the solicitor and architect of the company, charging them with "Concerting and effecting various fraudulent and illegal transactions, whereby the property of the company was misapplied, alienated and wasted." The plaintiffs prayed that the defendants might be ordered by the court to make good to the company the losses caused by the wrongful acts complained of. The court dismissed the action holding that the conduct with which the defendants are charged is an injury not to the plaintiffs exclusively, it is an injury to the whole corporation and therefore the corporation alone, and not the plaintiffs, could bring the action at law. Otherwise, the court might be acting vainly, for the alleged breach of duty could be ratified by the company (Majority shareholders) in general meeting.

The judgement in Foss Vs Harbottle case established that on a suit filed by the minority, the court will not interfere with the internal management of companies acting within their powers even though negligence and inefficiency on the part of the management is proved. For, it is pointless to have legal actions based on matters which can be ratified by a general meeting. It was further expounded in this case that if any injury is done to the company, it is logical that the company itself should bring an action to get it redressed and

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individual members can not assume to themselves the right of suing in the name of the company, because in law a company is separate legal person from the members who compose it. Moreover, there will be no use in permitting the minority to bring a suit for any injury done to the company, if the majority of shareholders do not object to that, for, in such a case a meeting can be called and the injury be authorised by a majority vote. The rule laid down in Foss Vs Harbottle, has been followed in many other cases since then. For instance –

1. Mac Dougall Vs Gardiner, (1875) 1 Ch. D 13

2. Parildes Vs Jenson, (1956) Ch. 565 and

3. Rajahmundry Electric Supply Corporation Ltd. Vs A. Nageshwara Rao, (1956) AIR, SC 213.

From the rule in Foss Vs Harbottle, it becomes clear that the majority decisions are binding upon the company and a minority has no voice in the control and management of company's affairs. But in the strict application of this rule, suppose the majority are not acting bonafide for the benefit of the company as a whole, the minority could be exploited by the majority against which the minority could take no legal action, it would be shocking thing indeed. Therefore, certain exceptions have been admitted for the protections of the minority and in the interest of justice to the rule of supremacy of the majority of shareholders.

Exceptions to the Rule of Supremacy of the Majority of Shareholders : In the below mentioned situation, the 'will' of the majority shall not prevail and individual shareholders or minority shareholders may bring an action against the company to protect their interest.

1. Where the Act Done is Ultravires the Company or Illegal : The rule in Foss Vs Harbottle case does not apply to acts which are ultra vires the company or which are illegal because no majority of shareholders can ratify such acts. As such every shareholder has a right of preventing the company from doing such acts by filing a suit of injunction [Bharat Insurance Company Ltd. Vs Kanhaya Lal, 1935 AIR Lah. 792].

2. Where the Act Done is Supported by a Resolution Passed by Insufficient Majority : The Act itself modifies the above primary principle in certain cases by

requiring two-thirds or three-fourths majority for the validity of the resolution. In such cases a bare majority is insufficient. Certain resolutions, e.g., to alter the objects clause in the memorandum require a three fourth majority. If any such resolution has been passed by the simple majority, any shareholder may institute an action to restrain the company from acting on the resolution [Nagappa Chettiar Vs Madras Race Club, 1949, 1 M.L.J. 662].

3. Where the act complained of constitutes a fraud on the minority and those responsible for it are in control of the company, in such situation any member of the minority can file a suit and the rule in Foss Vs Harbottle does not apply in such situation.

4. Where the Personal Membership Rights of an Individual Shareholder have been Infringed: No majority of votes can deprive a shareholder of his individual

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membership rights, which have been conferred upon him either by the companies Act or by the Articles of the company (Nagappa Chettar Vs Madras Race Club). Any individual shareholder can, therefore, sue the company in his own name where for instance, he is prevented from exercising his right to vote or his name has been removed illegally from the register of members.

5. Where the Provisions of Section 397 to 409 of the Companies Act, 1956,

Apply : The Companies Act itself contains provisions which protect minority in the case of oppression and mismanagement. These provisions are discussed in detail in the next topic namely prevention of oppression and mismanagement.

PREVENTION OF OPPRESSION AND MISMANAGEMENT

Sections 397 to 409 of the companies Act, 1956 lay down specific provisions whereby both the national Company Law Tribunal and the Central Government are empowered to interfere in the affairs of the company for preventing 'oppression and mismanagement'. According to Section 397 and 398 the specified minimum number of members of a company, may make an application to the Tribunal for appropriate relief on either on the ground of oppression or mismanagement.

Oppression

Oppression may be understood, for the purpose of company law, as observed by Wanchoo J. of the Supreme Court in case of Shanti Prasad Jain Vs Kalinga Tubes Ltd. (1965), 35 Companies Case 351 in the words "The essence of the matter seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair dealing, and a violation of the conditions of fair play on which every shareholder who entrusts his money to the company is entitled to rely."

There must be continuous acts on the part of the majority shareholders, continuing up to the date of petition, showing that the affairs of the company were being conducted in a manner oppressive to some part of the members. An unreasonable refusal to accept a transfer or transmission of shares has been held to be oppressive.

In Kanika Mukherji vs. Rameshwar Dayal Dube, 1955 cal., it has been held by Justice Sinha that the principle embodied in Sections 397 & 398 of the Indian Companies Act which provide for prevention of oppression and mismanagement, is an exception to the rule in Foss vs. Harbottle which lays down the sanctity of the majority rule.

In case of Hindustan Co-operative Insurance Society Ltd. case², the company was carrying on life insurance business which was acquired by the Life Insurance Corporation of India on payment of compensation. The directors, who had the majority voting power, refused to distribute the compensation amount among the shareholders and instead passed a special resolution changing the objects of the company to undertake more risky activities. The unwilling minority made a petition to the court. It was held that this amounted to an oppression of the minority. The court observed: "The majority exercised their authority

wrongfully in a manner burdensome, harsh and wrongful. They attempted to force the minority shareholders to invest their money in a different kind of business against their will. The minority had invested their money in a life insurance business with all its safeguards and statutory protections. But they were being forced to invest where there would be no such protections or safeguards.”

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Mismanagement

In case of mismanagement as per Section 398, there must be an unfair abuse of power and the persons incharge of management of the company must be guilty of fraud or misappropriation. The term misappropriation implies misapplication of the funds of the company, e.g., to appropriate dishonestly for one self or to apply the funds of the company to the ultra-vires purposes. In both the cases of oppression and mismanagement, the persons who can apply to the Tribunal for relief have been discussed in Section 399 and 401 of the Act.

Apart from these provisions discussed in the topic, Section 408 empowers the Central Government to interfere for preventing oppression and mismanagement.

Hence, in brief, the provisions under sections 397 to 409 are of very vital importance to protect the members of a company specially in case of oppression and mismanagement by the majority of the shareholders or directors.

Protection of oppression and mismanagement

These are the followings powers of the court to prevent oppression and mismanagement in a company:-

- (a) the regulation of the conduct of the company's affairs in future ;
- (b) the purchase of the shares or interests of any members of the company by other members thereof or by the company ;
- (c) in the case of a purchase of its shares by the company as aforesaid, the consequent reduction of its share capital ;
- (d) the termination, setting aside or modification of any agreement, howsoever arrived at, between the company on the one hand, and any of the following persons, on the other, namely : (i) the managing director, (ii) any other director, (iii) the manager, upon such terms and conditions as may, in the opinion of the *Tribunal* be just and equitable in all the circumstances of the case ;
- (e) the termination, setting aside or modification of any agreement between the company and any person not referred to in clause (d), provided that no such agreement shall be terminated, set aside or modified except after due notice to the party concerned and provided further that no such agreement shall be modified except after obtaining the consent of the party concerned ;
- (f) the setting aside of any transfer, delivery of goods, payment, execution or other act relating to property made or done by or against the company within three months before the date of the application under section 397 or 398, which would, if made or done by or against an individual, be deemed in his insolvency to be a fraudulent preference ;
- (g) any other matter for which in the opinion of the *Tribunal* it is just and equitable that provision should be made.

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INSPECTION AND INVESTIGATION

Inspection : Section 610 confers upon the members of the public the right of inspection and of obtaining copies of documents filed with the Registrar. The inspection shall be in accordance with the rules made under the Declaration of Records Act, 1917. The right

extends to any documents kept by the Registrar, being documents filed or registered by him in pursuance of the Companies Act or making a record of any fact required or authorised to be recorded or registered in pursuance of the Act. The right of inspection can be exercised on payment of prescribed fees.

The Registrar can also be asked on payment of prescribed fee to give a certified copy of a company's certificate of incorporation or a copy or extract of any other document or any part thereof. The prospectus of a company and other papers and documents filed alongwith it can be inspected within 14 days of the date of the publication of the prospectus and at other times with the permission of the Central Government. Documents in connection with the prospectus which have to be registered under Section 605 can be inspected within 14 days of the date of publication and at other times with the permission of the Central Government.

A process of production of any document by the Registrar has to issue from the Court. The process should bear a statement on its face that it is issued with the leave of the Board. Certified copies issued by the Registrar are admissible in evidence in all legal proceedings as of equal validity with the original document. Documents which have to be filed or registered within a fixed period of time, may be registered after the expiry of that period on payment of additional prescribed fees.

The amendment of 1996 (Section 610-A) permits the filing of documents in micro films, facsimile copies of documents, computer printouts and documents on computer media. The Central Government has been authorised to make Rules for bringing about the facility of filing requisite documents in an electronic form and also that of inspection of document in electronic form. Sections 610-B, 610-D and 610-E have been inserted into the Act for this purpose by the Amendment of 2006.

Investigation : National and individual savings constitute the chief source of capital formation in a democratic country, and is, therefore, vital to economic growth. Incorporated enterprise is one of the methods of allocating and channelling limited capital resources. The proper functioning, that is to say, a performance that will ensure adequate return on capital, is ultimately the best protection of those who provide capital. Effective functioning can be achieved by preventing corporate abuses and wrongs.

Corporate managements are today free from many of the earlier restraints. For example, the doctrine of ultra vires is no longer a significant check up corporate spending. Again, the power of management are vested in the board to the total exclusion of shareholders. The shareholder has become an investor, separated in time and understanding, insulated by distance and the proxy machinery from the business activities of the enterprise. The reality of the internal corporate structure has changed from democratic to bureaucratic. Hence the shareholder is no longer available as an adequate field of responsibility. Due to great diffusion of stock, shareholders become indifferent to voting and controlling. It is an

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'illusion that anything like an effective control of the shareholders over the management of a big company can be re-established. The divorce between financial interest and power of management is a fact. Further the shareholders are ill-equipped to challenge the wisdom and expertise of officers.

Accordingly, remedies against corporate abuses that have to depend for their effectiveness upon shareholder initiative are not likely to be very successful. The law suit against management is an uncertain road, open only in relatively extreme cases and subject to heavy toll charges in the form of lawyer's fee. Remedies afforded by the exceptions to the rule in Foss v. Harbottle and Sections 397 and 398 for prevention of oppression and mismanagement are beset with a variety of procedural and financial hurdles. The reality of control can only be found in the action of public opinion and in the organised supervision

exercised by Government agencies. Hence the importance of investigations. There is no doubt that few shareholders have the means or ability to act against the management. It could furthermore be difficult for the shareholders to find out the facts leading to the poor financial condition of a company. The Government thought it right to take power to step in where there was reason to suspect that the management may not have been acting in the interests of the shareholders and to take steps for the protection of such interests (the Act) gives the exploratory power. Section 235 to 251 provide for investigation of the affairs of a company. The power is split into two sets, one containing mandatory and the other permissive provisions.

WINDING UP

Winding up is the process by which the life of a company is over and its property administered for the benefit of its members and creditors. Winding up of a company is different from the insolvency of an individual because a company can never be declared insolvent and on the other may be wound up.

Winding up is a term commonly associated with the ending of a company's existence. In fact winding up or liquidation is a process by which the assets of the company are collected in and **realised**, its liabilities are discharged and the net surplus, if there is any distributed in accordance with the company, articles of association.

Winding up is a method of putting an end to the life of a company. According to Gower, winding up 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. Winding up of a company differs from insolvency of an individual in as much as a company cannot be made insolvent under the insolvency laws. Moreover, a perfectly solvent company may be wound up. The company is not dissolved immediately at the commencement of winding up. Its corporate status and powers continue. Winding up precedes dissolution. Winding up is the process by which the assets of the company are salvaged and the affairs of the company are wound up. During winding up, the company continues to be a legal person. When the affairs of the company are completely wound up, the company is killed with surprisingly little ceremony. The legal status comes to an end. This is called dissolution. Since a company is created by the process of law, it can only be destroyed by

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the process of law. When the affairs of a company are completely wound up, there is no purpose in keeping it alive. It shall be dissolved. However, a company may be dissolved without being wound up. In other words, there can be dissolution without winding up. As we have seen earlier, this can happen in the case of amalgamation. The transferor company is dissolved without being wound up. Again under Section 560, the name of a defunct company may be struck off the register by the Registrar.

Distinction between Insolvency and Winding up

Insolvency Winding Up

Only an individual can be adjudged an insolvent. Only a company can be wound up. Only a debtor can be adjudged as an insolvent. A solvent company may be wound up. Insolvency always results deficiency. Winding up may end in surplus assets. When a person is adjudged as insolvent he continues to be a legal person until it is dissolved. Assets vest with the Official Assignee. Assets continue to be with the company but the administration is taken over by the liquidator.

When the insolvency proceedings are completed there is no such discharge. When winding up the insolvent will be discharged i.e. freed from has been completed the company will be killed, all his debts. He again becomes a legal person. i.e., dissolved.

Any goods in the possession of an insolvent will The principle of reputed ownership does not apply. be deemed to be his until proved to be otherwise. This principle is known as reputed ownership.

We all know that a company is an artificial legal person and it can not die a natural death

like a human being. So, whenever it is desired to put an end to the life of a company, anyone of these below mentioned legal processes must be followed–

1. Through a scheme of 'reconstruction' and amalgamation' under section 394, where the undertaking of one company is transferred to another company and the court orders for the dissolution of the transferor company without undergoing the process of winding up; or
2. Through the removal of its name from the register of companies by the registrar³; or
3. Through the winding up process.

Hence, winding up is one of the processes to bring about an end to the life of a company. Again, winding up or liquidation is a means by which the dissolution of a company is brought about, and its assets realized and applied in payment of its debts, and after satisfaction of the debts, the balance, if any, remaining is paid back to the members in proportion to the contribution made by them to the capital of the company. It is a proceeding in which all the affairs of a company are wound up, its rights and liabilities ascertained, and the claims of its creditors paid off out of the assets of the company including the contributions by its members to the extent to which they may be necessary.

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MODES OR CIRCUMSTANCES OF WINDING UP OF A COMPANY

[SECTION -425]

A company registered under the companies Act, may be wound up in any of the following ways.

I Compulsory winding up under the orders of the court.

II Voluntary winding up which is of two kinds namely

[i] Members Voluntary winding up, and

[ii] Creditors voluntary winding up

[iii] Voluntary winding up under the supervision of the court.

Indian companies Act-1956 provides two specific modes. Winding up can be either through Tribunal or Voluntary. Voluntary winding can be members' voluntary winding up or creditors voluntary winding up. If a declaration of solvency is made, it is members' voluntary winding up. If the declaration of solvency can not be made, it becomes creditors' voluntary winding up. The further distinction lies in the appointment of liquidator. In case of voluntary winding up by members, the members will have their say in the appointment of liquidators while in case of creditors voluntary winding up the creditors will have their say in the appointment of liquidator.

I. Compulsory Winding Up By Court [Section 433]

The Compulsory winding up of a company which is also called winding up by the court, is initiated by an application by way of petition to the appropriate court for a winding up order.

The Court having jurisdiction under Section 433 of the Act, is the High Court 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 subordinate to the High Court. But the Winding up of a company share capital of not less than one lakh rupees must take place only in the High Court. However, Section 435 of the companies Act provides that the high Court may. After making the winding up order, transfer the subsequent proceedings to a District Court. The High Court is further empowered by section 436 to transfer any winding up proceeding pending before a District Court either to itself or to another District Court. The High Court can pass any of the above orders at any time either at its own motion, as on application by any of the parties to the proceedings. The circumstances in which a company may be wound up by the court are stated in section 433 of the companies Act. They are as follows:-

[a] Special Resolution

A company may be wound up if a special resolution for its winding up by the Court has been passed. The Court is, however, not bound to order winding up simply because the company has so resolved. The power of the Court being discretionary. It may not be exercised if the winding up is opposed to the public interest or the interests of the company.

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[B] Default in holding statutory Meeting

Where a company has made a default in holding the statutory meeting or delivering the statutory report to the registrar. It may be ordered to be wound up under section 433[b]. The power of the court in this case is discretionary and it may either order the winding up or direct the statutory report to be filed or the statutory meeting to be held, as the case may be. However if the company fails to comply with the orders then the court may order winding up of the company.

[C] Failure to Commence Business

Where a company has not commenced its business within one year from the date of its incorporation or has suspended its business for a whole year. It may be ordered to be wound up. The power of the court being discretionary. It will not be exercised unless there are indications that the company has no intention to commence or continue its business. If the suspension of business is due to some temporary or unavoidable reason the court may refuse to order winding up. Again, the petition for winding up would not be allowed if the delay in commencement or suspension or interruption of business is duly explained and the court is satisfied that the business could not be commenced or resumed for a valid reason.

[d] Reduction in Membership Below Statutory Limit

If the number of members of a company is reduced below the prescribed statutory limit, in the case of a public company, below two, the company may be ordered to be wound up. The term members' in this clause refers to present members and does not include past members or legal representatives of deceased member or assignees of insolvent members.

[e] Inability to pay Debts or Commercially Insolvent

A company may be ordered to be wound up if it is unable to pay its debts provided under section 433[e]. The expression unable to pay debts' has to be taken in commercial sense of being unable to meet current demands though the company may be otherwise solvent. Section 434 further provides that a company is deemed unable to pay its debts if a creditor for an amount exceeding Rs. 500/- does not get his money within three weeks after it fell due, and the creditor is entitled to make a petition to the court for an order of winding up of the company. According to section 434. A Company is said to be Unable to pay its debts in the following three Cases.

(1) When a Creditor to Whom the Company Owes more than Hundred Rupees has served a demand and the company has for three weeks neglected to pay or otherwise satisfy him. The debt must be presently payable and the company should not have any bona fide dispute about it. The courts do not allow this remedy to be used as a short cut or cheap device to coerce payment of a disputed debt. The power is discretionary.

(2) A company is unable to pay its debts if execution or any other process issued on a decree against the company is returned unsatisfied in whole or in part.

(3) If the court is unable to pay its debts, that is the company is commercially insolvent. "Commercial insolvency" means that the assets and liabilities are such as to make

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it reasonably certain that the existing and probable assets would be insufficient to meet the existing liabilities. Inability to pay taxes or a bill of exchange, as they due is an evidence of commercial insolvency.

[f] Just and Equitable

Section 433[f] of the companies Act provides that the tribunal can order winding up of a company when the Tribunal is of the opinion that it is just and equitable that the company should be wound up. It is the remedy of the last resort. In this case the Tribunal has wide powers and has a complete discretion to decide when it is "Just and equitable" to order winding up of a company. The expression, "Just and equitable" is general in nature and it is undesirable to attempt to define the circumstances in which it will apply. In short, the powers under this clause are to be exercised with great care and circumspection. Referring to the 'just and equitable' clause in relation to the discretionary power of the Tribunal in ordering winding up of a company, Lord Wilberforce in *Ebrahimi v. Westbourne Galleries Ltd. & others* (1972) 2 WLR 1289, observed, "the general words of the subsection should remain general and not be reduced to the sum of particular instances". The discretion of the Tribunal under this clause is very wide and the courts have exercised this discretion on a variety of grounds which may be generalized in the following categories:-

- 1- Dead lock in the management of a company.
- 2- Where the company has lost its substratum,
- 3- Losses,
- 4- Oppression of minority shareholders by the majority,
- 5- Fraudulent or illegal purpose,
- 6- Where a private company is in essence a partnership.

According to Section 433, under following circumstances, a company may be wound up by the tribunal –

1. If the company itself passes a special resolution, resolving that the company be wound up by the tribunal;
2. If any default is made in delivering the statutory report to the Registrar or in holding the statutory meeting within the fixed or prescribed time period;
3. If the company does not commence its business within a year from its incorporation or suspends its business for a whole year;
4. If the statutory number of members is reduced, in case of a public company, below seven, and in case of a private company, below two;
5. If the company is unable to pay its debts;
6. If the tribunal is of the opinion that it is just and equitable that the company should be wound up;
7. If the company has made a default in filing with the Registrar its balance sheet and profit and loss account or annual return for any five consecutive financial years;

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8. If the tribunal is of the opinion that the company should be wound up under the circumstances specified under section 424 G.
9. If the company has acted against the interests of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality.

Who may File Petition (Section 439) : The petition can be presented by–

1. The company; or
2. By creditors; or
3. By contributories; or
4. By the Registrar with the Sanction of the Government; or
5. Any person authorized by the Central Government provided the case falls under

section 243.

Office Liquidator

The liquidator is a person who helps the tribunal to complete the liquidation proceedings. According to Section 448 an official liquidator may be appointed from a panel of professional firms of CA, advocates, company secretaries etc. which the central government shall constitute for the tribunal; or may be a body corporate consisting of such professionals as may be approved by the central government from time to time; or may be a whole time or part time officer appointed by the central government.

Powers of Official Liquidator

The following powers may be exercised only with the sanction of tribunal–

1. To institute or defend any suit, other civil or criminal proceedings in the name and on behalf of the company.
2. To carry on the business of the company so far as may be necessary for the beneficial winding up of the company.
3. To sell movable or immovable property of the company – wholly or in parcels either privately or through public action.
4. To raise money on the security of the assets of the company.
5. To do all such other things as may be necessary for the winding up of the affairs of the company and distributing its assets.

There, are however, some other powers as well which may be exercised by him even without the sanction of the tribunal. These are–

1. To do all acts and to execute all deeds, receipts and other documents in the name and on behalf of the company and for that purpose to use the company's seal.
2. To prove, rank and claim the insolvency of a contributory.
3. To draw, accept, make and endorse any bill of exchange or promissory note in the name and on behalf of the company.

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4. To appoint an agent to do any business which the liquidator is unable to do himself, etc.
5. Appoint security guards, valuer and CA etc.
6. Publish an advertisement inviting bids for sale of the assets of the company etc.

Duties of Official Liquidator

His main duties are as follows–

1. To conduct the proceedings in winding up (Section 451).
2. To submit preliminary report to the Tribunal after the receipt of the 'statement of Affairs' (Section 454 & 455)
3. Custody of company's property (Section 456)
4. To give regard to the resolutions of the creditors or contributories.
5. To summon meetings of creditors and contributories [Section 460(3)].
6. To maintain proper books (461).
7. To present an account of his receipts and payments to the tribunal (Section 462)
8. To submit information as to pending liquidation (Section 463).

II. Voluntary Winding Up

Voluntary Winding up is different from compulsory winding up. In voluntary winding up, the members of the company may, instead of presenting a petition to the Tribunal for winding up of the company, pass a resolution in the general meeting that the company be wound up. The main advantage of a voluntary winding up is that the company and its creditors shall be left free to settle their affairs amicably without coming to the tribunal. Winding up by the tribunal is usually the result of hostile action by a creditor or sometimes a contributory whereas voluntary winding up is the act of company itself. Voluntary winding up may become necessary for a company. When it desires to reconstruct itself

by forming a new company or amalgamate its business with another company. The question whether the court has power to intervene and with hold voluntary winding up of company came up for consideration before the court in S.P. Sood Vs. Company Register, Delhi, Nirnaya Patrika 1978. Delhi 287. In this case the court (Now Tribunal) held that Section 518 (1) of the Act empowers the court to use its powers relating to winding up even in case of voluntary winding up of a company when a petition for this purpose has been presented by the company.

Resolution for voluntary winding up [Section 484 (1)]

Section 484 (1) provides that a company may be voluntarily wound up in any of the following two ways. Namely :-

1. By Ordinary Resolution :-

A company is voluntarily wound up by passing an ordinary resolution under section 484 (1) (a) in its general meeting when the period fixed for the duration of the company by

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the articles has expired or an event on the occurrence of which the articles provide that the company would be dissolved, has occurred. The company can commence its voluntary winding up after an ordinary resolution to this effect has been passed in the general meeting.

2. By Special Resolution

The articles of the company usually do not contain any provision as to the duration of the company or the mention of an event on the happening of which the company is to be dissolved. Therefore in absence of any such provision in the articles, a special resolution is necessary if the company decides its winding up voluntarily. The winding up commences at the time when the special resolution has been passed by the company in its general meeting.

Kinds of voluntary winding up

Voluntary winding up may be of two kinds, namely :-

1. Member's voluntary winding up; and
2. Creditor's voluntary winding up.

Before resolution for voluntary winding up is passed the company has to decide whether the winding up will be member's or creditor's.

1. Member's voluntary winding up [Section 489]

A member's voluntary winding up can take place only if a Declaration of solvency of the company has been made in accordance with the provisions of the Act as explained below.

Declaration of Solvency [Section 488]

Section 488 of the companies Act. Provides that where it is proposed to wind up a company voluntarily as a member's voluntary winding up the directors, or in case the company has more than two directors, the majority of them, may, at a meeting of the Board, make a declaration commonly known as 'Declaration of Solvency; verified by an affidavit to the effect that they have made a full inquiry into the affairs of the company and that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. The provisions applicable to member's voluntary winding up are contained in sections 490 to 499 of the companies Act. They are as follows :-

1. Appointment and Remuneration of liquidator;
2. Board's power to cease on appointment of a liquidator;
3. Liquidator's power to sell company's business or property;
4. Meeting of creditors;
5. Company's General Meeting;

6. Final Meeting and Dissolution under section 497.

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2. Creditors' Voluntary Winding Up

Provisions applicable to creditors' voluntary winding up are contained in sections 499 to 509, both inclusive of the companies Act. Section 499 provides that provisions contained in sections 500 to 509, shall apply in relation to a creditors' voluntary winding up.

Where a declaration of solvency of the company is not made and filed with the Registrar, it is presumed that the company is unable to pay its debts and meet its liabilities in full within three years. In that case, the company must call a meeting of its creditors for the same day or the day next following the day fixed for the general meeting of the company at which the proposed resolution for winding up the company is to be passed.

There are these below-mentioned three circumstances in which a company may be wound up voluntarily. These are—

1. When the period fixed for the duration of the company by Articles has expired.
2. The event on the occurrence of which the Articles provide that the company is to be dissolved has occurred.
3. The company resolves by a special resolution to be wound up voluntarily (Section 484).

Winding up commences from the date of passing of the resolution in the general meeting (Section 486). The company shall cease to carry on its business, except so far as may be required for the beneficial winding up of such business. The legal status of the company shall continue until it is dissolved (Section 487).

Under section 488, majority of directors, in case of members voluntary winding up, are required to declare solvency of the company as required by Section 488.

According to Section 490, appointment of liquidator will be made in the general meeting of members of the company. The powers and duties are almost same in every kind of the winding up process of a liquidator.

The provisions applicable to the members' voluntary winding up are contained in Section 489 to 498, while the provisions applicable to 'creditors' voluntary winding up' are contained in Section 500 to 509. An exhaustive detail about the topic is not possible to discuss here. That is why, the students are advised to study text books of the subject for further enhancing their knowledge.

3. Winding Up Subject To Supervision of Court

Even after the commencement of the voluntary winding up of a company the Tribunal may order for its compulsory liquidation. Alternatively, the Tribunal can order that the voluntary winding up shall continue, but subject to the Tribunal supervision. Thus it would be noticed that winding up under the supervision of the Tribunal is a mid way recourse to compulsory winding up and voluntary liquidation.

Section 522 of the Act. Provides that at times after a company has passed a resolution for voluntary winding up the Tribunal may make an order that the voluntary winding up shall continue, but subject to the supervision of the Tribunal. The extent of supervision is to be determined by the Tribunal.

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Where the Tribunal makes a supervision order under section 522. it may entertain or dispose of any suit or legal proceedings by or against the company which may be pending in any other tribunal.

The Tribunal may appoint an additional liquidator or liquidators. It may also remove any liquidator so appointed or fill any vacancy caused by removal or by death or resignation. A company, the winding up of which is being continued under the supervision of the

tribunal may still be subsequently order to be compulsorily wound up by the court. In that case, the Tribunal may order that the liquidator who was then functioning as liquidator, may be allowed to continue in office either provisionally or permanently in the compulsory winding up, subject to the control of the official liquidator.

To conclude it can be said that these are three circumstances or modes under which a company may be wound up. The above two modes of winding up are the main modes as the third circumstance has the same provisions which are already contained in sections 440 and 515 of the Act relating to wind up of the company.

Liability of past members

(1) Subject to the provisions of sub-section (2) the liability of a past member or of the estate of a deceased member of a co-operative society for the debts of the cooperative society as they existed -

(a) in case of a past member, on the date on which he ceased to be a member; and
(b) in the case of a deceased member, on the date of his death; shall continue for a period of seven hundred and thirty days from such date.

(2) Where a co-operative society is ordered to be wound up under section 95, section 96 or section 97, the liability of a past member or of the estate of a deceased member who ceased to be a member or died within seven hundred and thirty days immediately preceding the date of the order of winding up shall continue until the entire liquidation proceedings are completed but such liability shall extend only to the debts of the co-operative society as they existed on the date of his ceasing to be a member or death, as the case may be.

Winding Up of Unregistered Company:

1. An unregistered company, cannot be wound up voluntarily, or, subject to supervision of court.

2. However, the circumstances, in which unregistered company may be wound up, are as follows :

- If the company, is dissolved, or has ceased to carry on business, or is carrying on business only for the purposes of winding up, its affairs,
- If the company is unable to pay its debt
- If the court is of opinion, that it is just and equitable, that the company, should be wound up.

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A creditor, contributory, or company itself by filing a petition, or any person authorized by central government may institute winding up proceedings.

In respect to other aspects, the same provisions and procedure shall follow, as in winding up of registered company.

A foreign company, carrying on business in India, which has been dissolved, may be wound up, as unregistered company.

Corporate Liability

In criminal law, corporate liability determines the extent to which a corporation as a legal person can be liable for the acts and omissions of the natural persons it employs. It is sometimes regarded as an aspect of criminal vicarious liability, as distinct from the situation in which the wording of a statutory offence specifically attaches liability to the corporation as the principal or joint principal with a human agent.

The imposition of criminal liability is only one means of regulating corporations. There are also civil law remedies such as injunction and the award of damages which may include a penal element. Generally, criminal sanctions include imprisonment, fines and community service orders. A company has no physical existence, so it can only act vicariously through the agency of the human beings it employs. While it is relatively uncontroversial

that human beings may commit crimes for which punishment is a just desert, the extent to which the corporation should incur liability is less clear. Obviously, a company cannot be sent to jail, and if a fine is to be paid, this diminishes both the money available to pay the wages and salaries of all the remaining employees, and the profits available to pay all the existing shareholders. Thus, the effect of the only available punishment is deflected from the wrongdoer personally and distributed among all the innocent parties who supply the labour and the capital that keep the corporation solvent.

Because, at a public policy level, the growth and prosperity of society depends on the business community, governments recognise limits on the extent to which each permitted form of business entity can be held liable (including general and limited partnerships which may also have separate legal personalities).

Using the criminal law

- Represents formal public disapproval and condemnation because of the failure to abide by the generally accepted social norms, codified into the criminal law. Police powers to investigate can be more effective, but the availability of relevant expertise may be limited. If successful, prosecution reinforces social values and shows the state's willingness to uphold those values in a trial likely to attract more publicity when previously respected business leaders are called to account. The judgment may also cause a loss of corporate reputation and, in turn, a loss of profitability.
- Justifies more severe penalties because it is necessary to overcome the higher burden of proof to establish criminal liability. But the high burden means that it is more difficult to secure a judgment than in the civil courts, and many corporations are cash-rich and so can pay apparently immense fines without difficulty. Further, if the corporation knows that the fine is going to be severe, it may seek bankruptcy protection before sentencing.

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- The theoretical value of punishment is that the offender feels shame, guilt or remorse, emotional responses to a conviction that a fictitious person cannot feel.
- If a state turns too often to the criminal law, it discourages self-regulation and may cause friction between any regulatory agencies and businesses that they are to regulate.

Using the civil law

- With the lower burden of proof and better case management tools, civil liability is easier to prove than criminal liability, and offers more flexible remedies which can be preventative as well as punitive.
- But there is little moral condemnation and no real deterrent effect so the general management response may be to see civil actions as a routine cost of business which is tax deductible.

Salient Features of the Company Law Tribunal

(a) The National Company Law Tribunal (NCLT) working in benches all over the country and having its Principal Bench at New Delhi.

(b) It shall abolish the existence of Company Law Board and replace its wider powers and jurisdiction by NCLT.

(c) In majority of the sections of the principal Act, for the words 'Company Law Board/Court', wherever they occur, the word 'Tribunal' has been substituted.

(d) Appeal against the orders of the Tribunal shall be heard by the Appellate Tribunal (NCLAT) at New Delhi.

- (e) The orders of the NCLT and the NCLAT are binding on parties to the issue and appeal against them in Court of Law is not maintainable.
- (f) The Supreme Court can be reckoned to hear an appeal against an order only on a moot question of law.
- (g) The employees of the NCLT and the NCLAT are to be treated as public servants. Therefore, no suit against order of the NCLAT or its staff for any action in good faith is maintainable.
- (h) The NCLT and the NCLAT are not to be bound by Code of Civil Procedure, 1908 but guided by principles of natural justice.
- (i) Applicant, can appear before the Tribunal or the Appellate Tribunal in person or can authorise a chartered accountant, company secretary, cost and works accountant or a lawyer to appear before NCLT, NCLAT.
- (j) Any appeal against the order of Company Law Board before the commencement of Companies (Second Amendment) Act, 2002 to be made to the High Court of competent jurisdiction.
- (k) All matters pending before the CLB on or before constitution of the NCLT shall be transferred to the NCLT.

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- (l) The cases which remain pending before District Court or High Court, for any compromise, arrangement or winding up of company (not being winding up under supervision of Court) under the Companies Act, 1956, or any other law for the time being in force other than Banking Regulation Act, 1949, if already started, shall be transferred to the NCLT, from such date as notified by Central Government. Provided that where winding up of companies subject to supervision of Court has commenced before the Court it shall continue in the same manner as was before the commencement of the Companies (Second Amendment) Act, 2002.
- (m) The Tribunal may either *de novo* proceed with such cases transferred, or may continue it from the stage it was so transferred.

Benefits of the National Company Law Tribunal

The efforts of the Government to review the multiplicity of judicial bodies and consolidate them into one shall have far reaching impact on all facets of corporate life, not only the companies but also the investors as well as the professional community shall gain by such consolidation. Some of the benefits are noted as under:

- (a) Since the plurality of agencies is avoided, not much of reporting is required from various other agencies. It shall serve as single window settlement of cases related to the corporate affairs. Hence, the time required for any restructuring will be reduced as multiplicity of work will be reduced.
- (b) Individual affidavits are required to be filed to the Tribunal by the directors while filing a petition under the Companies Act and other laws. The Tribunal is also entrusted with powers of contempt of court. This provides a built-in seriousness in the entire procedure of appearing before the NCLT.
- (c) Reduction in time for completion of proceedings leads to increase in savings of cost.
- (d) The NCLT and the NCLAT shall be formulated as judicial body and hence, decisions of the NCLT are binding on all parties concerned.
- (e) The powers of Court are delegated to the NCLT and no appeals are preferred in court of law. This saves time of High Court as well.
- (f) Appearance of CAs, CSs, ICWAs and Lawyers before the Tribunal and Appellate Tribunal provides better professional opportunity. Also the time and cost to the clients declines. Also, first hand information can be really made available to the

NCLT.

(g) A Rehabilitation and Revival Fund proposed to be set up to make:—

(i) interim payment of dues of workmen of company declared sick;

(ii) protection of assets of sick company;

(iii) revival and rehabilitation of sick companies.

(h) Multiplicity of judicial bodies and litigation avoided.

(i) The NCLT and the Appellate Tribunal not to be bound by the Code of Civil

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Procedure, 1908, but shall be guided by the principles of natural justice. The NCLT and the NCLAT have the power to regulate their own proceedings within the framework of the Act.

Everybody knows that the legislature has proposed to constitute a special tribunal to deal with the issues under the Companies Act, 1956 through Companies (Second Amendment) Act, 2002. The constitution of National Company Law Tribunal and Appellate Tribunal is challenged by the Madras Bar before the High Court of Madras. Justice Jayasimha Babu of Madras High Court has passed a considered and laudable judgment while disposing of the Writ Petition filed by the Madras Bar challenging Companies (Second Amendment) Act, 2002. Senior Advocate Sri Aravind P. Datar has appeared for the Petitioner before Madras High Court in the Writ Petition referred to and placed all the material and the history of constituting Special Tribunals in

India. Though, there was lot of discussion on tribunalization as the High Court has referred, the validity of the constitution of National Company Law Tribunal has not been declared illegal by the Madras High Court as such, but, has pointed-out vital defects in appointing of presiding officers to the Tribunal etc. Every effort has been made by the Madras High Court to preserve the independence and efficiency of the Tribunal laudably. The order passed by the Madras High Court challenging the Companies (Second Amendment) Act, 2002 and especially the constitution of National Company Law Tribunal and the Appellate Tribunal, went to Supreme Court and the Supreme Court has upheld the order of the Madras High Court and declared that the constitution of NCLT and NCLAT is legal. The order of the Apex Court is on expected lines and there should not be any compromise with the independence and efficiency of the Dispute Redressal Mechanism. Before the proposed amendment to the Companies Act, 1956 proposing to constitute National Company Law Tribunal, the High Court and the Company Law Board used to entertain Company Petitions under the Companies Act, 1956.

Constituting Tribunals with the intention of providing a specialist mechanism aiming at speedier justice is not a new phenomenon in India and it has started even before independence as pointed out in the Judgment of Madras High Court while disposing of the Writ Petition filed by the Madras Bar.

All issues connected to constitution of Tribunals were looked into and the constitution and functioning of Tax Tribunals and Debt Recovery Tribunals etc. have also been discussed at length by the Constitutional Courts while looking into the issue of validity of constitution of National Company Law Tribunal and Appellate Tribunal. It is the strong opinion that the functioning of the proposed NCLT and NCLAT can not be seen at par with other Tribunals like Tax Tribunals and the Debt Recovery Tribunals. Tax law and interpretation of provisions dealing with payment of tax are always complicated and there are many authorities to look into the challenge by the assesses and we are also observing the functioning and the aim of Settlement Commission now. A finding on a Tax dispute may not, in many cases, threaten the functioning of the Company or the assesses. When it comes to the adjudication by the Debt Recovery Tribunals, Banks are supposed to be very careful while granting

loans and they will get all the required documents and security from the borrower. Usually, the borrower tries to prolong a dispute before the Debt Recovery Tribunal

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while it is also true that there can be a genuine litigation before the Debt Recovery Tribunals at times.

When it comes to the functioning of the NCLT and NCLAT under the Companies Act, 1956, the proposed Tribunal discharges very complicated responsibilities. Despite the Complications, the High Court while exercising Company Jurisdiction could deal with the Winding-up Petitions and the Petitions for grant of sanction under section 391 and 394 of the Companies Act etc. well. The Company Law Board too discharges very complicated responsibilities under the Companies Act, 1956 and especially the Petitions under section 397/398 of the Companies Act, 1956.

A Company dispute can not be seen at par with a civil dispute and Company Law is very complicated. Many corporates feel that they lack an effective redressal mechanism to get their corporate rights protected under the Companies Act, 1956. When we look at the functioning of the Company Law Board and especially the proceedings under section 397/398 of the Companies Act, 1956, we can find lot of interesting things. There are propositions like "disputed facts can not be decided by the Company Law Board" and the Company Law Board has certain limitations on its power under section 397/398 of the Act and it makes a corporate or a shareholders to be in dilemma as to where they should go to get their corporate rights protected. The corporates really scare to approach a Civil Court for getting their corporate rights protected as it will take lot of time and also as the Civil Court lacks the needed expertise in understanding the complications and the subject of Company Law. These are all practical problems and the proposed NCLT and NCLAT should address all these issues, as otherwise, the object constituting a single specialistic forum under the Companies Act, 1956 will get defeated and turning the clock back will definitely be a difficult thing to think of.

With a logical analysis, we can find the glaring difference between the functioning of Company Court and the Company Law Board now. While the litigants or the corporates effectively implement the orders of the Company Court, the Company Law Board is taken for granted and the power of contempt of the orders of the Board has been a complicated issue to deal with. Again, High Court, while exercising the powers under the Companies Act, 1956, used to be very effective and speedy given the complications and I am not exaggerating the situation and my opinion is based on my personal observation and facts which can not be denied as I feel.

But, it can be seen from the express bar on the jurisdiction of the Company Law Board in the proposed Companies Bill, that the legislature is committed to establish a single and effective forum to deal with all issues under the Companies Act, 1956 and we are also aware of the background of constituting a special tribunal called National Company Law Tribunal and everyone is aware of the report of the Committees.

Nobody can deny the merits of the constitution of National Company Law Tribunal provided that it functions well as intended by the legislature.

It is the considered view that the proposed National Company Law Tribunal and Appellate Tribunal cannot be seen at par with other Tribunals and it would be really interesting to look into the functioning of the National Company Law Tribunal and the Appellate

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Tribunal. The constitution of National Company Law Tribunal and the Appellate Tribunal

should provide speedy and effective redressal to the corporates under the Companies Act, 1956 as otherwise, turning the clock back will definitely be difficult and it will also affect the corporate growth to a great extent.

NCLT and Appellate Tribunal

Ever since the passing of the Companies (Second Amendment) Act, 2002 paving the way for setting up of the National Company Law Tribunal (NCLT) and the Appellate Tribunal (NCLAT), various professionals associated with the corporate sector were looking forward to setting up of a one-window Quasi-Judicial Authority like the NCLT to deal with virtually all types of corporate law related cases and ensure their speedy disposal. Since the said amendment in the Companies Act also enabled the NCLT to take over the functions of the Board for Industrial and Financial Reconstruction (BIFR) and the Appellate Authority (AAIFR) with regard to rehabilitation and revival of sick industrial companies, it was expected that speedy disposal of cases of sick industrial companies will get a boost. Furthermore, since the Companies Act was also amended to speed up the winding up processes of companies by appointment of professionals as Private liquidators, the process of speedy exit of unviable companies and utilization of assets locked therein was expected to be speeded up.

As is well known, the Central Government had constituted a High Level Committee on the Law relating to Insolvency of Companies under the Chairmanship of Justice V. Balakrishna Eradi, a retired Judge of the Supreme Court of India, with other experts to examine the existing laws relating to winding up proceedings of the company in order to remodel it in line with the latest developments and innovations in corporate laws and governance and to suggest reforms to the procedures at various stages followed in insolvency proceedings of the company in order to avoid unnecessary delay, in tune with international practices in the field. The said Committee identified and highlighted several areas which contributed to inordinate delay in finalization of winding-up/dissolution of companies viz. filing statement of affairs; handing over of updated books of accounts; realization of debts; taking over possession of the assets of the company and sale of assets; non-availability of funds for the Official Liquidator to discharge his duties and functions; settlement of the list of creditors and settlement of list of contributories and payment of calls; and disposal of misfeasance proceedings etc.

The Eradi Committee found that multiplicity of court proceedings is the main reason for the abnormal delay in dissolution of companies. It also found that different agencies dealt with different areas relating to companies, that Board for Industrial & Financial Reconstruction (BIFR) and Appellate Authority for Industrial & Financial Reconstruction (AAIFR) dealt with references relating to rehabilitation and revival of companies, the High Court's dealt with winding-up of companies and the Company Law Board (CLB) dealt with matters relating to prevention of oppression and mismanagement etc. Therefore, keeping in view the laws on corporate insolvency prevailing in industrially advanced countries, the Eradi Committee recommended various amendments in the Companies Act, 1956 for setting-up of a National Company Law Tribunal which will combine the powers of the CLB under the Companies Act, 1956, and that of the BIFR and AAIFR under the Sick Industrial Companies (Special Provisions) Act, 1985 as also the jurisdiction and powers relating to winding-up presently vested in the High Courts. The

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recommendations of the Eradi Committee were accepted by the Government and the Companies (Second Amendment) Act, 2002 was passed providing for the establishment of NCLT and NCLAT to take-over the functions which are being performed by CLB, BIFR, AAIFR and the High Courts. The amendment Act of 2002 received the President of India's assent on 13.1.2003 and the provisions of Sections 2 and 6 of the Act were

brought into force w.e.f. 1.4.2003 to enable setting up of the NCLT and its Appellate Authority viz. NCLAT. It was expected that setting up of NCLT will have the beneficial effects of reducing the pendency of cases and reduce the period of winding-up process from 20 to 25 years to about two years; would avoid multiplicity of litigation before various forums (the High Courts and the quasi-judicial Authorities like CLB, BIFR and AAIFR) as all can be heard and decided by the NCLT; and that the appeals will be streamlined with an appeal provided against the orders of the NCLT to an appellate Tribunal (NCLAT) exclusively dedicated to matters arising from NCLT, with a further appeal to the Supreme Court only on points of law, thereby reducing the delay in appeals. It was envisaged that all the pending cases before the Company Law Board and all winding-up cases pending before the High Courts would be transferred to NCLT, and thereby the burden on the High Courts will be reduced and that the BIFR and AAIFR could be abolished.

However, what was not envisioned, inter-alia, was that the amended provisions of the Companies Act for setting up of the NCLT and its Appellate Tribunal (NCLAT) contained provisions whereby officials holding administrative positions in the Government and/or officials who were on the verge of retirement could be appointed as the Members of the NCLT and grave concerns were expressed specially because NCLT was to take over the functions now being performed by the High Courts. Furthermore, what also irked the corporate watchers was that the amended provisions of the Companies Act enabled some control of the Administrative Ministry in the Government over the Tribunal and scope for favoritism with regard to tenure of service of the members of the Tribunal. Legal experts were also worried with the manner in which the powers of the High Courts in matters of merger/amalgamation of companies; winding up of companies etc. were being transferred in a wholesale manner to the NCLT.

The Madras High Court Bar Association (MBA) through its President R.Gandhi filed in the year 2003 a Writ Petition in the Madras High Court being WP No. 2198/2003 challenging the constitutional validity of Chapters 1B and 1C of the Companies Act, 1956 ('Act' for short) inserted by Companies (Second Amendment) Act 2002 ('Amendment Act' for short) providing for the constitution of National Company Law Tribunal and National Company Law Appellate Tribunal.

The Madras High Court by its order dated 30.3.2004 held that the creation of the NCLT and vesting the powers hitherto exercised by the High Courts and CLB in the Tribunal was not unconstitutional. However, the High Court referred to and listed the defects in several provisions (that is, mainly Sections 10FD(3)(f)(g)(h), 10FE, 10FF, 10FL(2), 10FR(3), 10FT) in Parts IB and IC of the Act). The Madras HC therefore declared that until the provisions of Parts IB and IC of the Act, introduced by the Amendment Act which were defective being violative of basic Constitutional scheme (of separation of judicial power from the Executive and Legislative power and independence of judiciary enabling impartial exercise of judicial power) are duly amended by removing the defects that were pointed

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out; it will be unconstitutional to constitute a Tribunal and Appellate Tribunal to exercise the jurisdiction now exercised by the High Court or the Company Law Board. The Union of India has accepted that several of the defects pointed out by the High Court in Parts IB and IC of the Act require to be corrected and stated that those provisions will be suitably amended to remove the defects. The Union of India, however, did not accept the decision of the High Court that some other provisions of Parts IB and IC are also defective. Appeals against the Madras High Court's judgment were filed in the Supreme Court of India by the Union of India as well as by the Madras Bar Association. To narrow down the controversy in regard to the appeal by the Union of India, the following

defects inter alia pointed out by the High Court in regard to various provisions in Parts IB and IC of the Act and the stand of Union of India in respect of each of them were as under :

1. Sections 10FE and 10FT : Tenure of President/Chairman and Members of NCLT and NCLAT fixed as three years with eligibility for re-appointment.

The Madras HC held that unless the term of office is fixed as at least five years with a provision for renewal, except in cases of incapacity, misconduct and the like, the constitution of the Tribunal cannot be regarded as satisfying the essential requirements of an independent and impartial body exercising judicial functions of the state.

The Central Government accepted the finding and agreed to amend Sections 10FE and 10FT of the Act to provide for a five year term for the Chairman/President/Members.

However, the Government proposed to retain the provision for reappointment instead of 'renewal', as the reappointments would be considered by a Selection Committee which would be headed by the Chief Justice of India or his nominee. As the Government proposed to have minimum eligibility of 50 years for first appointment as a Member of the Tribunal, a Member will have to undergo the process of re-appointment only once or twice.

2. Section 10FE – second proviso: Enabling the President/ Members of the NCLT to retain their lien with their parent cadre/Ministry/Department while holding the office in NCLT.

The Madras HC held that in so far as the President is concerned, there is no question of holding a lien and the reference to President must be deleted from the second proviso to section 10FE.

The Union Government accepted the decision and stated that it proposes to amend the proviso and delete the reference to the President in the second proviso. The Madras HC also held that the period of lien in regard to the members of the NCLT should be restricted to only one year instead of the entire period of service as a Member of NCLT. The Union Government had submitted that in view of the proposed longer tenure of five years against the three years, the Government proposes to permit the Members to retain their lien with their parent cadre/Ministry/Department for a period of three years, as one year may be too short for the members to decide whether to give up the lien or not.

3. Section 10FD(1) : Qualification for appointment as President-

The Madras HC had suggested that it would be appropriate to confine the choice of

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persons to those who have held the position of a Judge of a High Court for a minimum period of five years instead of the existing provision which provides that Central Government shall appoint a person who has been, or is qualified to be, a Judge of a High Court, for the post of President of the Tribunal. The Central Government agreed in part and proposed to amend the Act for appointment of a retired or serving High Court Judge alone as the President of the Tribunal. It however felt that minimum length of service as experience, need not be fixed in the case of High Court Judges, as the Selection Committee headed by the Chief Justice of India or his nominee would invariably select the most suitable candidate for the post.

4. Section 10FD(3)(f) : Appointment of Technical Member to NCLT

The Madras HC held that appointment of a Member under the category specified in section 10FD(3)(f), can have a role only in matters concerning revival and rehabilitation of sick industrial companies and not in relation to other matters. The High Court had therefore virtually indicated that NCLT should have two divisions, that is an Adjudication Division and a Rehabilitation Division and persons selected under the category specified in clause (f) should only be appointed as members of the Rehabilitation Division.

The Central Government contended that similar provision exists in Section 4(3) of the Sick Industrial Companies (Special Provisions) Act, 1985; that the provision is only an enabling one so that the best talent can be selected by the Selection Committee headed by the Chief Justice of India or his nominee; and that it may not be advisable to have Division or limit or place restrictions on the power of the President of the Tribunal to constitute appropriate benches. It was also pointed out that a Technical Member would always sit in a Bench with a Judicial Member.

5. Section 10FD(3)(g) : Qualification for appointment of Technical Member

The Madras HC had observed that in regard to the Presiding Officers of Labour Courts and Industrial Tribunals or National Industrial Tribunal, a minimum period of three to five years experience should be prescribed, as what is sought to be utilized is their expert knowledge in Labour Laws.

The Union Government submitted that it may be advisable to leave the choice of selection of the most appropriate candidate to the Committee headed by the Chief Justice of India or his nominee. The Madras HC has also observed that as persons who satisfy the qualifications prescribed in section 10FD(3)(g) would be persons who fall under section 10FD(2)(a), it would be more appropriate to include this qualification in section 10FD(2)(a). It has also observed in section 10FL dealing with "Benches of the Tribunal", a provision should be made that a 'Judicial Member' with this qualification shall be a member of the special Bench referred to in section 10FL(2) for cases relating to rehabilitation, restructuring or winding up of Companies. The Union Government did not accept these findings and contended that the observations of the High Court would amount to judicial legislation.

6. Section 10FD(3)(h) : Qualification of technical member of NCLT

The Madras HC had observed that clause (h) referring to the category of persons having special knowledge of and experience in matters relating to labour, for not less than 15 years is vague and should be suitably amended so as to spell out with certainty the qualification which a person to be appointed under clause (h) should possess.

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The Central Government contended that in view of the wide and varied experience possible in labour matters, it may not be advisable to set out the nature of experience or impose any restrictions in regard to the nature of experience. It submitted that the Selection Committee headed by the Chief Justice of India or his nominee would consider each application on its own merits. The second observation of the Madras HC was that the Member selected under the category mentioned in clause (h) must confine his participation only to the Benches dealing with revival and rehabilitation of sick companies and should also be excluded from functioning as a Single Member Bench for any matter. To this, the Union Government contended that it may not be advisable to fetter the prerogative of the President of the Tribunal to constitute benches by making use of available members. It is also pointed out that it may not be proper to presume that a person well-versed in labour matters will be unsuitable to be associated with a Judicial Member in regard to adjudication of winding-up matters.

7. Section 10FL(2) – Proviso : Winding up proceedings by single Member

The Madras HC had held that it is impermissible to authorize a single Member Bench to conduct the winding up proceedings after a special three Members Bench passes an order of winding up; and if such single Member happens to be a labour member appointed under section 10FD(3)(f), it would be a mockery of a specialist Tribunal.

The Union Government accepted this finding and agreed to amend the proviso to section 10FL(2) to provide that a winding up proceedings will be conducted by a Bench which would necessarily include a Judicial member.

8. Sections 10FF and 10FK(2) : Power of Central Government to designate any

member to be a Member (Administration)

The Madras HC held that sections 10FF and 10FK(2) should be suitably amended to provide that a member may be designated as Member (Administration) only in consultation with the President, and further provide that the Member (Administration) will discharge his functions in relation to finance and administration of the Tribunal under the overall control and supervision of the President.

The Union Government accepted this decision and agreed to drop the provision for Member Administration. It was stated that the Act would be amended to provide that the administration and financial functions would be discharged under the overall control and supervision of the President. It was stated that the Act would be further amended to provide for creation of the posts of Vice-Presidents.

9. Section 10 FR(3) : Appointment of members of the Appellate Tribunal

The Madras HC had observed that section 10FR(3) must be suitably amended to delete the reference to all subjects other than law and accountancy. It was also stated that it would be more appropriate to incorporate a provision similar to that in section 5(3) of the SICA which provides that a member of the Appellate Authority shall be a person who is or has been a Judge of a High Court or who is or has been an officer not below the rank of a Secretary to the Government who has been a member of the Board for not less than three years. To this, the Union Government contended that the provision is only an enabling one; and since the Chairperson of the Appellate Tribunal would be a former

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Judge of the Supreme Court or former Chief Justice of High Court, it may not be advisable to limit the scope of eligibility criteria for members especially when a Selection Committee headed by the Chief Justice of India or his nominee would make the selection.

10. Section 10FX – Selection Process for President/ Chairperson

The Madras HC had expressed the view that the selection of the President/Chairperson should be by a Committee headed by the Chief Justice of India in consultation with two senior Judges of the Supreme Court. The Union Government submitted that it would not be advisable to make such a provision in regard to appointment of President/ Chairperson of statutory Tribunals. It was pointed out that no other legislation constituting Tribunals has such a provision.

Points of challenge in the Appeal to the Supreme Court of India

In the challenge in the Appeals to the Supreme Court, the Union of India contended that the High Court having held that the Parliament has the competence and power to establish NCLT and NCLAT, the High Court ought to have dismissed the Writ Petition. The Union of India also submitted that some of the directions given by the High Court to reframe and recast Parts IB and IC of the Act amounts to converting judicial review into judicial legislation. However, as the Union of India has agreed to rectify several of the defects pointed out by the High Court (set out above), the appeal by the Union Government was restricted to the findings of the High Court relating to sections 10FD(3)(f), (g) and (h) and 10FX of the Act. On the other hand, the Madras Bar Association in its appeal to the Supreme Court contended that the High Court ought not to have upheld the Constitutional validity of Parts IB and IC of the Act providing for establishment of NCLT and NCLAT; and that the High Court ought to have held that constitution of such Tribunals taking away the entire Company Law jurisdiction of the High Court and vesting it in a Tribunal which is not under the control of the Judiciary, is violative of doctrine of separation of powers and the independence of Judiciary which are parts of the basic structure of the Constitution. The Appellant MBA also contended that the decisions of the Supreme Court providing for constitution of Debt Recovery Tribunals and the Consumer Protection Forums on the models of which the NCLT was constituted also require

reconsideration. When these Civil Appeals came up for hearing before a three- Judge Bench of the Supreme Court, the Bench was of the view that the earlier decisions of the Supreme Court holding that the Parliament and the State Legislatures possessed the legislative competence to effect changes in the original jurisdiction in the Supreme Court and High Court, had not dealt with the following issues viz:

- To what extent the powers and judiciary of High Court (excepting judicial review under Article 226/227) can be transferred to Tribunals?
- Is there a demarcating line for the Parliament to vest intrinsic judicial functions traditionally performed by courts in any Tribunal or authority outside the judiciary?
- Whether the “wholesale transfer of powers” as contemplated by the Companies (Second Amendment) Act, 2002 would offend the constitutional scheme of separation of powers and independence of judiciary so as to aggrandize one branch over the other?

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Therefore the Three Judge Bench, by order dated 13.5.2007 directed the appeals to be heard by a Constitution Bench, observing that as the issues raised are of seminal importance and likely to have serious impact on the very structure and independence of judicial system.

After hearing detailed arguments from the Union of India as well as by the Madras Bar Association, the Constitution Bench of the Supreme Court (comprising of Hon'ble Justice K.G. Balakrishnan, CJI; and Judges R.V. Raveendran; D.K. Jain; P. Sathasivam and J.M.Panchal,) vide its Judgment dated 11th May, 2010 has upheld the establishment of the National Company Law Tribunal and the National Company law Appellate Tribunal, but has suggested certain amendments to be carried out in the Companies Act to make the NCLT and its Appellate Authority functional. Since this Judgment is very important and deals with many aspects of Constitutional law with regard to separation of power between the Legislature and Judiciary and the wholesale transfer of High Court's powers to a specially constituted Tribunal, it needs to be read in totality to understand its ramifications. However, for this Article, only certain excerpts of the Judgment are highlighted below to apprise the professionals about the important aspects dealt with by the Constitutional Bench of the Supreme Court of India. In paragraph 56 of the Judgment, the Supreme Court tabulated the defects in Parts IB and IC of the Act and held that: ã Only Judges and Advocates can be considered for appointment as Judicial Members of the Tribunal. Only High Court Judges, or Judges who have served in the rank of a District Judge for at least five years or a person who has practiced as a Lawyer for ten years can be considered for appointment as a Judicial Member. The Supreme Court held that persons who have held a Group A or equivalent post under the Central or State Government with experience in the Indian Company Law Service (Legal Branch) and Indian Legal Service (Grade-1) cannot be considered for appointment as judicial members as provided in sub-section 2(c) and (d) of Section 10FD. The expertise in Company Law service or Indian Legal service will at best enable them to be considered for appointment as Technical Members.

ã As the NCLT takes over the functions of High Court, the members should as nearly as possible have the same position and status as High Court Judges. This can be achieved, not by giving the salary and perks of a High Court Judge to the members, but by ensuring that persons who are as nearly equal in rank, experience or competence to High Court Judges are appointed as members. Therefore, only officers who are holding the ranks of Secretaries or Additional Secretaries alone

can be considered for appointment as Technical members of the National Company Law Tribunal.

ã The Supreme Court further held that clauses (c) and (d) of sub-section (2) and Clauses (a) and (b) of sub-section (3) of section 10FD which provide for persons with 15 years experience in Group "A" post or persons holding the post of Joint Secretary or equivalent post in Central or State Government, being qualified for appointment as Members of Tribunal is invalid.

ã A 'Technical Member' presupposes an experience in the field to which the Tribunal relates. A member of Indian Company Law Service who has worked with Accounts Branch or officers in other departments who might have incidentally dealt with

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some aspect of Company Law cannot be considered as 'experts' qualified to be appointed as Technical Members. Therefore Clauses (a) and (b) of sub-section (3) are not valid.

ã The first part of clause (f) of sub-section (3) providing that any person having special knowledge or professional experience of 15 years in science, technology, economics, banking, industry could be considered to be persons with expertise in company law, for being appointed as Technical Members in Company Law Tribunal, is invalid.

ã Persons having ability, integrity, standing and special knowledge and professional experience of not less than fifteen years in industrial finance, industrial management, industrial reconstruction, investment and accountancy, may however be considered as persons having expertise in rehabilitation/revival of companies and therefore, eligible for being considered for appointment as Technical Members.

ã In regard to category of persons referred in clause (g) of sub-section (3) at least five years experience should be specified.

ã Only Clauses (c), (d), (e), (g), (h), and later part of clause (f) in sub-section (3) of section 10FD and officers of civil services of the rank of the Secretary or Additional Secretary in Indian Company Law Service and Indian Legal Service can be considered for purposes of appointment as Technical Members of the Tribunal.

ã Instead of a five-member Selection Committee with Chief Justice of India (or his nominee) as Chairperson and two Secretaries from the Ministry of Finance and Company Affairs and the Secretary in the Ministry of Labour and Secretary in the Ministry of Law and Justice as members mentioned in section 10FX, the Selection Committee should broadly be on the following lines:

(a) Chief Justice of India or his nominee – Chairperson (with a casting vote);

(b) A senior Judge of the Supreme Court or Chief Justice of High Court – Member;

(c) Secretary in the Ministry of Finance and Company Affairs – Member; and

(d) Secretary in the Ministry of Law and Justice –Member.

ã The term of office of three years shall be changed to a term of seven or five years subject to eligibility for appointment for one more term. This is because considerable time is required to achieve expertise in the concerned field. A term of three years is very short and by the time the members achieve the required knowledge, expertise and efficiency, one term will be over. Further the said term of three years with the retirement age of 65 years is perceived as having been tailor-made for persons who have retired or shortly to retire and encourages these Tribunals to be treated as postretirement havens. If these Tribunals are to function effectively and efficiently they should be able to attract younger members who will have a reasonable period of service.

ã The second proviso to Section 10FE enabling the President and members to retain lien with their parent cadre/ministry/department while holding office as President or

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Members will not be conducive for the independence of members. Any person appointed as members should be prepared to totally disassociate himself from the Executive. The lien cannot therefore exceed a period of one year.

ã To maintain independence and security in service, subsection (3) of section 10FJ and Section 10FV should provide that suspension of the President/Chairman or member of a Tribunal can be only with the concurrence of the Chief Justice of India.

ã The administrative support for all Tribunals should be from the Ministry of Law & Justice. Neither the Tribunals nor its members shall seek or be provided with facilities from the respective sponsoring or parent Ministries or concerned Department.

ã Two-Member Benches of the Tribunal should always have a Judicial member. Whenever any larger or special benches are constituted, the number of Technical Members shall not exceed the Judicial Members.

The Supreme Court disposed of the Appeals, partly allowing them, as follows:

ã Upholding the decision of the High Court to the effect that creation of National Company Law Tribunal and National Company Law Appellate Tribunal and vesting in them, the powers and jurisdiction exercised by the High Court in regard to company law matters, are not unconstitutional.

ã Declaring that Parts 1B and 1C of the Act as presently structured, are unconstitutional for the reasons stated in the judgment. However, Parts 1B and 1C of the Act, may be made operational by making suitable amendments, as indicated above, in addition to what the Union Government has already agreed in pursuance of the impugned order of the High Court.

CONCLUSION

Urgent Need to amend the Companies Act, 1956 The Central Government is already considering bringing in several changes and modifications in the Companies Act, 1956 and the Companies Bill, 2009 is already before the Parliament. Since several provisions of the amendments effected by the Companies (Second Amendment) Act, 2002 have been held to be unconstitutional and since several changes in the provisions relating to appointment of Members of the NCLT and its Appellate Tribunal are to be incorporated before the NCLT and its Appellate Tribunal becomes operational, it would be appropriate if the Companies Act is thoroughly examined and the new Companies Act amending and modifying the existing Companies Act, 1956 is passed by the Parliament at the earliest. Unless this is done urgently, the expectation of one-window clearance for corporate law related cases will remain a distant dream. When the economic scenario all over the globe is changing fast and the Indian companies are attracting foreign investments, the Indian Companies Act ought to match the expectation of the trade and industry not only of India, but of the other industrialized countries coming to India. It is time for the Corporat

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IMPORTANT QUESTIONS

Q.1. 'Majority must prevail' is the principle of company management. Explain the exceptions to this rule.

Q.2. Explain the rule laid down in Foss Vs Harbottle with exceptions, if any.

Q.3. Examine the provisions of the Company Act, 1956 regarding oppression and mismanagement.

- Q.4.** "The courts do not, in general, intervene at the instance of shareholders in matters of internal administration of the companies." Discuss.
- Q.5.** State the circumstances when a company may be wound up by the court. Explain in this connection the meaning of the expressions 'Commercially Insolvent' and 'Just and equitable'.
- Q.6.** What is winding up? How many modes of winding up of a company have been provided by Indian Company Act, 1956?
- Q.7.** Write a detailed note on winding up. Who can file petition in the Tribunal for winding up of a company through it?
- Q.8.** Who is an official liquidator? What are his powers and duties?
- Q.9.** Write a note on voluntary winding up of a company.
- Q.10.** What do you understand by the expression "winding up"? How does it differ from 'dissolution'? In what circumstances may the shareholders wind up their company on voluntary basis?
- Q.11.** What protective devices have been evolved by the courts to safeguard the interest of minority shareholders against unworthy use of majority power?
- Q.12.** It is often said that our law in regard to prevention of mismanagement in companies is far ahead of the English law. Do you agree? Discuss critically.
- Q.13.** 'Section 397 (of the Companies Act, 1956) and its supplementary sections are an innovation in our company law introduced between 1951 and 1956. They were introduced in order to suppress an acknowledged mischief but it is clear that section 397 could not prove to be an infallible source of relief to the oppressed minority.' Do you agree with this statement? Discuss critically with reference to decided cases, particularly those decided by the Supreme Court of India.
- Q.14.** A proper balance between majority supremacy and minority right is essential for smooth functioning of the company. Discuss.
- Q.15.** Explain the facts and principles of law laid down in Foss vs. Harbottle. To what extent the courts in subsequent years restricted the scope of the rule in Foss vs. Harbottle?
- Q.16.** What do you know by the Insider Trading? Discuss the role of Security and Exchange Board of India (SEBI) in this respect.

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Q.17. Write notes on :

- a) Amalgamation in public interest
- b) The rule in Foss vs. Harbottle
- c) Official liquidator

Q.18. "A petition for a winding-up order is a proper as well as effective mode of enforcing payment of a debt due from a company." Discuss indicating the grounds on which a winding-up order can be made and the effect of such an order.

Q.19. Explain the scope of relief which can be provided to aggrieved shareholders against oppressive managerial policies. Can there be an oppression of majority by minority?

Q.20. "The words reconstruction and amalgamation are commercial terms which denote two operations which are similar in form, but vastly different in purpose." Explain and discuss fully what is conveyed by the statement. Briefly describe the extent to which the courts and Central Government have jurisdiction in the matter of amalgamation.

Q.21. Write a note on National Company Law Tribunal.

Q.22. Write a note on National Company Law Appellate Tribunal.

(Footnotes)

1. 2 Hare 461.

2. AIR (1961), Cal 443

3. This method is adopted in case of a defunct company.

'Defunct company' means a company which has never commenced operation or which is not in operation and has no assets to divide and without resorting to the winding up process (Section 560).

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SUGGESTED READINGS

1. A.K. Majumdar & Dr. G.K. Kapoor, Company Law & Practice.

2. K.S. Anantharaman, Lectures on Company Law & Competition Act.

3. Avtar Singh, Company Law.

4. M.C. Kuchhal, Modern Indian Company Law.

5. Dr. S.C. Tripathi, Modern Company Law.

6. A. Ramaiya, Guide to the Companies Act.

7. R.K. Bangia, Company Law.

8. A.K. Majumdar & Dr. G.K. Kapoor, Students Guide to Company Law.

9. K.S. Anantharaman, Lectures on Company Law & Competition Act.